City of Alexandria, Virginia

MEMORANDUM

DATE: AUGUST 1, 2011

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: BRUCE JOHNSON, ACTING CITY MANAGER

SUBJECT: DIRECT EFFECTS OF FEDERAL DEBT CEILING CRISIS AND DEFICIT REDUCTION ISSUES ON THE CITY

As the August 2 federal debt ceiling deadline approaches, there has been increasing concern that the failure to reach an agreement on the debt ceiling or the passage of significant federal budget cuts as part of a deficit-reduction deal may have repercussions for local governments. Yesterday's bipartisan compromise, if enacted into law, will eliminate the default risks described in this memo. However, the budget reduction and bond rating risks remain real concerns. As a result, it is important for City Council and the community to be aware of the issues that may arise.

This memorandum will focus on the City's <u>direct</u> exposure in the event that: 1) a failure to raise the debt ceiling (now not a likely event) leads to temporary federal liquidity issues and/or the downgrading of the nation's credit rating; and/or 2) a debt ceiling/deficit-reduction agreement is reached and it includes significant cuts to federal aid to local governments. The most significant immediate concern is the City's dependence on federal funding for Housing, Community and Human Services and the Schools. Fortunately, the City does not rely as heavily on federal funding as other jurisdictions, as evidenced by the fact that federal aid comprises just 4.8 percent of combined City and School expenditures (including All Funds). However, the City will likely have to make some adjustments to address short- and long-term funding issues.

City staff has begun an immediate in-depth review of the <u>indirect</u> effects that credit rating downgrades, federal default, and federal budget cuts may have on the City's economy, budget, and financial condition and will update City Council soon.

<u>FUNDING ISSUES</u>: If the federal government experiences liquidity problems due to a failure to raise the debt ceiling, or makes significant budget cuts as part of a deficit-reduction agreement, the City will likely receive lower than expected federal grant, fee and contract revenues in FY 2012 and subsequent fiscal years. The severity of any revenue loss will depend on the outcome of the debt ceiling/deficit-reduction deliberations in Congress and how funds that have already been obligated or promised to programs will be impacted; however, we can identify those areas where the City would be most affected. If the federal government delays transfer payments to the state and local governments, the City is likely to have sufficient cash flow in the short and medium term to handle late federal reimbursements.

Federal Government Grant, Fee and Contract Revenues

For FY 2012, the City government has budgeted (excluding Schools) $28.8 million in revenues from the federal government, which represents 4.2 percent of total City revenues for the All Funds Budget. These revenues, which are made up of direct intergovernmental revenues and federal grants, could be directly affected by federal liquidity issues or significant federal spending cuts as part of a deficit reduction agreement.

Budgeted federal intergovernmental revenues in the City's General Fund equal $8.8 million and come primarily from the Federal Prisoner Per Diem ($6.1 million) and the Build America Bonds (BAB) subsidy ($1.7 million). Both of these revenue sources represent the federal government's legal obligations through contract and statute and are likely high priorities for continuation. With any stoppage of payments (due to liquidity issues) or cuts to the Federal Prisoner Per Diem, the City would have less revenue to cover the fixed costs of operating the jails. If the federal government stopped paying the jail per diem, the City may have the option of limiting the intake of new federal prisoners. Since the BAB subsidy covers 35 percent of the debt service costs for taxable bonds issued in June 2009 and June 2010, a stoppage of payment due to liquidity issues would shift some of the debt service costs to the City until payments resume. It is unlikely that the federal government will decide not to pay the BAB subsidy to state and local governments as the BAB subsidy is a statutory promise to pay by the federal government and its nonpayment could produce a cascade of state and local bond defaults.

Excluding the Schools, the City anticipates receiving approximately $20 million in federal grant revenues. Most of these revenues are budgeted for the Department of Community and Human Services (DCHS), the Office on Housing, and the Fire Department.

