



# CAPITAL BUDGETING

# INTRODUCTION

- General operations of local government are financed through Current Fund appropriations (police, fire, admin., etc.)
- Capital improvements are financed through the Capital Fund (road imp., heavy equipment purchases)
  - Require large outlay of funds
  - Often financed by debt - Bonds or Notes
  - Minor capital improvements and some major capital projects may be financed by current fund appropriations.
    - “PAY AS YOU GO” VS. DEBT
    - KNOW YOUR BUDGET AND CAPITAL PLAN

# CAPITAL BUDGET

- The identification of capital requirements of the municipality is the first step in the debt issuance cycle.
  - When the operating budget appropriation requests are being compiled and submitted by dept. heads, a list of capital needs for the ensuing years should be prepared.
  - The administrator, department heads, or engineer should also prepare and update a capital plan
    - population less than 10,000 = 3 year plan
    - Greater than 10,000 = 6 year plan

# CAPITAL BUDGET

- The DLGS requires the adoption of a capital budget where the cumulative cost of such items will exceed \$25,000, for capital items with an expected useful life of 5 years or more.
  - This includes acquisition of land, heavy equipment, etc.
  - N.J.S.A. 40A:2-22 sets the useful life for such items.
- A bond ordinance can be adopted
  - only if a capital budget (or temporary capital budget) has been adopted,
  - or if a capital budget amendment has been passed.
    - The capital budget must be advertised (published) in the same manner as the official operating budget on forms prescribed by the DLGS.

# CAPITAL BUDGET

- The Capital Budget contains the following information:
  - Project Title (Specificity is required)
  - Project Number
  - Estimated Total Cost
  - Amounts Reserved in Prior Years
  - Planned Funding Sources
  - Operating Budget
  - Capital Improvement Fund
  - Capital Surplus
  - Grants in Aid
  - Future Years Funding
- If priorities change during the course of a year, a bond ordinance is necessary, then the capital budget must be amended.
  - The capital budget must contain the above information, on forms prescribed by the DLGS.

# DEBT LIMITS

- Municipalities and counties may incur debt only within certain limitations as defined by the Local Bond Law.
  - Must file a Supplemental Debt Statement as of the date of ordinance introductions
    - states debt outstanding, including the debt about to be authorized, and any debt activity during the year (payments and additions).

# DEBT LIMITS

- No municipal bond ordinance may be finally adopted if the supplemental debt statement indicates that the % of net debt exceed  $3\frac{1}{2}$  % of the average of the prior 3 years' equalized assessed real property valuations
- Counties have a 2% debt limitation
- School debt is limited to a maximum of 4% of the 3 year average for districts under a K-12 system
- Said valuations are provided at the beginning of each year in the Municipal Information Sheet by the State of New Jersey – DLGS

# DEBT LIMIT EXCEPTIONS

- Exceptions to the debt limitations
  - Refundings
  - Emergency
  - Self Liquidating
- The Local Bond Law provides for the Local Finance Board to approve so-called extensions of credit
- Municipalities seeking to exceed their debt limit must submit an application on standard forms to the Local Finance Board
  - include a list of projects contemplated and maturities,
  - the present debt service and outstanding debt, and the estimated annual debt service costs for the next 10 years
- The Local Finance Board then holds a hearing on the extension of credit request
  - The Board must determine that the improvements are in the public interest
  - that the amounts to be expended are not unreasonable or exorbitant
  - the issuance of such obligations will not materially impair the credit of the municipality or substantially reduce its ability to meet debt service payments

# PURPOSES FOR ISSUING BONDS

- Bonds may be issued for any capital improvement or acquisition of property:
  - Cannot bond “day to day” items
  - requires that the period of usefulness of the project to be financed by bonds be at least 5 years
  - a maximum useful life of 40 years which applies only to certain types of buildings
- The term of the bonds cannot exceed the life of the item being financed
- The bond law also requires that a municipality provide a down payment of 5% of the amount of the obligations authorized
  - the current year’s budget appropriations
  - an emergency appropriation
  - the capital improvement fund
  - capital surplus
  - A waiver of the down payment is possible with Local Finance Board Approval

# PURPOSES FOR ISSUING BONDS

- In addition to the 5-year useful life requirement the purposes of debt obligations may also be viewed from the perspective of general or local improvements financed by bond ordinances
- General improvements are paid from general municipal budget revenues, including property taxes
  - Local improvements which specifically benefit certain portions (or properties) of a municipality are financed by special assessments against the property owner receiving the specific benefit

# PROCEDURE FOR AUTHORIZING DEBT

- Identification of capital needs
  - Preparation of Capital Budget
  - Capital Plan
  - prepare capital budget amendment, if necessary
- Supplemental Debt Statement
- Bond Ordinance is prepared
  - includes description -total amount and amount of debt authorized
  - period of usefulness -down payment
  - funding sources -Indicates Supplemental Debt Statement was filed properly
  - “Section 20” cost (soft costs)
- Introduced by majority vote (first reading only)
- published in “legal” newspaper at least ten day after intro to set hearing date
- public hearing/adoption
  - 2/3 vote of full membership
- after adoption
  - publish in paper
  - does not take effect for 20 days (allows for residents to challenge)
    - file a petition of at least 15% of registered voters (NJSA 40A:49-27)

