



**Presentation to  
Tennessee Association of  
Utility Districts**

**Re: Debt Management  
Policies**

**August 4, 2011**



# Debt Management Policies

**Recent concerns in Tennessee and across the Nation about debt transactions due to:**

- **Not understanding the transaction**
- **Lack of transparency**
- **Self-dealing / excessive costs**
- **“Kicking the can down the road”**
- **Too much debt**
- **Defaults**





# We owe how much?





# Debt Management Policies

## **Four principles for strong financial management in the public sector:**

- Understand the transaction
- Explain to citizens/customers what is being considered
- Avoid conflicts of interest
- Disclose costs and risks



# Debt Management Policies

**What is a debt management  
policy?**





# Debt Management

- Debt Management is the practice of planning, executing and monitoring of financial borrowing activities in conformance with federal, state and local laws policies rules and regulations.

Leonard P. Wales  
Debt Manager  
Fairfax County, Virginia



# Debt Management Policies

- **How to finance debt**
- **How to structure and sell debt**
- **How to manage debt**
- **How to fit debt in overall financial management**



# Debt Management Policies

## **Policy: *defines outcome***

A course of action, principle or guideline adopted by an organization to reach long-term goals. Designed to influence major decisions and actions.

## **Procedure: *defines way to outcome***

Specific methods necessary to carry out policy in action in day-to-day operation

# Debt Management Policies

**Why have a debt management  
policy?**





# Debt Management Policies

**Adopting a debt management policy can help a public entity:**

- make better financial decisions;
- provide clear objectives for staff;
- avoid reinventing the wheel;
- demonstrate strong financial management practices to credit rating agencies; and
- distinguish policy decisions from transaction decisions.



# Debt Management Policies

T.C.A. Section 9-21-151(b)(1) authorizes the State Funding Board to develop model Finance Transaction Policies, including a debt management policy, for use by Public Entities.



# Members of Funding Board

- Bill Haslam, Governor, *Chairman*
- Justin P. Wilson, Comptroller of the Treasury, *Secretary*
- Tre Hargett, Secretary of State
- David H. Lillard, Jr., State Treasurer
- Mark A. Emkes, Commissioner of Finance & Administration



# Debt Management Policies

## Timeline:

**November 2, 2009-** Publicly began seeking input from interested persons

**September 22, 2010-** Public hearing held

**December 15, 2010-** SFB adopted statement on debt management

**December 31, 2011** – Deadline for adoption of debt policy



# Debt Management Policies

**What debt management  
policy should be  
adopted?**



# Debt Management Policies

**A public entity needs to adopt its own policy designed for its own needs.**

*“local decision making and responsibility”*



# Debt Management Policies

- Should reflect a public entity's:
  - Legislative authority & regulatory environment
  - Capital Budget
  - Risk assessment
  - Ratio analysis & debt capacity
  - Rating agency requirements
  - Existing debt covenants



# Debt Management Policies

## ■ **Definitions:**

- Public entity- UTILITY DISTRICT as well as the state, state agency, local government, local government instrumentality, and any board, district, instrumentality, or entity created by them or any combination
- Debt obligation- bonds, notes, capital leases, loan agreements, or evidence of lawful indebtedness (agreements to repay money over time)



# Debt Management Policies

## Adoption of policy

- Is evidence of strong financial management practice
- Separates policy discussion from immediacy of transaction
- Provides guidance for decision-making
- Does NOT prevent unforeseen or negative events from occurring

# Debt Management Policies

## Adoption Process

When adopting the debt management policy in an *open and transparent process*, the public entity needs to:

- Articulate
- Discuss
- Adopt





# Debt Management Policies

## Deadline

**January 1, 2012** is the deadline for public entities to have their own debt management policies in place in order to issue or enter into debt.



# Debt Management Policies

**What must be in the debt management policy?**





# Debt Management Policies

## **A debt management policy must address (minimum requirements):**

- Transparency
- Professionals (Written agreements, disclosures of compensation and fees, permitted roles)
- Conflicts of interest
- Specific justification of deferral of principal repayment (No blanket approval)



# Attachment A: Minimum Language- Transparency

The Entity shall comply with legal requirements for notice and for public meetings related to debt issuance. In the interest of transparency, all costs (including interest, issuance, continuing, and one-time) shall be disclosed to the citizens/members, governing body, and other stakeholders in a timely manner. *(The method for disclosure of costs and other information, including documentation of compliance with the policy, shall be developed and outlined in the policy.)*



# Minimum Language- Transparency

“Clear disclosure of terms and life of each debt issue, including principal and interest payments”  
and “debt service schedule outlining the rate of retirement for the principal amount”



# Attachment C: Glossary

**Costs** means fees and expenses of professionals and service providers and other similar fees and expenses, whether or not payable at the time the debt is incurred. “Costs” also means recurring and nonrecurring fees and expenses during the life of the debt.