DCHS anticipates $16.3 million in federal funding for FY 2012. This amount represents about 18 percent of total DCHS planned funding for FY 2012 ($90.8 million). According to the Virginia Department of Social Services (VDSS), current federal funds on hand should carry DCHS through the end of the federal fiscal year on September 30, so short-term federal liquidity issues may not have any effect, especially since the City could make use of Commonwealth of Virginia fund balances, if necessary, to maintain funding in the short term. However, cuts to federal social services expenditures after September 30 as part of a deficit-reduction deal may force the City to make cuts to these programs and/or find alternative funding for them. The table below gives a sampling of the programs that are expected to receive the most funding from the federal government in FY 2012. This excludes significant Medicaid revenues earned by DCHS on a fee-for-service basis. While Medicaid funding will be reduced at the national level, how that eventually impacts the DCHS may not be known for some time.

Program(s)	**Funding**
Mental Health and Substance Abuse Programs	$2.1 million
VDSS* Eligibility Determination	$2.1 million
VDSS Child Welfare Administration	$1.6 million
Foster Care IV – E	$1.1 million
Adoption Subsidy	$0.9 million
TANF/View Child Care and Wrap Around	$1.0 million
Child Care Fee System	$1.8 million
Head Start	$1.9 million
Total Funding for This Sample	**$12.5 million**

The Office of Housing anticipates receiving $2.2 million in federal grants for FY 2012, $1.1 million through the Community Development Block Grant (CDBG) program and $0.8 million through the HOME Investments Partnership Program. This represents approximately 40 percent of planned City Housing program funding (approximately $5.6 million). A stoppage or reduction of grant payments due to federal liquidity problems could push the costs of Housing programs onto the City until liquidity is restored. Cuts to housing-related federal grant expenditures after September 30 as part of a deficit-reduction deal would require the City to make cuts to some programs or find alternative funding for them. The table below shows the Office of Housing programs that may be directly affected by federal liquidity problems or budget cuts. If the federal government does cut CDBG or HOME funding, the City can quickly slow down CDBG and HOME spending.

Program	Purpose
Home Rehabilitation Loan Program	To improve the quality of homes owned by low- and moderate-income City residents
Rental Accessibility Modification Program	To assist low- and moderate income tenants with physical disabilities in completing accessibility modifications to their residences
Homeownership Assistance	To provide affordable homeownership opportunities for lower-income homebuyers
Moderate Income Homeownership	To provide affordable homeownership opportunities for moderate-income homebuyers
Microenterprise Loan	To support the development of micro-enterprises in Alexandria
Fair Housing Testing	To identify discriminatory practices in the Alexandria housing market and promote compliance with fair housing laws
Housing Opportunities Fund	To provide project financing to support the development and preservation of affordable rental and sales housing in the City

The Fire Department has budgeted $0.8 million of the Staffing for Adequate Fire and Emergency Response (SAFER) grant for FY 2012. This amounts to an insignificant portion (2.1 percent) of the total Fire budget of $38.6 million. This grant allowed the City to create and fill 12 new Firefighter / Medic positions and covers the new recruits' full salary and basic benefits for two years. If the federal government stopped payment due to liquidity issues lasting past September 30, the City could face higher personnel costs for the Fire Department until liquidity issues are resolved. The City would be reimbursed once the federal government resumed grant payments.

School Federal Grant Revenues

In FY 2012, the Alexandria City Public Schools anticipate receiving $15.5 million in federal revenues, which represent 6.7 percent of the total Schools budget. At this time, the Schools seem to be well-prepared to handle the effects of a short-term grant slowdown or stoppage; however, the effects of any long-term stoppage or substantial federal spending cuts would be significant.

The ACPS School Nutrition Program is heavily dependent on federal revenues. For FY 2012, ACPS anticipates $4.2 million in federal funding (64.1 percent of the program's revenues). The

School Nutrition Program is required to keep sufficient reserves on hand to fund three months of operations; however, the reserve is currently only built up enough to cover two months of operations. The Schools should be able to compensate, at least in the short term, for any temporary stoppage; however, any longer term liquidity issues or future cuts to this funding source as part of a deficit-reduction agreement would pose a significant challenge.

