

## Debt Capacity: An Overview

By Angelica Hernandez, California Debt and Investment Advisory Commission Policy Research Unit



Debt is a powerful tool, but to use it effectively public officials must examine future debt levels and determine the impact of debt issued today on the ability to borrow tomorrow. Most public agencies have capital and infrastructure needs that exceed the size of their annual capital budgets making it difficult to use traditional “pay as you go” financing methods for costly projects.

When voters approve general obligation bond measures they trust public officials to exercise prudence and fiscal judgment when making long-term capital decisions.

Knowing the amount of debt a public agency can issue, known as “debt capacity,” enables officials to effectively prioritize projects during the capital planning and budgeting process, as well as better conduct long-term financial planning. This article is intended to provide public agency officials and their staff an overview of debt capacity; information that can help public officials understand one aspect of their agency’s debt position.

### What is Debt Capacity?

In the context of debt affordability, debt capacity refers to the amount of debt or financing obligations an agency may incur without overextending its ability to pay. Debt capacity can be defined as the difference between the amount of debt an issuer has outstanding (sold and authorized) and the maximum amount of debt an issuer can incur within its legal, public policy and financial limitations. There is no one measure of a public agency’s debt capacity. Instead, debt capacity consists of many factors, including legal limitations as well as measures of debt financial stability.

**Analyzing debt capacity.** Debt capacity measures provide policymakers with a basis for assessing the impact of bond programs on the public agency’s fiscal position.

Using objective criteria can help a public agency measure, monitor and manage its use of debt using objective criteria and facilitate fiscal discipline. These criteria consist of standard industry ratios as a basis of comparison to other comparable public agencies. This comparison enables the public agency to better monitor debt levels. How can I compare my public agency to others? Moody’s publishes what it calls Moody’s Medians--a consistent set of debt ratios by state. In addition, Moody’s

and the other rating agencies periodically publish samples of debt ratios for local issuers, usually on a regional basis.

Taking the use of debt indicators a step further, the Government Finance Officer’s Association (GFOA) recommends a public agency use a forecasting approach with an established comparative peer group to calculate appropriate levels of debt. Using the comparative peer group, the public agency will test different debt issuance scenarios to calculate the impact on those debt indicators. The debt scenarios used include a baseline of no new debt and several different levels of proposed debt; for example, the impacts of issuing \$10 million, \$20 million, or \$30 million of debt on the public agency’s debt indicators. The results will indicate how the public agency fares against its comparative peer group.

Relying on debt indicators to calculate debt capacity is one approach, another approach to calculating debt capacity advocated by the State Treasurer in his 2007 Debt Affordability Report (2007 DAR) is comprehensive debt capacity modeling. The 2007 DAR concluded that the state’s debt capacity should be a matter of public policy that can be set by establishing spending priorities and then budgeting to implement those priorities. Calculating debt capacity solely on a single debt ratio, according to the 2007 DAR, “is flawed because it assumes decisions about the operating budget and the level of revenues have already been made, and debt can only take up what’s left.”



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A debt affordability model should be established that will regularly evaluate the public agency's future debt profile. The impact of the debt capacity model depends on how the model is used by the public agency and on how well the public agency adheres to the affordability parameters established in the model. There is no question that debt capacity analysis can enhance the capital budgeting and related policy decisions regarding debt.

#### How often should debt capacity be reviewed?

A regularly updated debt capacity report can be used by policymakers to evaluate the long-term impact of financing decisions and assisting in prioritizing capital budgeting/spending. Debt capacity is analyzed at the time of each bond issuance but for purposes of financial planning and forecasting should be reviewed regularly. For example, California's Debt Affordability Report prepared by the State Treasurer is statutorily required to be submitted annually to the governor and Legislature and is intended to be a tool to assist in the state's financial planning (budgeting and bond issuance forecasting). One of the benefits of reviewing debt capacity on a regular basis is that the review facilitates integrating executive debt management practices with capital spending decisions typically made by the legislative branch. If done on an annual basis, a debt capacity report can incorporate changes in a public agency's debt position and review projections used to measure the financial impact of future debt issuance as well as any economic changes, such as lower revenues estimates.

While every public agency is different, almost every public agency prepares basic debt capacity ratios as part of the Statistical Section of its Comprehensive Annual Financial Report (CAFR). As required by GASB Statement 44, certain debt capacity ratios reflecting the most recent ten years are part of the supplementary information contained in the statistical section of a public agency's CAFR. These tables are intended to assist users of a CAFR in understanding and assessing a government's debt burden and its ability to issue additional debt and could serve as the basis of an annual debt capacity review.

#### Conclusion

Debt capacity analysis provides public officials with the substance to facilitate decisions about the issuance of additional debt. Operating with a clear understanding of a public agency's debt capacity is beneficial for both governing boards of newer communities as well as mature, established communities since both require long-term planning for capital costs coupled with debt capacity issues. ■

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#### DEBT CAPACITY FACTORS

While debt capacity measures the maximum amount of debt a public agency can issue, that amount is influenced by a variety of factors; including debt indicators, public policy and statutory debt limits.

**Debt Indicators.** Debt represents a leverage against the local economic base and the taxable resources that are ultimately responsible for debt repayment. Debt indicators are an integral part of any debt capacity analysis. They measure the leverage of a public agency's resources, are used to convey a public agency's existing debt status and can be used to evaluate whether the agency can afford additional debt. These comparative statistics are referred to as "debt ratios" and reflect the relationship between a public agency's outstanding debt and variables such as its tax base, income or population. To get a sense of a public agency's debt levels, these ratios are often compared to other public agencies of similar size and scope. These ratios are most effective for general tax supported debt (general obligation debt) or other tax-supported debt.

Common fiscal factors that are used to evaluate the financial aspect of debt capacity include debt burden ratios that measure debt service as a percentage of revenues; personal income; and population, current financial capacity; bond covenants, projected future capacity, and statutory and constitutional limitations.

**Public Policy.** An agency's policy on debt can be more limiting than other fiscal constraints. A conservative policy can impose more strenuous debt limits than those prescribed by state statute or local ordinance. For example, the City of San Luis Obispo notes that while state law provides for a legal debt limit of 3.75 percent, the city's debt management policy sets a direct debt limit of 2 percent of assessed valuation.

**Statutory Debt Limits.** Each local agency authorized to issue general obligation (GO) bonds has established its own bonding capacity or debt limit that is usually represented as a fixed percentage of the assessed value of taxable property in the jurisdiction of the issuer.