# Issues and Considerations

## Professional selection

- Process
- Timing
- Criteria
- Documentation/contracts



# Issues and Considerations

## Professionals:

- Financial Advisor
- Bond Counsel
- Issuer's Counsel
- Underwriter/Banker/Lender
- Trustee/Paying Agent



# Attachment A: Minimum Language- Professionals

The State Funding Board approved changes to Attachment A on June 30, 2011 in response to federal regulatory action concerning the activities of financial advisors (MSRB Rule G-23).



# Attachment A: Minimum Language- Professionals

The Entity shall require all professionals engaged in the process of issuing debt to clearly disclose all compensation and consideration received related to services provided in the debt issuance process by both the Entity and the lender or conduit issuer, if any. This includes “soft” costs or compensations in lieu of direct payments.



# Attachment A: Minimum Language- Counsel

Counsel<sup>1</sup>: The Entity shall enter into an engagement letter agreement with each lawyer or law firm representing the Entity in a debt transaction. *(No engagement letter is required for any lawyer who is an employee of the Entity or lawyer or law firm which is under a general appointment or contract to serve as counsel to the Entity. The Entity does not need an engagement letter with counsel not representing the Entity, such as underwriters' counsel.)*

<sup>1</sup> The requirement for an engagement letter does not apply to any lawyer who is an employee of the Entity or any lawyer or law firm under a general appointment as counsel to the Entity and not serving as bond counsel for the transaction. If bond counsel for a debt transaction does not represent the Entity in that transaction, the Entity will enter into a fee payment letter agreement with such lawyer or law firm specifying:

- a) the party represented in the debt transaction; and
- b) the Entity's obligation with respect to the payment of such lawyer or law firm's fees and expenses.



# Attachment A: Minimum Language- FA

Financial Advisor: If the Entity chooses to hire financial advisors, the Entity shall enter into a written agreement with each person or firm serving as financial advisor for debt management and transactions. Whether in a competitive or negotiated sale, the financial advisor shall not be permitted to bid on, privately place or underwrite an issue for which they are or have been providing advisory services for the issuance.



# Attachment A: Minimum Language- Underwriter

If there is an underwriter, the Entity shall require the Underwriter to clearly identify itself in writing (e.g., in a response to a request for proposals or in promotional materials provided to an issuer) as an underwriter and not as a financial advisor from the earliest stages of its relationship with the Entity with respect to that issue. The Underwriter must clarify its primary role as a purchaser of securities in an arm's-length commercial transaction and that it has financial and other interests that differ from those of the Entity.



# Attachment A: Minimum Language- Underwriter-2

The Underwriter in a publicly offered, negotiated sale shall be required to provide pricing information both as to interest rates and to takedown per maturity to the governing body (*or its designated official*) in advance of the pricing of the debt.



# Attachment A: Minimum Language- Conflicts

Professionals involved in a debt transaction hired or compensated by the Entity shall be required to disclose to the Entity existing client and business relationships between and among the professionals to a transaction . . . , as well as conduit issuers, sponsoring organizations and program administrators. This disclosure shall include that information reasonably sufficient to allow the Entity to appreciate the significance of the relationships.



# Attachment A: Minimum Language- Conflicts cont.

Professionals who become involved in the debt transaction as a result of a bid submitted in a widely and publicly advertised competitive sale conducted using an industry standard, electronic bidding platform are not subject to this disclosure. No disclosure is required that would violate any rule or regulation of professional conduct.



# Attachment C: Glossary

**Conflicts of Interest** occur in situations where parties in a transaction have multiple interests or relationships that could possibly corrupt the motivation to act. The presence of a conflict of interest indicates the potential for divided loyalty and does not automatically indicate wrong doing.