ACPS anticipates receiving another $11.3 million in other federal grants in FY 2012. These grants should be covered through September 30, 2011, so they should not be affected by liquidity issues. However, since a deficit-reduction deal may include cuts to federal education funding, after September 30, there may be some longer-term issues for school improvement efforts, Title I programs, special education programs, and other grant-dependent projects and programs.

In the event that federal budget reductions were to significantly impact ACPS operations, ACPS staff would work with the School Board and City Council to determine the appropriate budget measures for continued operations on a short and medium term basis.

CITY CREDIT RATING UNDER REVIEW: The two major ratings agencies, Moody's and Standard & Poor's (S&P), were reviewing and considering a potential downgrading of the nation's credit rating due to the current stalemate over the debt ceiling increase and deficit-reduction plans. A generally accepted debt ceiling increase and related deficit-reduction actions are likely to set aside the issue of downgrading the nation's debt. On July 19, Moody's placed the Commonwealth's credit rating under review due to the state's high number of federal employees and significant dependence on federal spending. Moody's announced on July 28 that the City, along with the other Northern Virginia jurisdictions, is on the list of 162 Aaa-rated local governments under review for possible downgrade. S&P has indicated in broad general terms that it will re-review municipal bond ratings due to the federal fiscal crisis. These rating agency actions come less than 30 days after both Moody's and S&P gave the City unequivocal, positive AAA/Aaa ratings. Even though national actions have been or will be taken in regards to the debt ceiling, the impact of federal budget reductions on local governments in the D.C. regional economy will likely remain of interest to the bond rating agencies for the next few months or longer.

City staff discussed the screening and review processes with Moody's on July 29. In preparing its watch list, Moody's screened Aaa-rated local governments' economic sensitivity to federal action (i.e. level of federal employment, level of federal contracting, etc.), dependence on transfers from the federal government, access to capital markets, and available resources. Based on these factors, all Northern Virginia Aaa-rated jurisdictions were placed on the list. Moody's has stated that, once the outcomes of the federal debt ceiling and deficit-reduction deliberations are known, it will review each jurisdiction individually, considering each jurisdiction's financial relationship with the federal government as it relates to both the federal government's credit rating and the long-term impacts of potential federal budget cuts. They will also review each jurisdiction's long-term economic and financial plans. City and AEDP staff are beginning to pull together information on the federal government's impact on the City's economy and other factors that will help the City in its efforts to defend its AAA/Aaa bond ratings. City staff will also be in contact with our AAA/Aaa regional counterparts, who are facing the same ratings review issue. It should be noted that while the City has over 20,000 federal jobs in the City and is gaining another 6,400 over the next year, the nature of those federal jobs will help temper the impact on the City. Also, the U.S. Patent and Trademark Office with its over 8,000 employees is indirectly fee financed and may increase in size via fee funding because of the patent application backlog.

Since the City's economy is materially linked to federal expenditures, which the rating agencies have always considered a strength, there is significant cause for concern. Despite the City's strong overall financial and economic profiles and history of fiscal stability and responsibility, the City's credit rating may be more vulnerable than it would be based solely on the City's overall economic performance and financial management practices. The worst-case scenario is that the City's rating will be changed to match that of the federal government, which could mean either a lower rating, such as Aa1, or the maintenance of our current Aaa rating but with a "negative outlook" qualification, which would replace our current designation by Moody's of having a "stable outlook" qualification. In a phone call with staff, Moody's indicated that the City can expect a resolution to its credit rating review within 90 days of the original announcement, which would place the deadline for resolution no later than October 26. However, Moody's anticipates that the review process may be completed prior to that date. Staff will continue to update City Council as the process goes forth.

Since the City has no plans to issue bonds until next summer, there will be no immediate effect on City borrowing costs even in the event of a downgrade; however, a downgrade of the City's credit rating would increase the City's future borrowing costs.