# FINANCING CONSIDERATIONS

- Interest Rate Risk
- Extension Risk

# SHORT TERM FINANCING

- **Capital Purposes:**
  - **Types of notes authorized by the Local Bond Law, which may be used by the municipality, include:**
    - **Bond Anticipation Notes – These notes may be issued in anticipation of bonds, provided they have been authorized in the bond ordinance**
      - **Notes may be issued for period not exceeding 1 year**
      - **may be renewed from time to time for periods not exceeding 1 year.**
      - **All such notes, including renewals, shall mature and be paid not later than the 10th anniversary date of the original notes**
        - **Notes must mature and be paid no later than the 1st day of the 5th month following the close of the 10th fiscal year**
    - **Annual installment must be paid from the 3rd Anniversary date for principal payments**
    - **Interest payments must be made annually including the 1st 2 years**

# SHORT TERM FINANCING

- Special Assessment Notes – Notes may be issued to finance local improvements or special assessments
  - may be renewed for periods not exceeding 1 year
  - shall mature and be paid not later than the 5th anniversary of the date of the original notes

# SHORT TERM FINANCING

- Operating Purposes:

- The Local Budget Law permits municipalities to borrow money on a short term basis to meet budgeted operating needs when cash flow shortfalls occur or when regular or special emergency appropriations are authorized
  - Tax Anticipation Notes (TANS) – The Local Budget Law permits a municipality to issue tax anticipation notes in anticipation of the collection of taxes in any fiscal year
    - TANS may be renewed, but all notes shall mature in the case of the municipality not later than March 31 of the succeeding fiscal year and
    - in the case of a county not later than June 30 of the succeeding fiscal year
  - Emergency Notes – The Local Budget Law also permits a municipality to issue notes to meet an emergency appropriation
    - Such notes must be authorized by resolution of the governing body
    - and may be renewed
    - The notes must mature not later than the 1st day of the fiscal year succeeding the fiscal year in which such notes were issued and the emergency appropriation authorized

# SHORT TERM FINANCING

- Special Emergency Notes – The Local Budget provides for the issuance of special emergency notes to finance special emergency appropriations for:
  - tax maps, master plans, codifications, and revaluations
  - The notes may be renewed, but at least 1/5th must mature annually and must be included in the annual budget
  - The notes are authorized by a resolution adopted by 2/3rds vote of the full governing body
- All BANS & Capital Notes may be sold on the basis of negotiation
  - it is not necessary to advertise and receive bids for the sale of notes as is the case of bonds
  - It is recommended that competitive proposals be received to ensure the best possible interest

# THE SALE OF BONDS (LONG TERM/PERMANENT FINANCING)

- Bonds must be sold by public sale.
  - A municipality must advertise and receive bids with the following exceptions:
    - 1. the total amount is less than \$1,000,000,
    - 2. there are no bidders,
    - 3. they are refunding bonds, or
    - 4. they are sold to a political subdivision of the state or to an agency of the federal government.
- The sale of municipal bonds is sometimes complex requiring adequate preparation and careful planning including a thorough review of the “Local Bond Law”.
  - Advice should be sought from the municipality’s bond counsel, bankers, financial consultant, and bond underwriters.
- All bonds issued by the municipalities must be in registered form,
  - whereby the individual or firm purchasing the bond registers their name, address, and social security # with the municipality or its registration agent.

# THE SALE OF BONDS

## (LONG TERM/PERMANENT FINANCING)

- Preparing for a bond sale
  - Contact bond council early
    - List of potential bidders (underwriters) should be notified
    - Notice sent to The Bond Buyer and local paper
  - Official State Preparation (OS)
    - Notice of Sale
    - Socioeconomic Information
    - Financial Information about the community (audit schedules and other schedules as needed)
      - Rating Agencies will require this information
  - Schedule of bond maturities must be prepared
    - Equal annual debt service (P&I may change, but total remains constant)
    - Equal annual maturities
      - Local Bond Law requires all bonds must mature in annual installments
        - No annual installment may exceed 100% of the amount of the smallest installment
        - Need LFB approval for nonconforming issues (back loading)

# BOND RATINGS

- Bond or credit ratings are simply an expression of the odds of loss to the investor.
  - A rating is concerned with the security and the safety of the bonds
- The investor is concerned with being protected against inordinate increases in debt and in the consequent ability of the municipality to meet the debt service requirements
  - The rating assigned to a municipality's bonds assists the investor in determining the amount of risk in purchasing a municipality's bonds
- Bonds with a higher (better) rating generally carry a lower interest rate because the debt is better secured and has a higher probability of being repaid than lower rated bonds
- A municipality cannot purchase a bond rating

# RATING OF MUNICIPAL BONDS

- In order to rate the bond issue the rating agencies require a large amount of data from the municipality, including the following:
  - 1. Annual financial reports for at least the last three years
  - 2. Interim financial statement
  - 3. Annual budget for the current year, both operating and capital
  - 4. Listing of long term debt of all types, with each type identified and details given
  - 5. A comparison of outstanding debt of all types over a period of ten years
  - 6. Schedule of annual bond principal maturities by class of bonds
  - 7. Identification of overlapping debt, if any
  - 8. Comparative trends of past debt service and those planned for the future
  - 9. Full text of enabling bond ordinance
  - 10. Ten year trend of assessed valuations of real property

# RATING OF MUNICIPAL BONDS (CONT'D)

- 11. Ratio of assessed valuations of real property to market value (true value)
- 12. Tax Rates, for the borrowing unit and the overall rate for all local governments such as city, school, county and districts
- 13. Tax collection record for the past five years, including interest charges and frequency of tax sales
- 14. Special details of utility operations, if any, including physical facilities; record of output and consumption patterns, rate schedules and service rules
- 15. Economic and demographic data that can serve to identify resources of the community, sources of personal and business income, past and current trends
- 16. Population
- 17. Extent of retail, commercial, industrial zones
- 18. Summary of local building code, zoning and land use
- 19. Range of selling prices for new residential construction
- 20. Judgments against municipalities

# QUESTIONS