# Attachment C: Glossary

**Backloading** refers to delaying repayment of principal until the end of the financing term. A standard or default structure for debt service is level debt service payments, similar to a standard home mortgage. Backloading should be considered only when beneficial to the overall amortization of debt, upon the occurrence of natural disasters, or when project revenues are not available during the early years of a project.



# Attachment C: Glossary

**Finance transaction** means both debt obligations and derivatives.

A derivative is a financial product deriving value from a separate security. This term refers to many different products.

“Derivative” includes an Interest Rate Agreement as defined in Tennessee Code Annotated Section 9-22-103 and other transactions as identified by the State Funding Board.  
TCA Section 7-82-502 (c)-(h).



# Debt Management Policies

**What else should be in  
the debt management  
policy?**



# Issues and Considerations: Derivatives

If permit derivative or synthetic debt products:

- Compliance with SFB Guidelines

<http://www.comptroller1.state.tn.us/sl/pdf/SFBGuidelines10-9Final.pdf>

- III.D.- Conditions Precedent
- IV.- Specifics for Request for Letter of Compliance

- Circumstances and restrictions

- Professionals: Swap Advisor, Swap Counsel



# Recommendations

**It is strongly recommended that the public entity address:**

- Maximum total level of debt
- Level and type of variable rate debt
- Process for decision-making and debt issuance
- Management and monitoring of issued debt
- Plan for regular review and update of policy



# Recommendations

## LIMITATION ON DEBT:

- Debt outstanding
  - “as per capita debt”
  - “a comparison of debt to property values”
- Annual debt service
  - “debt service as a percentage of revenues or expenditures”

“The policy should either require or recommend that this limitation be evaluated before additional debt is assumed and be monitored and reported to the governing body periodically .”



# Recommendations

## LIMITATION ON:

- Debt structures
- Maximum maturity:
  - “In no event may payment of either principal or interest exceed the useful life of any asset financed”
- Timing for principal and interest payments
  - “must require specific justification for each deferral—it may not, however, permit blanket approval”
- Use of credit enhancement



# Recommendations

## Types of Debt

- Source of debt service:
  - Revenue or fee backed (UD's)
  - General obligation from tax revenues
- Instrument: bonds, notes, commercial paper, loan agreements, interfund loans, capital leases



# Recommendations

Types of projects to fund with debt.

- Capital projects
- Working capital
  - Gas UD- TCA Section 7-82-501(b): finance gas purchase, including storage and pipeline capacity costs



# Recommendations

- Process and responsibilities
- Structuring
- Issuance
  - Forward Purchase Agreement- compliance with SFB Guidelines
- Management and monitoring
- Refundings
- Record retention
- Policy review process and amendment



# Debt Management Policies

**How to start the process  
for development of a debt  
management policy?**



# Process

- Determine existing policies and practices related to finance transactions, budgeting, capital improvement, and transparency
  - Official and unofficial
- Identify applicable debt laws and regulations
- Identify key players (and stakeholders)
- Determine location of existing records

# Process



- Develop a schedule
- Locate current written policy
- Determine “unwritten” policy by gathering and reviewing:
  - Governing Body minutes
  - Transcripts from prior and outstanding debt
  - CAFR and audit reports
  - Rating reports
  - “Interview” finance employees
- Determine prior means for soliciting community input (hearings, meetings or charettes)

# Evidence of policy



## HALLSDALE-POWELL UTILITY DISTRICT OF KNOX COUNTY, TENNESSEE

### MANAGEMENT'S DISCUSSION AND ANALYSIS

This section presents management's analysis of the District's financial condition and activities for the years ended March 31, 2010 and 2009.

The acquisition and construction of utility plant is financed partially through customer revenues and partially through bonded indebtedness. Based on cost of service rate studies, the District assesses the need for funds at current and projected operating levels in relation to the projected capital needs for new construction, maintenance of current distribution and collection system assets and replacement of assets as needed. The District's water and sewer rates are established by the Board of Commissioners based on cost of service rate studies which determine the projected revenue necessary to satisfy projected costs of operations, debt service, costs of necessary improvements to the District's Systems and the requirements of the District's bonded debt, bond covenants and state laws.



# Evidence of policy



## *COMPREHENSIVE ANNUAL FINANCIAL REPORT*

*June 30, 2010 and 2009*

Board of Commissioners

The West Knox Utility District of Knox County

Page Four

### Long-Term Financial Planning

The District has projected a 2% to 3% annual increase in the number of customers over the next five years. The District is currently making several capital improvements including several water line improvements and extensions.

