



City of Sweet Home
3225 Main Street
Sweet Home, OR 97386
541-367-5128
Fax 541-367-1215
www.sweethomeor.gov

Finance Department

MEMORANDUM

To: Sweet Home City Council

From: Brandon Neish, Finance Director

RE: Debt Options for Capital Projects

During the City Council meeting on April 13, 2021, the City Council and staff discussed options for utility rates. As part of that discussion, the topic of capital improvements was broached and the need for long-term resources to fund much of the work that needs to be completed and Councilors expressed a desire to see how obtaining capital loans could expedite capital construction and the costs therein associated with this practice. Staff was asked to return to a subsequent Council meeting with an outline regarding debt options.

As previously discussed, interest rates are at a record low currently. As of May 6, 2021, the interest rate on a 10-year AA rated municipal bond is 1.05%. For the purposes of this conversation and given the potential that any new debt would not be full-faith and credit (more on this later), 25 basis points (.25%) has been added to this for an interest rate of 1.3%. Based on the capital improvement listing submitted by the departments, the City would need to borrow up to \$9.7 million (all projects – streets, water, parks, etc.) and this assumes no cost increases due to timing of project completion. For the purposes of this discussion, we will be focusing on water treatment and system projects. The total list of projects submitted by Public Works for the water system was \$4,225,000. To set this conversation up further, the U.S. Census Bureau indicates that construction materials costs have risen at an average rate of 6.0% per year over the last ten years. This will be used in our assumptions discussed below. The bottom line is this: should the City Council decide to incur debt to pay for capital projects, the savings in total project costs would total \$1.7 million, an estimated \$4.30 per utility account per month at 600 cubic feet.

Assumptions:

Two scenarios were built to calculate the savings as stated above. One scenario included the City “self-funding” projects using set aside reserves annually. The second included incurring debt with specific timing requirements to complete the projects. Each scenario had its own set of assumptions to get to the end result.

For the first scenario, self-funding capital projects, we started with the total project costs as predetermined by Public Works (PW). To determine available funding for a given fiscal year, the five-year forecast was utilized and a look back at the last five years to determine our average capital contribution. For this scenario, it is assumed that the City could afford \$450k annually with a 2.5% rate increase (3% after 2025). \$4.3 million less the \$450k contribution left \$3.8 million in projects for the second year. For the beginning balance in the second year, a 6.0% increase (construction materials cost escalation) was applied to the ending balance for year 1 which leaves a beginning balance of \$4.0 million. In order to complete all of the projects as they are currently presented, the City would spend \$6.6 million over 16 years assuming 6.0% cost increases annually and no change in the available funds for projects. Part of this assumption also includes a “pause” on project spending for one large-scale project, the construction of a water reservoir, budgeted at nearly \$3.0 million. To accumulate \$3.0

million in funds, the City would have to save \$450k annually for six years. Pausing for six years, however, adds \$1.2 million in total project costs and nine years to the overall timeline.

Scenario two, incurring debt for capital project funding, presented a surprising benefit to the City. While interest rates have been low, and it has always been assumed that now vs. later would yield some sort of savings. Using the same assumptions for construction material cost increases, the debt option would result in \$4.6 million in expenditures and completion in five years. Using the \$450k in funds available described above, staff assumed that this \$450k could be used for debt payments instead and results in a loan that could be repaid within ten years while saving rate payers \$1.98 million in overall costs. It is important to note that this scenario still requires an annual rate increase of 2.5% to fund the debt service payments though the terms of the loan could be extended to limit that necessary increase. For example, extending the repayment to 20 years would increase the assumed interest rate to 1.75% reduces savings to \$1.1 million (\$2.87 per month) but eliminates rate increases in the forecasting models through 2026. This would not last beyond 2026 as expenses would begin to outpace revenues in 2025 and fund balance would only carry until 2027 before being eliminated. By 2042, it is estimated that, without intervention, expenditures would exceed revenues by \$500k annually.

Considerations:

There are a number of things to consider with any attempt to incur a debt. The goal of this Council is to do the most good, for the most people, for the longest period of time. When incurring a debt such as this, there is a long-term impact in which funds are tied up to repay the loan. By self-funding capital projects, it is true that there are added costs associated due to completing projects as funding is available. However, if (when) the economy turns downward, having debt on the books means there is no ability to reduce debt payments. Self-funding means that capital projects can be delayed, maintaining operating expenditures. Choosing to incur debt means that the current City Council is likely tying the hands of future Councils.

Another consideration is whether or not the City is ready to embark on these projects. In consultation with PW, there is a concern that we do not have updated master plans which would inform the work that the debt would finance. Completing the master plans is estimated to take 12-18 months and would begin with the adoption of the 2021-2022 fiscal year budget (July 1, 2021). Two issues arise with this: 1) projects informed by the completion of master plans would then inform how much funding is necessary and; 2) there are timing requirements when obtaining debt. The City has a list of projects that PW believes are necessary over five years, but they are operating on assumptions. We could move forward with this list but if the master plans revealed issues with a higher priority, that could cause an issue as the debt obtained would be for the specific purpose listed in the loan documents (and the City would have available resources to pivot internally). For the second point, obtaining debt requires that 5% be spent within the first six months and 85% within 36 months. 5% of \$4.6 million is \$231k; 85% is \$3.9 million. If we assume the master plan takes 18 months, this leaves 18 months to plan and construct enough to spend \$3.9 million. This is a tall order.

The final considerations are related to reserve funding and total debt on City accounts. The debt scenario assumes that the amount of funds previously set aside for capital and emergencies would be redirected to pay for the debt service. This leaves no additional funding for emergent needs or unforeseen circumstances (new federal/state mandates, water main breaks, etc.). As much of a concern as the reserve funding, the City's debt load currently stands at approximately \$6.0 million. Adding this debt would increase total load to a total north of \$15.0 million and the inclusion of the Wastewater Treatment Plant in the near future would stack the City with \$45 million in total debt. This is more in total than the City brings in annually and would present a major concern for investors who are purchasing our debt.