



Commissioner Bill James

Mecklenburg County Government
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Name
Position
Company
Address
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Dear 'Name':

My name is Bill James and I am a member of the Mecklenburg County Board of Commissioners. I have served the people of Mecklenburg for 12 years and was recently re-elected to a seventh two-year term. I serve on and helped found Mecklenburg County's 'Audit Review Committee'. I am writing to you and your colleagues at other rating agencies because you are going to be meeting with various elected and management individuals of Mecklenburg County regarding our bond rating. My reason for writing to you is not to convince you that we are not deserving of receiving the much sought after AAA rating (or equivalent) designation, but rather to point out what I believe is a dangerous path that Mecklenburg County has pursued. A path that I believe will cause damage to Mecklenburg County's long-term financial health that I believe the ratings agencies need to be made aware of in the clearest possible terms.

My background is as a CPA. I spent roughly 10 years with Price Waterhouse in their financial services practice roaming the world working on most of the major banks of the day. Prior to that, I spent approximately five years with Arthur Andersen & Co. working on various other 80's Texas banking issues. When I left Price Waterhouse and 'big 6' accounting, I was a Senior Manager and had worked for the RTC handling various financial institution failures. What I believe Mecklenburg County is engaging in is equally risky to the taxpayers, citizens and to the holders of bonds purchased from us.

These issues of import are:

- Failure of Mecklenburg County to work or communicate regarding financial matters with Charlotte-Mecklenburg Schools or reach consensus on operating or debt limits that are reasonable and prudent.

- Failure of Mecklenburg County to follow its own debt policy and restrict spending as needed to comply with the policy.
- Manipulation of “Pay-Go” as a method of reducing debt.

These matters will be discussed on the following pages.

Failure to Communicate with CMS a debt policy: Mecklenburg County and our local school affiliate (Charlotte-Mecklenburg Schools or ‘CMS’) are both elected bodies and each body governs a budget of over \$1 billion. Approximately 1/3 of CMS’ operating budget is provided by Mecklenburg County along with all of its normal capital budget. In November 2007 voters approved a \$500 million bond package. Two prior bond packages over the past 10 years were defeated, in part, because they were seen as ineffective stewards of the public trust. The County Manager on April 4th of 2008 was facing a tough budget season and asked CMS to work with him. The answer from CMS and its Superintendent was to politely refuse to do so. When CMS requests a bond package as they did in 2007 and it passes they expect the money using a timetable and spending schedule that is dangerous to Mecklenburg County’s Financial health. In particular, they are asking for Mecklenburg County to sell on the bond market this January \$270 million in bonds for CMS alone when the amount sold for them in 2007 was \$194 million. The Board of County Commissioners for political reasons has been unable to stand up to them and County management has been unwilling to seriously stop this excess spending. The result is that debt service has been escalating at a speed that is beyond growth and beyond any normal or rational debt level.

According to CMS, they claim that they have \$2,505,226,824 (since adjusted upward to \$3.2 billion) in capital needs totaling roughly \$320 million a year for the next 10 years. In reality, the projects on this list are a combination of required spending on new needed facilities, needed renovations along with a large dose of political patronage to insure that money is allocated in way that placates political interests within the majority here locally. While that is understandable from a political perspective when times are good and money is easily accessed; it is not a sound financial plan for the upcoming 10 years when only the highest priority items should be constructed.

This 10 year capital plan of CMS which now stands at around \$3.2 billion is utterly unaffordable without massive tax increases and violations of normal and safe debt management practices. Realizing that this will ravage its current debt policy, Mecklenburg County changed that policy to mask the fact that it was out of compliance with its (our) own policy regarding debt limitation standards as I will outline.

Failure to follow a consistent debt policy: In 2003 the then Board of County Commissioners reviewed what were referred to as the 'PRAG' recommendations completed by the Public Resources Advisory Group in New York City. I believe we hired them in 2002.

In this report were various standards that were adopted by the Board in an effort to manage Mecklenburg County's debt load. While the Board adopted them, they were ignored. No effort was made by the majority to rein in spending or to insure compliance with the various limits and, as one might expect, Mecklenburg County became more and more non-compliant as the years from 2003 to the current date passed.

This past year on June 24, 2008, the County's new finance director prepared a PowerPoint presentation to the Board showing the severity of non-compliance amid concern that you and other rating agencies would react negatively if steps were not taken to correct this non-compliance. In particular the finance director cited the commentary from Moody's and Fitch to justify her changes. Her suggestions included relaxing the standards (which we could not meet anyway at that point) but also included an annual debt spending cap of \$350 million a year. She made this recommendation knowing that CMS has just passed a \$500 million G.O. initiative at the ballot box and 'wanted' another \$500 million in 2009, and succeeding \$500 million initiatives for 2011 and 2013. At the time, she acknowledged that adopting the limit would reduce the amount available to CMS and would force a slower rate of capital construction delaying the next needed bond ballot issue to 2011 or 2012.