The financing of the District's capital improvements is by internally generated cash flows and the issuance of long-term debt. The District's debt coverage ratio has consistently been in excess of the required bond covenants.

# Evidence of Policy

SEVIER COUNTY UTILITY DISTRICT OF SEVIER COUNTY, TENNESSEE

NOTES TO FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED OCTOBER 31, 2010 AND 2009

## B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED



Depreciation of utility plant is computed and recorded by the straight-line method. Estimated useful lives of the various classes of depreciable utility plant assets are as follows:

	<u>Depreciable Life (Years)</u>
Distribution plant	18 – 50 years
General plant	7 – 40 years

### Unamortized debt issuance costs

Unamortized debt issuance costs consist of the costs of issuing debt, which are capitalized and amortized using the interest method over the term of the debt issue.

# Evidence of Policy



BLOUNTVILLE UTILITY DISTRICT  
Blountville, Tennessee  
OTHER SUPPLEMENTAL INFORMATION

PLEGGED REVENUE COVERAGE

(a) Gross Revenues	(b) Operating Expenses	Net Revenues Available for Debt Service	Debt Service Requirements			(d) Coverage Ratio
			(c) Principal	(c) Interest Paid	Total	
\$1,831,182	\$1,570,198	\$260,984	\$106,377	\$57,716	\$164,093	1.59

Notes:

- (a) Includes operating revenues and interest income received.
- (b) Does not include depreciation and amortization expense.
- (c) Principal and interest paid on revenue bond debt.
- (d) Net revenues/debt service.



# Evidence of Policy



BLOUNTVILLE UTILITY DISTRICT  
Blountville, Tennessee  
OTHER SUPPLEMENTAL INFORMATION

OUTSTANDING DEBT PER CUSTOMER

<u>(a)</u> <u>Revenue Bonds Principal</u>	<u>(b)</u> <u>Number of Customers</u>	<u>Outstanding Debt</u> <u>Per Customer</u>
\$1,418,612	5,317	\$267

Notes:

- (a) Outstanding debt principal is the face value.
- (b) Number of customers is based upon water customers.

# Evidence of Policy



## Supplemental Information Years Ended Sept. 30, 2010 and 2009 Consolidated Utility District of Rutherford County, TN

### CONSOLIDATED UTILITY DISTRICT OF RUTHERFORD COUNTY, TENNESSEE SCHEDULE OF HISTORICAL DEBT SERVICE COVERAGE (Unaudited)

(dollar amounts expressed in thousands)

	Fiscal Year									
	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Operating Revenues	\$ 22,124	\$ 20,723	\$ 21,145	\$ 19,976	\$ 17,610	\$ 16,035	\$ 14,166	\$ 13,294	\$ 12,865	\$ 12,044
Operating Expenses	19,047	19,927	18,643	16,596	14,471	12,510	11,050	9,692	8,520	8,128
Net Operating Income	\$ 3,077	\$ 796	\$ 2,502	\$ 3,380	\$ 3,139	\$ 3,525	\$ 3,116	\$ 3,602	\$ 4,345	\$ 3,916
Non-Operating Income(Expense)	(2,145)	(1,508)	(886)	(195)	(346)	(467)	(410)	(237)	(86)	917
Net Income Before Contributions	\$ 932	\$ (712)	\$ 1,616	\$ 3,185	\$ 2,793	\$ 3,058	\$ 2,706	\$ 3,365	\$ 4,259	\$ 4,833
Add: Contributed Capital - Cash	1,243	1,434	1,417	3,724	3,239	3,363	2,629	1,222	1,621	2,393
Depreciation	6,814	6,550	6,041	5,051	4,326	3,468	2,897	2,575	2,388	2,148
Interest Expense	2,544	2,295	2,143	2,189	1,751	1,123	900	1,053	1,075	1,125
Net Available for Debt Service	\$ 11,533	\$ 9,567	\$ 11,217	\$ 14,149	\$ 12,109	\$ 11,012	\$ 9,132	\$ 8,215	\$ 9,343	\$ 10,499
Annual Debt Requirements	\$ 4,011	\$ 3,406	\$ 3,377	\$ 3,385	\$ 2,470	\$ 1,610	\$ 1,869	\$ 2,258	\$ 2,347	\$ 2,633
Debt Service Coverage (times)	2.88	2.81	3.32	4.18	4.90	6.84	4.89	3.64	3.98	3.99

