DAVENPORT
PUBLIC FINANCE

Davenport Public Finance

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To: Glen T. Adams, Interim Town Manager, *Town of Purcellville, Virginia*
Elizabeth B. Krens, Director of Finance, *Town of Purcellville, Virginia*

CC: Town Council, *Town of Purcellville, Virginia*

From: David P. Rose, Senior Vice President and Manager of Public Finance, *Davenport & Company LLC*
Kyle A. Laux, Senior Vice President, *Davenport & Company LLC*

Date: May 22, 2023

Subject: Potential Policy Regarding Use of Meals Tax to Support Water & Sewer Utility Enterprise Funds

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Background

Davenport & Company LLC ("Davenport"), in our capacity as Financial Advisor to the Town of Purcellville (the "Town"), was asked to comment on the use of revenue from the Town's Meals Tax (which is a revenue of the General Fund) to help support the Town's Water and Sewer Utility Enterprise Funds. Davenport understands that the Town is in the midst of finalizing its FY2024 Budget for the General Fund and Water & Sewer Utility Enterprise Funds.

Rationale for our Recommendation

It is a recognized "best practice" and industry norm for well run Water & Sewer Utility Enterprise Funds to be fully self-supporting and not reliant on recurring annual financial assistance from the General Fund. In practice, this means that expenditures of the Town's Water & Sewer Funds (whether operating, capital, or debt service) are paid for by revenues derived from the Water & Sewer Funds. This concept is a critical factor in the Town's very strong credit ratings and has been cited by the National Credit Rating Agencies in their written reports (see May 1, 2023 Davenport presentation to Town Council – included as an appendix).

The Town's Water & Sewer Funds have historically adhered to this "self-supporting" concept, but has at times relied heavily on reserves and debt refunding/restructuring to maintain it. Currently, the Town is facing a situation where recurring revenues are not sufficient to cover recurring expenditures resulting in a "structural imbalance." This means that the Town will need to identify ways to regain structural balance or put at risk the Town's Credit Ratings and potentially the financial health of the General Fund. In recent years, numerous concepts/strategies have been identified to allow the Town to regain structural balance in the Water & Sewer Funds. One of these is to use a portion of the revenues from the General Fund Meals Tax to help support the recurring annual expenditure obligations of the Water & Sewer Funds.

Observations

1. Meals Tax is a revenue of the General Fund and thus its use to help support the Water & Sewer Funds will not be in-line with industry norms for highly rated local governments – especially those in Virginia;

2. As Davenport understand it, using Meals Tax to support the Water & Sewer Funds is likely an allowable strategy from a legal and accounting perspective, but will defer to the Town's experts in those areas on the specifics thereof;

3. From a financial management stand-point, using Meals Tax to help support the Water & Sewer Funds will take revenue from the General Fund that is currently being used to support General Fund operations. Thus, any discussion or analysis of this strategy would necessarily have to include a corresponding analysis on the impact to the General Fund and its recurring expenditure needs. The Town should not move forward with a strategy to fix a budget gap in the Water & Sewer Funds by creating one in the General Fund;

4. From a Credit Rating stand-point, it is reasonable to assume that such a strategy will put downward pressure on the Town's Credit Ratings. Whether or not such a strategy would result in a downgrade of the Town's Credit Ratings will depend on a variety of factors including (but not limited to) the Town's ability to demonstrate a methodical and holistic strategy that will result in both the Water & Sewer Funds and the General Fund being able to demonstrate financial sustainability (i.e. "structural balance") over multiple years; and

5. Based on analysis provided by the Town's Utility Rate Consultant (Stantec), it is not reasonable to assume that the Town's Meals Tax alone can bring the Water & Sewer Funds into "structural balance". Thus, raising revenue from the Water & Sewer Funds (i.e. increasing Water and Sewer User Rates) should be the primary source of recurring revenue with other potential revenues (i.e. Meals Tax) as secondary revenues sources.

Next Steps

If the Town wishes to pursue a study of this strategy, Davenport recommends the following:

1. Adopt the FY2024 budget with User Rate Increases as calculated by Stantec;
2. After budget adoption (i.e. late Spring/Summer), senior Town Staff along with Stantec and Davenport to perform an analysis of the impact to the General Fund and Water & Sewer Funds of using the Meals Tax - in concert with other revenue sources from the Water & Sewer Funds – to help support the Water & Sewer Funds; and
3. The results of the analysis would be presented to the Town Council in the Fall of 2023 to allow Town Council to consider its options and impacts at roughly the halfway point of FY2024 and in advance of the FY2025 budget process.

