DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Why Do Public Agencies Use Debt Financing | Part 1: Governmental Powers

This module gives an overview of the powers given to public agencies by the constitution, why public agencies use debt financing, and when it is appropriate to issue debt. Other topics include the three Ws of project planning and making decisions within the context of economic conditions and past financial and management actions.

Editor's Note: This transcript has been prepared by the California Debt and Investment Advisory Commission (CDIAC) and it believes it to be a fair and accurate reproduction of the comments of the speakers. Any errors are those of CDIAC and not the speakers.

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Narrator: The preamble of the U.S. Constitution states that one of the purposes of government is to promote the general welfare. State and local governments are delegated powers by the US Constitution to provide for the general welfare of their constituents. The California State Constitution and other state laws provide public agencies with the power to enact codes and ordinances to maintain an orderly society, regulate the use of property, and manage public resources.

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Narrator: Public agencies do this by exercising their authority, including certain powers to create and enforce laws and to raise revenues. Although they differ regarding their missions, they all plan and execute projects. Examples may include the construction and maintenance of roads, schools, sewer, and water systems, flood control systems, and health facilities. Projects enable an agency to fulfill its mission to serve the public good.

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Narrator: As a member of the governing body of a public agency, one of the most important roles you play is deciding when and how to use the agency's authority to take on debt. This training module is designed to provide you with an understanding of why public agencies use debt financing, and when it is appropriate. If, after viewing this module, you decide that debt financing may be appropriate for your agency, you should complete the rest of the modules in this series.

Each module addresses part of the complex process. You must govern to ensure that your agency achieves its objectives for programming and finances, and that it meets its obligations to financial partners, including lenders. Failing to meet financial obligations has significant costs, including defaults that may hamper your agency's ability to provide basic services to your constituents.

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Narrator: Some public agencies are given the power to impose taxes, fees, and charges to be paid by property owners, businesses and those who use public services. These powers are subject to the limitations of state and federal law and frequently require voter consent. A public agency's taxing powers are used to generate the funds needed to provide services and facilities that meet the agency's strategic vision.

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Narrator: As an elected official, you will have to decide how to employ the agency's regulatory and taxing powers to construct and maintain public facilities. One rubric you may use in this process is the three Ws of project planning: what, who, and when. What is the project? Who is served by the project? When should you start the project? The answers to these questions should guide every project that you undertake.

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Narrator: The question what is the project, defines how big the project will be, where it will be located, what services it provides. How much it will cost, and how it will fulfill the community's vision.

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Narrator: The question who is served, must factor into any financing decisions the agency makes. Who will use the project? What benefits do they receive from the project? Think about who will benefit from the construction, replacement, or repair of facilities, including school buildings, streets, community centers, and parks. Ideally, the cost of the project will be paid by those who benefit from the project. Those who use the facility most or derive the greatest benefit should pay more for it than those who use it less. This is known as taxpayer equity.

A project for broad use, such as building a school, enhances the community and provides general benefits to all city residents. Since the project benefits the whole community, the cost is shared across the general population. A project for semi-specific use, such as a park for a new subdivision, benefits the property owners and residents, as well as those from the general public who choose to visit the facilities. The cost of a project like this is most likely to be borne by the primary users, the property owners. For a project with specific or limited use, such as a neighborhood parking garage, there is a small group of users who benefit. Those who choose to park there. These users can reasonably be expected to bear the cost by paying to use the facility. Aligning the benefits of the project with the source of payment is a fundamental principle of public finance. It makes both financial and political sense.

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Narrator: The question when should you start the project, depends on a combination of factors: who or how many constituents will benefit, relative to other potential projects? How urgently do constituents want or need the services provided by the project? How soon the project can be planned and funded or financed, and other financial or political context.

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Narrator: The following Venn diagram helps to explain this. As you can see, the when is a function of development pressures, including the local economy, past financial decisions, and past management decisions. An agency that has developed a strategic plan has also likely identified the necessary projects and facilities that enable the agency to deliver services and meet the community's expectations. By extension, these projects directly or indirectly respond to the demographic, economic, and geographic trends present in the community. As the community grows and its makeup changes, the agency will be obligated to provide services supported by facilities to an increasingly larger and more diverse constituency. In the same way, as the economy changes and new businesses move in or existing businesses expand, the community will be pressured to provide facilities that allow them to grow and thrive. Economic and development pressures drive the need for improved facilities and infrastructure.

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Narrator: Financial decisions include actions taken or not taken with respect to present and future financial resources of the agency. Past financial decisions made by the public agency affect its ability to undertake capital projects. The financial state of your agency includes the current balance of funds and investments, current and future revenues, and the amount and type of debt. If you are looking to borrow funds for a project, these are also factors that a lender will consider in order to determine whether a government agency is a good candidate for financing, and what they are willing to offer in terms of cost or interest rate. If your agency does not have a healthy balance in its debt-to-revenue ratio, the lender may not agree to finance additional debt. You may have to delay the project while you pay down other debts and arrange for an increase in future revenues so as to qualify for the loan.

