THE COMMISSIONERS OF LEONARDTOWN

DEBT AFFORDABILITY REPORT

WWTP ENR UPGRADE

DATED MARCH 4, 2015

This debt affordability report has been prepared in accordance with The Commissioners of Leonardtown's Debt Management Policy adopted on February 8, 2010.

SUMMARY

In December of 2003, The Town of Leonardtown completed the state mandated Biological Nutrient Removal (BNR) process upgrade to its wastewater treatment plant. In May of 2004, the Governor signed new legislation creating the Bay Restoration Fund. This fund was to be utilized to finance Enhanced Nutrient Removal (ENR) upgrades to 67 of the state's largest wastewater treatment plants. The fund is capitalized by receipts of Bay Restoration Fees paid by customers of those wastewater treatment plants. The original fee was $2.50 per month; raised to $5.00 per month on July 1, 2012.

In May of 2005, the Town began working with its engineer to comply with the ENR mandate. Original plans included an expansion of the treatment capacity to handle the anticipated explosion of growth from three new residential developments. Study and design proceeded through early 2008. As the nation started to feel the effects of the housing bubble and credit crisis, it became evident that growth in Leonardtown was not going to occur at the previously anticipated pace. A stable source of revenue was not available to fund a project of this magnitude; therefore, the project design was halted. Representatives from the Town and engineering firm attended a meeting with many representatives from the Maryland Department of the Environment. They approved a delay.

After countless meetings and design adjustments, the Town is now close to awarding a construction contract. Total project costs are coming into focus, so this debt affordability report should be reviewed by Town Council prior to approval of the debt issuance that is required to fund this project.

CHOICE OF FINANCING

Since the ENR portion of the project is a state mandate, a certain amount of grant funding will be supplied by the State of Maryland. At the present time, this amount is estimated at $9,029,000. The balance of the project will be financed with a loan from the Maryland Water Quality Financing Administration (MWQFA). The financing rate available through this program is far lower than any other option. It is the same program used when the BNR upgrade was constructed.

AMOUNT OF BORROWING

The final loan application was recently submitted to the Maryland Water Quality Financing Administration. The estimated loan value is $12,539,000 and will be executed for a twenty year term. The final loan application is currently being reviewed by MWQFA and certain other departments at MDE. Until the Town receives final approval regarding the amount of grant funding that will be provided, this loan value is subject to change. If there is a significant change, a new financial analysis will be necessary to ensure debt service requirements can be met.

OUTSTANDING DEBT AND DEBT SERVICE REQUIREMENTS

The Town's outstanding debt obligations are summarized in the audited financial statements dated June 30, 2014. Since then, additional principal payments were made totaling $136,181, reducing the total current debt outstanding to $1,592,153. Of this amount, $300,390 is related to the operation of the wastewater and water systems. Although this enterprise fund debt obligation is secured by the taxing power of the town, no general fund resources are intended to be used to fund debt service for this or future enterprise fund debt obligations. All payments are made from enterprise fund sources. For the remainder of this analysis, general fund debt obligations will be ignored.

The one existing enterprise fund debt obligation of $300,390 will be fully retired in February of 2018. The annual debt service for this obligation for each of the next three fiscal years is approximately $107,000 and is well covered by the existing enterprise fund *operating* revenues. After FY18, this amount will then be available to cover part of the new debt service requirement.

It is important to note that Metcom is also a funding participant in this project since their out of town customers continue to be served by the Town's wastewater treatment plant. The verbal arrangement to date is that the Town will borrow the full principal amount, and bill Metcom for their share of each debt service payment before it becomes due. The Town is working towards a new or amended inter-jurisdictional agreement with Metcom that will address this funding component.

The *Town* share of projected debt service for the new debt issuance is an annual amount of $665,000. Based on the timing of construction, it is likely that the first principal payment will not be due until FY18, so that will be the only fiscal year where the full amount of both of these debt obligations will overlap. Until construction is complete, the Town is only required to pay the interest that accrues on the proceeds as they are drawn down. Those interest payments will first be paid out of operating revenues where available. Operating and capital reserves are available to fund any remainder as necessary.

The majority of the new debt service obligation will be funded with the sewer impact fees. An analysis reveals that the Town currently has nine years of debt service payments covered with the sewer impact fees already collected. When accounting for the remainder of new home occupancies guaranteed by Quality Built Homes and Calvert LLC, the Town has a revenue stream of impact fees adequate to pay for more than seventeen years of debt service. There is no doubt that there will continue to be development over those 17 years in an amount that will more than cover the remainder of the debt service obligation.

ECONOMIC AND DEMOGRAPHIC TRENDS

As a designated growth area for St. Mary's County, Leonardtown will likely continue as one of the fastest growing municipalities in the State of Maryland. Although many jurisdictions are still feeling the effects of the housing bubble and credit crisis, Leonardtown continues to be an attractive location for continued development, especially residential units. This has directly affected the growth of property taxes. Preliminary estimates indicate that new development will yield a 5% growth rate in this revenue source for FY16. This residential heavy development should also have a positive effect on the local income tax distribution from the State of Maryland. After experiencing a significant drop beginning in FY09, this revenue source is definitely trending upward again and should continue to do so.

Although these two revenue sources will not be utilized to pay debt service on the new debt issuance, growth also generates new customers utilizing the water and wastewater systems and paying those requisite service charges. The larger customer base serves to spread the fixed operating expenses, helping Leonardtown achieve the goal of maintaining an affordable rate structure that will continue to attract future development.

I have attached a worksheet that shows where the Town's current rates fall in relation to what the EPA considers affordable. The primary use of this guidance was to address affordability of new federal clean water mandates as they began to be issued in the 1990s. Its benchmark 2% rule is still widely used as the standard for assessing residential affordability of water and wastewater charges, and the current Town charges fall well below that.