Day-to-Day Cash Investments

Separate from any potential downgrading of the City's rating, the City could be directly affected through possible losses on City day-to-day cash investments. However, at this time, it appears that the City's investments in Certificates of Deposit and the Local Government Investment Pool (LGIP) are safe unless there is a significant ongoing default on the part of the U.S. government, which now appears highly unlikely.

The City's investments in Certificates of Deposit should not be affected by a failure to raise the debt ceiling since the funds placed through the Certificates of Deposit Account Registry Service deposited in FDIC-insured depository institutions and allocated to multiple institutions in amounts that do not exceed $250,000 per institution. Since the FDIC's Deposit Insurance Fund is funded by premiums paid by depository institutions, it should remain able to pay insurance claims despite any failure to raise the debt ceiling.

The Commonwealth's Department of the Treasury has stated that it does not envision the LGIP being affected since the short-term rating of U.S. Treasury securities will continue to be Aa1 even if the long-term rating is lowered. If the U.S. Treasury did not make penalty and interest payments for a period of time, the LGIP would continue to have sufficient liquidity.

City Pension Fund Investments

There are two areas to be considered with regard to the impact of a possible default on the City's pension plans: 1) the performance of the pension funds' business functions; and 2) the pension funds' investment values. At this time, there is little reason for concern regarding business functions; however, there is greater but still moderate concern over investment values. It is important to note that the consequences of any investment losses will not be felt for perhaps a year or two, giving the City significant time to prepare for and address any issues.

The City's pension plans should have no problems with bill paying and benefit payments through FY 2012. Even if there is a crisis, the pension plans' business functions should not be affected until at least July 1, 2012. If the plans suffer investment losses related to a downgrade, the City may have to consider raising employer, employee, or both employer and employee contribution rates during FY 2013 budget deliberations.

The City's pension plans have both short-term and long-term investments and hold both fixed income and equity investments. PIMCO, which handles all of the City's fixed income available for investment, approximately 20 percent of the City's portfolio, currently has no holdings in Treasuries and 29 percent of holdings in cash and equivalents. This seems to indicate that PIMCO is ready to handle any federal liquidity problem and that there is little reason for concern over fixed income investments.

The City's equity investments give more cause for concern over the long term. If the outcome of the debt ceiling and deficit-reduction impasses is recessionary or causes a fall in the value of the dollar, then stocks will decline and domestic equity investments will be harmed. As far as international equity investments, a recessionary outcome would cause a decline in international stocks, but a fall in the dollar's value causes the value of international investments to increase relative to the dollar.

Since the real estate market is moved in large part by interest rates and capitalization rates, trouble in obtaining loans due to availability or terms may cause real estate values to fall (or not to increase as much as the market may be otherwise increasing); however, this market change would not be immediate. To some degree, if U.S Treasuries lose some of their gilt-edged investment appeal, then commercial real estate may be viewed as a safer investment class than it is now viewed.

CONCLUSIONS: The City can expect both short-term and long-term direct effects from any federal liquidity problems or budget cuts, especially if either leads to a downgrading of the national and/or City credit ratings. Short-term effects can be expected to be moderate since much of the federal grant funding upon which the City depends can be expected to carry through to the end of the federal fiscal year on September 30 and short-term effects on investments are expected to be limited. Long-term effects, particularly on the budget, could be more material, but the City should have time to prepare for and begin to address these issues before any significant crisis develops.

Staff has begun reviewing the indirect effects (such as tax collection decreases or changes in real estate assessments) that either federal liquidity problems or budget cuts may have on the City economy, budget, and financial condition, as well as which steps can be taken to address any issues that may arise. Staff will also be monitoring City economic indicators for any and all signs of problems so that they can be addressed promptly and effectively. City Council will be updated soon with a separate memorandum on the potential indirect impacts to the local economy. Finally, staff has begun and will continue to prepare a defense of the City's current top bond ratings.

CC: Department Heads and Constitutional Officers
Chair and Members, Budget and Fiscal Affairs Advisory Commission
Laura Triggs, Acting CFO
Mark Jinks, Deputy City Manager
Melinda Barton, Public Information Specialist, Finance Department