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Narrator: In determining when a public agency can undertake a project, you must also consider past management decisions. Management decisions have to do with the agency's deployment of resources to meet its legal, administrative, and political mission. The development of a general plan and enactment of land use regulations are examples of past management decisions. When an agency can pursue a project is a function of the combined effect of these three conditions, our local economic conditions, and the demographics of the community, creating conditions that can only be addressed by new facilities. Likewise, is the public agency in a position to afford the project? Has it done its homework, and does it have a strategy that explains when the project is needed?

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Narrator: If you have considered the questions who, what, and when, you will be in a position to evaluate the project financing option that provides the best alignment with your long-term project goals. In the next section, you will take a look at the features of the primary financing options available to public agencies to learn how planning and financing can complement each other.

DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Why Do Public Agencies Use Debt Financing | Part 2: Project Financing and the Need for Debt

Module 1 gives an overview of the powers given to public agencies by the constitution, why public agencies use debt financing, and when it is appropriate to issue debt. Other topics include the three Ws of project planning and making decisions within the context of economic conditions and past financial and management actions.

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Narrator: Public agencies have three primary methods to pay for the projects that provide for the welfare of their constituents: cash, grants, and debt.

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Narrator: Cash originates from fees, taxes, and other charges gathered throughout the agency's operations. From the perspective of the public agency, cash is the most flexible method of payment since it may be used to fund operations, capital facilities, and repay debt. In the context of project financing, the cash we are referring to is cash savings or funds reserved to pay for a project and not otherwise committed. Cash is available for immediate use, and you don't have to pay a lender to use your own cash, but once spent, it is no longer available for other priorities that may arise.

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Narrator: Grants function like cash with strings attached. Like cash, grants do not typically carry an interest cost or require repayment as long as the agency receiving the grant delivers on the project under the terms and conditions of the grant. However, grants are less flexible than cash. The organization providing the grant is likely to place constraints on how and when grant funds are used, and for what purposes, and may impose administrative burdens like frequent monitoring and reporting. If the grant is not well aligned with the goals of the project, you run the risk that the grant will have an undue level of influence and prevent you from accomplishing your vision. Grants are unlikely to be your main source of funding.

Cash and debt are far more common methods that public agencies use to finance projects.

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Narrator: Debt constitutes borrowed money that must be fully repaid, but it allows you to start the project immediately, spread the project costs over time, and realize the benefits of the project sooner. Debt can be represented in simple terms as a series of cash flows. When a lender makes a loan, there is a large transfer of funds from the lender to the public agency. This is the principal amount. It is typically used to fund a capital improvement or the startup cost of a project.

Over time, the agency makes a series of smaller payments back to the lender. Although the timing and structure of these payments may differ, they include funds to repay the principal amount as well as interest. The date on or by which principal must be repaid is known as the maturity date.

Interest and fees, expressed as a percentage of the unreturned principal, are in excess of what the public agency borrowed but serve the important role of compensating the lender for the economic costs of making the loan - costs associated with the risk of not being fully repaid, the transaction itself, and the lost opportunity to invest the loaned money elsewhere.

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Narrator: A public agency must have an appropriate alignment between the who, what, and when before taking on debt to finance a project. First, the agency must have decided what the project is. This includes its purpose, scale, and cost. These should be consistent with the agency's strategic vision and the community's expectations. Second, once the project has been identified, the agency must make a decision about how to pay for it. The source of funding should come from those who most benefit from the project, and it should be reasonable and sustainable over time.

Both of these are possible only if the agency has considered the social, economic, and political implications of assessing fees, taxes, or charges on particular members of the community to pay for the project. Finally, the agency must have determined that the project cannot be delayed and that, lacking sufficient cash resources, it must use debt financing.

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Narrator: While you, as an elected official, may not directly identify the project or determine the funding method to pay for the project, you are responsible for approving staff recommendations. In the case of the project itself, your approval may be part of your review and approval of the agency's plans, including its capital plan. A capital improvement plan, as we see in module two, is a list of capital improvements the agency hopes to construct to meet its operational and organizational goals.

Your role in reviewing and approving the funding method may come in the form of new fees, charges, exactions, or taxes and the processes by which these may be placed before the voters for their approval. Future modules will deal in greater depth with the sources of revenues used to support capital projects and debt financing.

You are also responsible for overseeing the agency's decisions regarding the timing of the project and, by consequence, the choice of financing. Is there sufficient cash on hand or is debt appropriate because the project must be completed sooner than cash resources will be available? In carrying out your duties as an elected official, you must place the long-term sustainability of your agency and the community above all other interests. Your decisions and the actions you take to approve the issuance of debt should be made on the basis of verifiable facts regarding the project and who will use it, and thus how much it will cost and how those costs will be shared among current and future taxpayers.

Avoid basing your decisions on personal or political ambitions or on fundamental mischaracterizations of the project, its need, or its benefits. Only by faithfully representing your constituents will you be able to preserve the financial welfare of your community and ensure that the project is able to continue to serve the community's needs. Elected officials are fiduciaries. As such, your constituents have entrusted you to represent them, and you are required to place their interests above your own.