As many years have passed since this guidance was issued, governments have questioned the guidance, arguing that median household income may not be the best indicator of community well-being and residential affordability for all segments of the community. It is likely that Leonardtown's median household income will increase above the most recent 2013 estimate of $56,667. Without further analysis, this leads one to conclude that Leonardtown has significant room to increase service charges before they would reach the 2% threshold and be considered unaffordable. Unfortunately, there will continue to be a segment of the Town's population that is underemployed and living below the poverty level. For them, the Town's current service charges may fall above the 2% threshold. Although many of these residents may live in apartments or rental homes and not be subject to paying utility bills directly, any rate increases would likely be passed along to them in the form of rent. It is important to analyze more than just median household income data whenever a rate increase is proposed. The most recent data from the U.S. Census Bureau American Fact Finder indicates that 12% of all families in Leonardtown are below the poverty level.

CURRENT AND POTENTIAL DEBT BURDEN ON RATEPAYERS

If this new debt service obligation was a part of the approved FY2015 enterprise fund budget, it would represent 23.2% of the total. This is a really big percentage and indicates the magnitude of the project. According to the Government Finance Officers Association, rating agencies tend to consider ratios in excess of 10% of the operating budget the point at which debt service begins to crowd other priorities in the budget. Another calculation that is customary in finance is the debt service coverage ratio. This calculation divides net operating income by the annual debt service expense. A ratio of 2.0 or more is considered acceptable. The higher the ratio, the higher likelihood of being able to meet the debt service requirements. Using FY14 actual results, the enterprise fund net operating income before depreciation was $492,850. The current debt service coverage ratio is 4.6. The new debt service coverage ratio would be .74. This is well below the 2.0 considered acceptable.

These ratios indicate that this new debt obligation is raising red flags and there is not enough operating revenue to support such a large issuance. Rather than increasing service charges to existing customers to generate adequate debt service coverage ratios, the Town will be utilizing accumulated and future impact fees to pay for most of the annual debt service. Were it not for the additional customers that have been connecting to the collection system, this major upgrade would not be necessary at this time. As those customers have connected and paid the requisite impact fees, those funds have been set aside for the specific purpose of upgrading the facility to accommodate them.

In reviewing the Town's current approved six year capital budget, there are no other enterprise fund projects that will require issuance of additional debt.

IMPACT OF OPERATIONS AND MAINTENANCE OF THE PROPERTY

The WWTP ENR upgrade project will have a significant effect on the physical operations and maintenance of the facility. The new process will have many more moving parts requiring manpower to operate and repair as necessary. It is likely that a new employee will be budgeted beginning July 1, 2015.

As the construction is in process, it is too hard to predict how other operating expenses will be affected. Once the new process is fully operational in FY2017, the Town should expect many of its operating expenses to rise. Although new equipment should not be subject to major repair in the first few years, other operating expenses like electricity, chemicals and sludge management will definitely increase. In anticipation of this, the last few operating budgets have included contingency funding. In the absence of needing to utilize this funding from year to year, it has served as a placeholder so the Town would be in a better position to absorb the new operating expenses without needing a significant increase in service charges. Additionally, the Town has accumulated operating reserves that could also be used to fund any significant increases in operating expenses that would not covered by the current service charges. Any necessary rate increases could be smoothed out over a period of years versus all at once.

ABILITY TO FINANCE FUTURE PROJECTS

As noted above, the Council has not approved additional enterprise fund capital projects that would require debt issuance over the next six years. That being said, as long as this debt is outstanding (20 years), it may limit the town's ability to finance future enterprise fund sewer projects with debt.

The Town continues to collect impact fees for new sewer and water connections. As noted above, the future stream of sewer impact fees at its current rate of $13,000 per edu was calculated and earmarked for retiring this new debt obligation. If future WWTP or collection system capital projects are approved that are growth related, this impact fee should be reexamined and increased as required in order to cover any new debt that would be issued.

The current water impact fee of $1,800 is being set aside for the construction of a new water tower in the future. These funds could be used either to pay the debt service on a new obligation or used as cash to forgo debt issuance.

CONCLUSION

As explained in previous sections, this debt issuance does not meet the standard affordability ratios commonly used in the government finance field. Fortunately, the Town has put itself in a position of being able to fund the debt service for this new obligation with a steady stream of impact fees that will last through the term of this loan. The burden to existing rate payers is minimized and should allow the Town to fund new operating expenses with smooth and even rate increases in future years.

This loan amount dwarfs all previous Town debt issuances. Despite the adequate resources to pay the annual debt service, it should not be taken lightly and will be on the Town's balance sheet for 20 years. Having a small customer base amongst which to spread fixed costs can easily lead to service charges that are not affordable for Town residents.

The Commissioners of Leonardtown
Analysis of service charges
3/4/2015

Traditional 2% rule as recommended by EPA

Leonardtown Median Household Income	56,667	2013 estimate from U.S. Census Bureau
	2.0%	
	1,133.34	The annual charge at which EPA would consider service charges to have a *large economic impact* on ratepayers

As billed to customers

	3/31/2014	6/30/2014	9/30/2014	12/31/2014		
Water	40,460.51	50,209.16	67,115.66	45,874.16		
Sewer	78,824.27	89,220.10	97,900.00	89,231.25		
	119,284.78	139,429.26	165,015.66	135,105.41		
Number of customers	890	902	919	937		
Average quarterly charge	134.03	154.58	179.56	144.19	612.36	**1.08% of MHI**

Minimum quarterly charge

Water	30.60	30.60	30.60	30.60		
Sewer	61.24	61.24	62.50	62.50		
	91.84	91.84	93.10	93.10	369.88	**0.65% of MHI**