Appendix

Davenport & Company

Town of Purcellville, Virginia

Credit Rating Briefing

May 1, 2023

Davenport's Role as Financial Advisor to Purcellville

- Davenport & Company LLC ("Davenport") serves as Financial Advisor to the Town of Purcellville (the "Town"). In our capacity as Financial Advisor, Davenport:
  - Reports to the Town Council and Town Manager;
  - Complements Town Staff with annual Budgetary, Capital, and general Financial Planning; and
  - Interacts with Lending Institutions and the National Credit Rating Agencies on behalf of the Town.
- Part of our role as Financial Advisor is to periodically educate the Council on a variety of financial related topics which impact the Town (i.e. overall financial standing, market / interest rate trends, rating agency updates, amongst others).

- **At the request of the Town, the materials herein are meant to provide a briefing on the Town's of Credit Ratings, review the most recent Rating Agency commentary, and discuss the Key Drivers of Credit Ratings.**

Why Credit Ratings Matter

- The Town's existing Credit Ratings from the National Credit Rating Agencies provide the Town the following benefits:
  - Credit Ratings act as barometers of the financial and economic health of the Town;
  - Potential Town investors look to Credit Ratings/Credit quality as key determinants in decisions as to whether to invest/lend and how to price the investment;
  - Strong Credit Ratings increase the universe of potential investors for the Town; and
  - Strong Credit Ratings maximize the Town's ability to refinance/restructure for interest rate savings or cash-flow purposes.

Credit Rating Scale

- The Town obtained initial credit ratings in Fall 2013 from the three National Credit Rating Agencies.
- The Town received a rating upgrade from Fitch in 2019.

Current Town Ratings

Initial Town Ratings

	Moody's	S&P	Fitch	
Top Tier "Highest Possible Rating"	Aaa	AAA	AAA	
2nd Tier "Very Strong"	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-	(Highest) (Middle) (Lowest)
3rd Tier "Strong"	A1 A2 A3	A+ A A-	A+ A A-	(Highest) (Middle) (Lowest)
4th Tier "Adequate Capacity to Repay"	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-	(Highest) (Middle) (Lowest)
5th – 10th Tiers "Below Investment Grade"	BB, B, CCC, CC, C, D			

