

# *City of Alexandria, Virginia*

## MEMORANDUM

DATE: MARCH 29, 2010

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER 

SUBJECT: BUDGET MEMO # 31 : BENEFITS OF THE CITY'S AAA/Aaa BOND RATING

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This memo is a response to a request from Councilman Fannon to describe the meaning and benefits of the City's AAA/Aaa bond rating.

Each time the City plans to issue general obligation bonds in order to fund capital expenditures, City staff asks both Standard and Poor's and Moody's Investors Service (the two primary rating teams) to each provide an official bond rating. Every City bond issuance since 1992 has received the AAA/Aaa ratings, which is the highest possible rating from these two rating houses. There are three primary benefits to receiving the AAA/Aaa. First, this rating enables the City to get the lowest possible interest rates on its sale of general obligation bonds, which saves the City considerable money over the 20-year repayment cycle. The second benefit of this rating is that it provides an external and expert, independent assessment of the City's conservative financial management practices and policies. The third reason is the financial management discipline that is self-imposed in order to obtain and retain these ratings.

The municipal bond market has experienced particularly high spreads (the distance between the interest rates of the different ratings) over the past two years. During periods like this it is particularly advantageous to the City to keep its AAA/Aaa bond rating as the potential debt service cost increases are much greater than during periods of small rate spreads.

### **Rating Agency Justification for AAA/Aaa**

When the City first obtained the AAA/Aaa bond rating in 1992, it was one of only ten U.S. cities to receive a AAA rating from both Standard and Poor's and Moody's rating agencies. The City has received a Aaa rating from Moody's beginning in 1986, but Standard and Poor's did not upgrade the City to a AAA until the 1992 issuance. At the City's most recent issuance in 2009, it was one of 54 cities and 25 counties to obtain this high rating. Even though there are now many more jurisdictions receiving this rating, both rating agencies have communicated that the City remains at the top end of this elite group.

For the 2009 Standard and Poor's assessment, they cited the following rationale when assessing the City a AAA long-term rating:

- o Deep, diverse, and strongly performing local economy, which serves as one of the anchors of the greater Washington, D.C. and northern Virginia regions;
- o Growing tax base that has decreased slightly in the past year as part of the national recession but that remains strong on a market value per capita basis;
- o Strong financial management; and
- o Moderate-to-low overall debt burden.

Moody's used a similar justification in 2009 when they rated the City as Aaa, their highest possible score.

- o Diverse tax base;
- o Above average wealth levels;
- o Economic stability derived from proximity to the Washington, D.C.; and
- o Sound financial operations characterized by adequate reserve levels, conservative budgeting, and a strong debt position.

**Bond Spreads**

As a rough approximation, each 0.1% on the interest rate equals an additional \$10,000 in interest annually on each \$10 million of debt issued. The interest rates for AAA-rated, tax exempt municipal bonds have been around 2.95% in recent weeks.

In recent bond sales, the spread (difference in interest rates between bond rating levels) between AAA and AA municipal bond rates has been about 0.15%. The spread between AAA and A municipal bond rates has been about 0.8%. Using these approximated spreads, the anticipated City borrowing in June/July of about \$35 million would cost the City about \$52,500 each year (\$1.1 million over 20 years) in increased debt service if we were an AA, and about \$280,000 each year (\$5.6 million over 20 years) if we were an A. The table below shows how the projected debt issuances over the next six years would be impacted by a reduction in the City's bond rating assuming the current rate spreads.

Fiscal Year	Millions Borrowed	AA rating <sup>1</sup>		A rating <sup>2</sup>	
		Annual D.S. Increase	20 -year D.S. Increase	Annual D.S. Increase	20 -year D.S. Increase
2010	\$35	\$52,500	\$1,050,000	\$280,000	\$5,600,000
2011	\$84	\$126,000	\$2,520,000	\$672,000	\$13,440,000
2012	\$53	\$79,500	\$1,590,000	\$424,000	\$8,480,000
2013	\$53	\$79,500	\$1,590,000	\$424,000	\$8,480,000
2014	\$43	\$64,500	\$1,290,000	\$344,000	\$6,880,000
2015	\$44	\$66,000	\$1,320,000	\$352,000	\$7,040,000
TOTAL	\$312	\$468,000	\$9,360,000	\$2,496,000	\$49,920,000

<sup>1</sup> assumes a 0.15% spread

<sup>2</sup> assumes a 0.80% spread

As is shown in this table, if the City was downgraded to a AA rating, the cumulative impact on annual debt service by FY 2015 would be almost \$500,000. Over the 20-year repayment periods of just these six issuances, that could cost the City almost \$9.4 million in additional debt service.

Over the past two years, the spreads for municipal bonds have been changing dramatically. Two years ago the spread between a AAA and AA was only 0.1%, which is a fairly typical level. One year ago that spread climbed to as high as 0.25% during some months. The corresponding impact on debt service of a small change like this has the potential to be huge. For example, assuming the City was downgraded to a AA for its \$79.7 million issuance in 2009, a 0.1% spread would have increased debt service by \$80,000 annually (\$1.6 million over 20 years), while a 0.25% spread would have increased the debt service by \$200,000 annually, or \$4.0 million over the 20-year repayment term. Even greater increases have been seen in the spreads between AAA and A ratings. This spread was 0.5% two years ago, climbed all the way to 1.5% one year ago, and now is back down to 0.8%. The basic lesson in this trend is that the potential cost to the City of being rated lower than a AAA is currently greater than it was in recent years. This phenomenon in the bond market is not anything new or an anomaly. Almost every decade or so, the spreads increase to high levels at the time when municipalities across the U.S. (particularly lower grade municipalities) are experiencing fiscal stress. It should be noted that there are multiple grades between a AAA and a AA (Standard and Poor's: AAA, AA+, AA; Moody's: Aaa, Aa1, Aa2, Aa3) with the interest spreads representing gradations.