



## Capital Financing and Debt Management

Debt financing is neither a “bad” nor a “good”—it is simply a tool for achieving community goals. However, debt does come at the price of costs of issuance and interest charges, as well as the obligation to make regular loan payments and conform to market disclosure and terms of the debt instruments on an ongoing basis.<sup>27</sup> Allowing these payments to become a dominant part of the agency’s budget limits the agency’s ability to respond to unplanned expenses.

Debt financing is usually appropriate for:

- **Temporary Short-Term Cash Flow Issues.** An agency may need to bridge cash flow gaps while waiting to receive key revenues (like property taxes in December and franchise fees in April). The agency may cover these gaps by issuing “tax” or “revenue” anticipation notes (sometimes known by the acronym “TRANS”). In this case, any amount borrowed must generally be paid back within a year.
- **Long-Term Improvements.** Debt financing is also appropriate for truly high-priority, one-time improvements – when it makes sense for current taxpayers to share the cost with those who will benefit 20 or 30 years in the future. By contrast, borrowing for ongoing operational expenses or short-term capital needs is inadvisable. The length of the debt should never exceed the useful life of the debt-financed asset.

Any agency’s ability to borrow and repay debt capacity is limited. Amounts borrowed for today’s project are funds that cannot be borrowed tomorrow. Amounts required for debt repayment in the future are funds that will not be available for other programs and services.

Recognizing the significance of the decision to incur long-term debt for a public agency, California’s constitution requires the public voters to approve debt<sup>28</sup> that would be repaid from future general fund revenues.<sup>29</sup> While there are a number of exceptions to this requirement (including the special fund doctrine for revenue bonds<sup>30</sup> and an exception for financing leases), the constitutional principle is important to keep in mind. Incurring debt obligates the community into the future and reduces financial flexibility. Accordingly, the benefits of doing so should outweigh these costs.<sup>31</sup>

## QUESTIONS TO ASK

- Does the agency have a multi-year capital improvement plan? (Having such a plan enables decision-makers to consider key factors like project priorities, debt capacity and what role fees will play in financing).
  - If the agency has such a plan, is it realistic? If not, what steps are necessary to make it realistic?
  - If an agency has such a plan, what does the plan *not* include? For example, does it assume that new development will bear the costs of capital improvements necessitated by that development? If so, the plan should so state.
  - Does the multi-year capital improvement plan include specific information about how future maintenance costs will be paid for? It's not wise to build an asset the agency cannot afford to maintain.
- Does the agency have clear capital financing and debt management policies? Who is responsible for implementing and monitoring compliance with these policies?
  - Do these policies provide decision criteria for when incurring debt is appropriate?
  - Do these policies address what type of debt financing is appropriate (for example, a) variable versus fixed rates, and b) are interest rate swap agreements allowable and under what circumstances?)
  - Do these policies address protection of credit quality?
- Do these policies address debt capacity?
- Do these policies address costs/benefits of risk examinations for proposed debt?
- Do these policies address who is on the agency's financing team and how consultants like bond counsel, financial advisors, trustees, assessment engineers and underwriters are selected? Are the selection criteria being followed?
- Do these policies address disclosure to and relations with debt rating agencies?
- Do these policies address who is responsible for conformance with bond covenants (obligations the agency agrees to as part of bond financing) on an ongoing basis?
- Does the agency have a debt advisory committee? If so, does the membership of the committee include representatives from the local community?

## Endnotes

- 27 GFOA Recommendation: Understanding Your Continuing Disclosure Obligations for Debt (2010), [http://www.gfoa.org/downloads/GFOA\\_understandingcontinuingdisclosureBP.pdf](http://www.gfoa.org/downloads/GFOA_understandingcontinuingdisclosureBP.pdf).
- 28 Cal. Const. art. XVI, § 18(a) (“No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose, except that with respect to any such public entity which is authorized to incur indebtedness for public school purposes, any proposition for the incurrence of indebtedness in the form of general obligation bonds for the purpose of repairing, reconstructing or replacing public school buildings determined, in the manner prescribed by law, to be structurally unsafe for school use, shall be adopted upon the approval of a majority of the voters of the public entity voting on the proposition at such election; nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and to provide for a sinking fund for the payment of the principal thereof, on or before maturity, which shall not exceed forty years from the time of contracting the indebtedness.”) Note that subdivision (b) goes on to provide for additional details relating to school debt.
- 29 *See Rider v. City of San Diego*, 18 Cal.4th 1035, 1045 (1998).
- 30 *See*, for example, *California Housing Finance Agency v. Elliott*, 17 Cal. 3d 575, 587 (1976).
- 31 *See generally*, GFOA Recommendation: Debt Management Policy (1995 and 2003), <http://www.gfoa.org/downloads/debtmanagement-policy.pdf>.

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