Considered Investment Grade

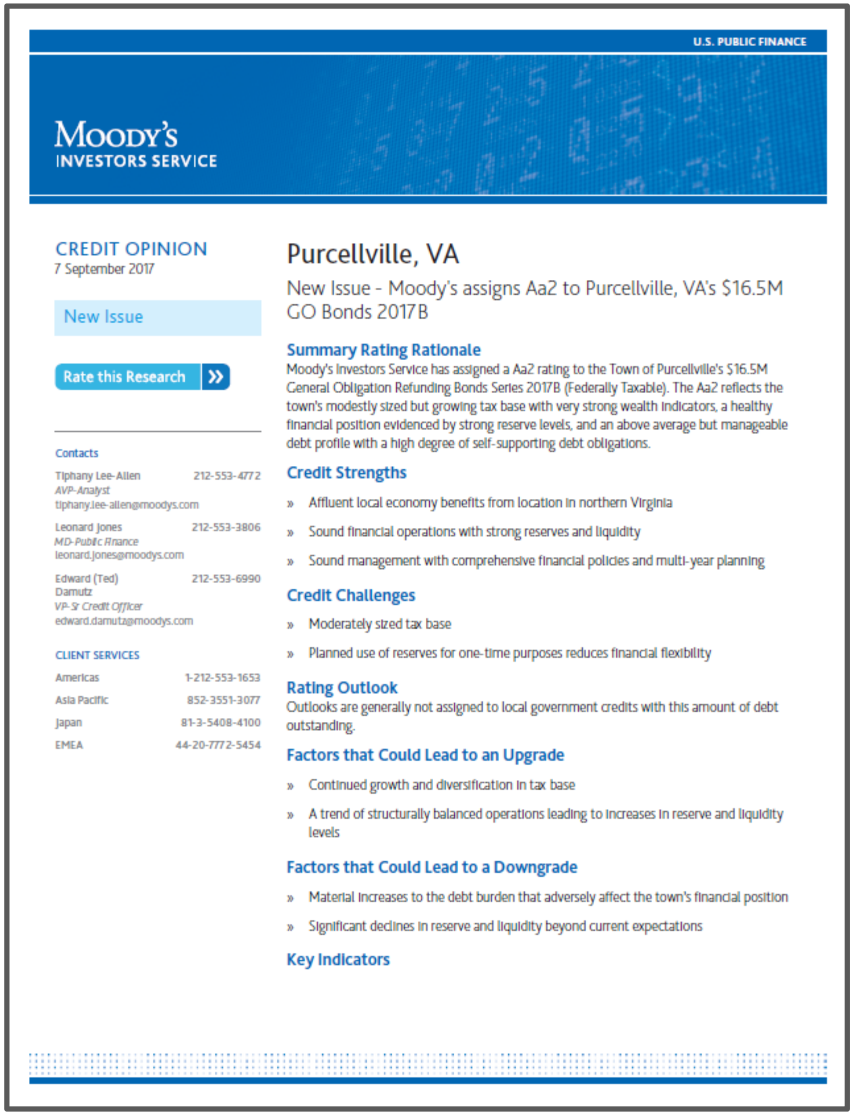
Below Investment Grade

Rating Agency Commentary

Moody's Credit Opinion – September 7, 2017

Town of Purcellville Virginia

Rating Report and Scale


U.S. PUBLIC FINANCE

MOODY'S INVESTORS SERVICE

CREDIT OPINION
7 September 2017

New Issue

Rate this Research

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Purcellville, VA

New Issue - Moody's assigns Aa2 to Purcellville, VA's $16.5M GO Bonds 2017B

Summary Rating Rationale

Moody's Investors Service has assigned a Aa2 rating to the Town of Purcellville's $16.5M General Obligation Refunding Bonds Series 2017B (Federally Taxable). The Aa2 reflects the town's modestly sized but growing tax base with very strong wealth indicators, a healthy financial position evidenced by strong reserve levels, and an above average but manageable debt profile with a high degree of self-supporting debt obligations.

Credit Strengths

» Affluent local economy benefits from location in northern Virginia

» Sound financial operations with strong reserves and liquidity

» Sound management with comprehensive financial policies and multi-year planning

Credit Challenges

» Moderately sized tax base

» Planned use of reserves for one-time purposes reduces financial flexibility

Rating Outlook

Outlooks are generally not assigned to local government credits with this amount of debt outstanding.

Factors that Could Lead to an Upgrade

» Continued growth and diversification in tax base

» A trend of structurally balanced operations leading to increases in reserve and liquidity levels

Factors that Could Lead to a Downgrade

» Material increases to the debt burden that adversely affect the town's financial position

» Significant declines in reserve and liquidity beyond current expectations

Key Indicators

Rating Overview

- Credit Strengths
  - Affluent local economy;
  - Sound financial operations with strong reserves and liquidity; and
  - Sound management with comprehensive financial policies.
- Credit Challenges
  - Moderately sized tax base.
- What Could Make the Rating Go Up
  - Continued growth and diversification in tax base; and
  - Trend of structurally balanced operations.
- What Could Make the Rating Go Down
  - Significant declines in liquidity and reserve levels.

Moody's Rating Agency Criteria

Methodology Update

- On November 2, 2022, Moody's updated its US Local Governments General Obligation Debt methodology and assumptions. Under the new methodology, an initial indicative rating is calculated from a weighted average of four key factors. Below the line qualitative adjustments can be made after the initial indicative rating.
- The Town's 'Aa2' rating was affirmed as part of this update process.

Previous Scorecard		New Scorecard		Difference
1. Economy		1. Economy		
Full Value	10%	Resident Income	10%	
Full Value Per Capita	10%	Full Value Per Capita	10%	
Median Family Income	10%	Economic Growth	10%	
Subtotal	30%	Subtotal	30%	0%
2. Finances		2. Financial Performance		
Fund Balance % of Revenue	10%	Available Fund Balance Ratio	20%	
5-Yr $ Change Fund Balance % of Rev.	5%	Liquidity Ratio	10%	
Cash Balance as a % of Revenue	10%	(All Governmental and Enterprise Funds)		
5-Yr $ Change Cash Balance % of Rev.	5%			
Subtotal	30%	Subtotal	$\boxed{30\%}$	0%
3. Management		3. Institutional Framework		
Institutional Framework	10%	Institutional Framework	10%	
5-Yr Avg. (Operating Rev./Operating Exp.)	10%			
Subtotal	20%	Subtotal	10%	-10% ⬇
4. Debt/Pensions		4. Leverage		
Net Direct Debt/Full Value	5%	Long-term Liabilities Ratio	20%	
Net Direct Debt/Operating Rev.	5%	Fixed-Costs Ratio	10%	
3-Yr Avg. ANPL/Full Value	5%	(All Governmental and Enterprise Funds)		
3-Yr Avg. ANPL/Operating Rev.	5%			
Subtotal	20%	Subtotal	$\boxed{30\%}$	10% ⬆
Grand Total	100%	Grand Total	100%	

Notes
- Moody's Methodology published 11/02/22.

Rating Agency Commentary
S&P Summary Analysis – September 11, 2017

- "S&P Global Ratings assigned its 'AAA' rating, and stable outlook, to the Town of Purcellville, Va.