# Evidence of policy

## OAK RIDGE UTILITY DISTRICT MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) YEARS ENDED SEPTEMBER 30, 2010 AND 2009



### *Debt Ratings*

The District purchased municipal bond insurance at the issuance of its Series 2000 and Series 2002 bonds. As a result of the insurance from the issue date until late 2008, the 2000 and 2002 bonds were Aaa rated by Moody's Investor Service. As a result of financial difficulties of the insurer of the bonds the financial strength of the insurer was downgraded to Baa1 by Moody's in November 2008 and consequently the District's insured bonds were also downgraded to Baa1. In July 2009 the insurer was further downgraded by Moody's to Caa2 which is below investment grade. This caused the District's insured bonds to no longer be rated by Moody's. As on November 23, 2010 the insurer was still rated Caa2. The District does not believe that the rating changes on its insured bonds will have any significant impact. However, should the District issue bonds in the future the District anticipates foregoing municipal bond insurance and having those bonds rated by one of the national rating agencies such as Moody's.

# Evidence of policy

*THE WEST KNOX UTILITY DISTRICT OF KNOX COUNTY  
NOTES TO THE FINANCIAL STATEMENTS (Continued)  
June 30, 2010 and 2009*



## **NOTE 7: INTEREST RATE SWAP**

Under its loan agreement, the Public Building Authority of Sevier County, TN (the “Authority”), at the request of the District, has entered into an interest rate swap agreement for all of the outstanding Local Government Improvement Revenue Bonds, Series 2000 II-D-2, which began on July 13, 2000, and matures on June 1, 2028. The District has one interest rate swap classified as a hedging derivative instrument. The hedging derivative is an effective hedge using the regression analysis method. The regression analysis method measures the statistical relationship between the fair value or cash flows of the potential hedging derivative and the hedgeable item.



# Attachment B: Resources

Comptroller of the Treasury (<http://www.comptroller1.state.tn.us/sl/index.asp>)

Government Finance Officers Association (GFOA) ([www.gfoa.org](http://www.gfoa.org))

Municipal Technical Advisory Service (<http://www.mtas.tennessee.edu/>)

County Technical Assistance Service (<http://www.ctas.utk.edu/>)

Rating Agencies:

- a) Fitch Ratings ([www.fitchratings.com](http://www.fitchratings.com))
- b) Moodys ([www.moodys.com](http://www.moodys.com))
- c) Standard & Poors ([www.standardandpoors.com](http://www.standardandpoors.com))

Municipal Securities Rulemaking Board ([www.msrb.org](http://www.msrb.org))

- Electronic Municipal Market Access ([www.emma.msrb.org](http://www.emma.msrb.org))

Securities Industry and Financial Markets Association ([www.sifma.org](http://www.sifma.org))

- Investing in Bonds (<http://investinginbonds.com/>)



# Debt Management Policies

## ***SECOND TIME***

### **Four principles for strong financial management in the public sector:**

- Understand the transaction
- Explain to citizens/customers what is being considered
- Avoid conflicts of interest
- Disclose costs and risks

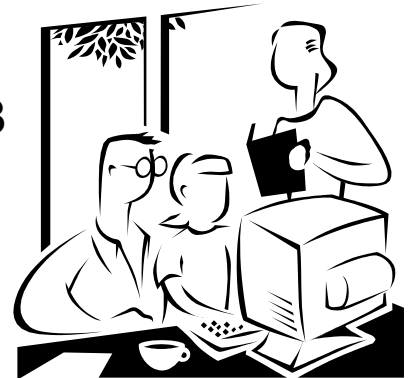


# We're Here to Help

Ann V. Butterworth (615) 401-7910  
[ann.butterworth@tn.gov](mailto:ann.butterworth@tn.gov)

<http://www.comptroller1.state.tn.us/sl/index.asp>

Additional contact:  
Office of State and Local Finance (615) 747-5368  
Mary-Margaret Collier (615) 747-5370





# Debt Management Policies

## *THIRD TIME*

### **Four principles for strong financial management in the public sector:**

- Understand the transaction
- Explain to citizens/customers what is being considered
- Avoid conflicts of interest
- Disclose costs and risks