- The GO rating reflects our opinion of the following factors for the Town:

  - Very strong economy, with access to the broad and diverse Washington-Arlington-Alexandria metropolitan statistical area (MSA);
  - Very strong management, with strong financial policies and practices under our financial management assessment (FMA) methodology;
  - Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2016;
  - Very strong budgetary flexibility, with an available fund balance in fiscal 2016 of 61% of operating expenditures, including a relatively small portion of committed reserves that we understand could be reclassified with council approval;
  - Very strong liquidity, with total government available cash at 118.7% of total governmental fund expenditures and 9.0x governmental debt service;
  - Very weak debt and contingent liability position, with debt service carrying charges at 13.2% of expenditures and net direct debt that is 191.2% of total governmental fund revenue; and
  - Very strong institutional framework score."

S&P Rating Agency Criteria

- Standard & Poor's US Local Government General Obligation Ratings methodology is shown below.
- An initial indicative rating is calculated from a weighted average of seven key factors:

	US Local Governments General Obligation Ratings Methodology	
1	Institutional Framework	10%
	Legal and practical environment in which the local gov't operates	
2	Economy	30%
	Total Market Value Per Capita	
	Projected per capita effective buying income as a % of US projected effective buying income	
3	Management	20%
	Impact of management conditions on the likelihood of repayment	
4	Budgetary Flexibility	10%
	Available Fund Balance as a % of Expenditures	
5	Budgetary Performance	10%
	Total Government Funds Net Result (%)	
	General Fund Net Revenue	
6	Liquidity	10%
	Total Gov't Available Cash as a % of Total Gov't Funds Debt Service	
	Total Gov't Cash as a % of Total Gov't Funds Expenditures	
7	Debt and Contingent Liabilities	10%
	Net Direct Debt as a % of Total Governmental Funds Revenue	
	Total Governmental Funds Debt Service as a % of Total Governmental Funds Expenditures	

Notes
- Rating Agency Criteria from Standard & Poor's.

Rating Agency Commentary

Fitch Rating Action Commentary – December 11, 2019

- "Fitch has upgraded the town's Issuer Default Rating (IDR) to 'AA+' from 'AA'.

- Key Rating Drivers:
  - Revenue Framework: 'aaa'
    - General fund revenues increased in line with national economic expansion over the past decade, after adjusting for tax policy action.
  - Expenditure Framework: 'aa'
    - Fixed carrying costs are moderate at an adjusted 18% of governmental spending in fiscal 2018.
  - Long-Term Liability Burden: 'aaa'
    - Long-term liabilities are low at 9% of personal income. Personal income metrics benefit from residents' access to the very strong regional economy.
  - Operating Performance: 'aaa'
    - The town's superior budget flexibility and ample general fund balance position it to comfortably manage through economic downturns without diminishing overall financial flexibility.

- Rating Sensitivities:
    - A change in the established practice of self-support for utility system debt service that required general fund support would weaken the long-term liability assessment and could put downward pressure on the rating."

Fitch Rating Agency Criteria

- Fitch's Key Rating Factors are shown below.
- Fitch explicitly does not weight the assessments of individual key rating factors in coming to an overall rating conclusion. There is no standard formula to link these inputs into an exact rating.

U.S. Tax-Supported Rating Criteria

1. Revenue Framework
Growth Prospects for Revenues Without Revenue-Raising Measures
Independent Legal Ability to Raise Operating Revenues Without External Approval
2. Expenditure Framework
Natural Pace of Spending Growth Relative to Expected Revenue Growth
Flexibility of Main Expenditure Items
3. Long-Term Liability Burden
Combined Burden of Debt and Unfunded Pension Liabilities in Relation to Resource Base
4. Operating Performance
Financial Resilience Through Downturns
Budget Management at Times of Economic Recovery

Notes
- Rating Agency Criteria from Fitch.
Additional Considerations:
- In cases where an entity relies heavily on third-party funding (e.g. from a higher level of government) in support of core functions that likely would continue at the same level even without the external support, an evaluation of the associated risk informs the assessment.
- The analysis of an issuer's expenditure framework also considers potential funding pressures, including outstanding or pending litigation, internal service fund liabilities and contingent obligations.
- The liability burden assessment could be negatively affected by high levels of derivatives exposure, short-term debt, variable-rate debt or bullet maturity debt or an exceptionally large OPEB liability without the ability or willingness to make changes to benefits. An exceptionally large accounts payable backlog can also negatively affect the long-term liability burden assessment.
- The operating performance assessment could be negatively affected by liquidity or market access concerns (in general, liquidity becomes a concern if the government-wide days cash on hand metric has or is expected to fall below 60 days); the risk of an outside party (e.g. another level of government) having a negative impact on operations; evidence of an exceptional degree of taxpayer dissatisfaction, particularly in environments with easy access to the voter-initiative process; or management weaknesses not captured above.

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