The PRAG guidelines in 2003 originally suggested the following:

- Debt to estimated full value ratio of 3.3% to 4.0%
- Debt per capita range of \$3,500 to \$3,600
- Debt service to expenditures ratio of 14% to 16%
- Ten-year payout ratio floor of 64%
- Unreserved general fund balance 12% to 14%

Ultimately, what was adopted was close to the above draft with an overall full value ratio set at 4.0%, Debt per capita of \$3,600, debt to expenditures of 16% and a payout ratio of 64%. At the time that this was adopted S&P's standards for the 'median' were much more restrictive according to PRAG. Mecklenburg County was already exceeding these median standards for sound financial planning when the standards were adopted.

Over the intervening period from 2004 to 2008, two ratios in particular became more and more non-compliant and resulted in 'red lights' under the County's public balanced score card system of accountability.

In 2006, the minority on the Board became increasingly alarmed by the ever increasing debt policy violations. We suggested instituting limits on various types of government bonds by limiting the amount we would sell in any one year. This was discussed and defeated. During that debate it was noted that in 2006 property taxes to household income was 23% higher in Mecklenburg than in peer counties. While the S&P median overall debt per capita was \$1,707 in 2003, Mecklenburg County's was \$3,029 and rising.

As noted previously, our Finance Director presented us with a series of changes to our debt policy to force compliance. Her suggested changes as of June 2008 were:

- Amend the Debt Policy to increase Debt per capita to \$4,000 (from \$3,600)
- Increase Debt service as a percentage of the operating budget to 22% (from 16%)
- Increase and Incorporate Pay-go strategy into the County's debt Policy, and
- Cap borrowing at \$350 million per year to stay within debt ratio targets

At the time that the Finance Director made those suggested changes it was well known that adopting them would significantly reduce CMS' annual debt sales and slow construction. On page 17 of this report she indicates that the S&P 2008 Median for debt to market was 1.9% while Mecklenburg County's ratio stood at 3.36%. S&P debt per capita for AAA rated counties in 2007 was \$2,484 while ours had increased to \$3,551. With a limit of \$3,600 it was either raise the limit or become out of compliance on another PRAG recommendation.

The majority of the Commission refused to consider discussing this runaway spending with CMS and the debt policy was amended without any restrictions on borrowing per year that are needed to prevent future debt policy violations. It is, I think, reasonable to believe that the reason for adopting the standards was to avoid a tough discussion with the rating agencies about why there was no reasonable limit set on bond sales that would keep Mecklenburg County at a reasonable level. The lion's share of this was and is the increase for CMS. We sold \$194 million in bonds for CMS in 2007 however they wanted \$270 million for 2008 and even more for the subsequent years. In one year the sales of CMS bonds had jumped by an astounding 40% even though the student population estimates used by CMS were off by roughly 50% over the last two years. In each of the

last two years CMS has routinely estimated thousands of new students that have not appeared at the start of school. This student estimate is the basis for the 10 year capital plan and spending.

At the end of fiscal 2009 it is estimated that Mecklenburg County's total outstanding debt will stand at approximately \$2.5 billion and is expected to increase to \$3.3 billion by 2015. If this continues our debt per capita of \$3,768 today will increase to \$3,890 and become 19.58% of our operating budget.

Manipulation of "Pay-Go" as a method of reducing debt. A number of years ago, Mecklenburg County agreed to set aside what amounted to 2.5 cents of property tax revenue for 'Pay as you Go' funding that would construct projects without issuing bonds. In the last 5 years however the majority has raided Pay-Go to fill operating budget gaps. In one case, taxes were:

- raised in one year,
- only to be spent on non Pay-Go items the following year,
- leading to a second tax increase (for the same Pay-Go funds) in the third year.

Requests from the minority to segregate Pay-Go and to place it in a restricted reserve as the City of Charlotte has done has fallen on deaf ears. The City of Charlotte uses a 'bucket' model that takes a dedicated tax rate and places all debt service inside it. As capacity is released because of growth revenue or retirement of debt, more bonds are issued. The amount of bonds that can be issued however is limited to the availability (capacity) of the fund. If the fund becomes unable to complete needed projects, the City Council of Charlotte votes on an increase in taxes to increase the size of the 'bucket' when the budget is adopted in June. Mecklenburg County has no such control and therefore there is no real governor on bond spending except the common sense of the elected officials which evidence shows can't withstand the public pressure of voting 'against the children'.

The manipulation of Pay-Go over the years has needlessly increased the tax rate but has also increased debt and contributed to the non-compliance noted in the previous section.

Summary: While I understand that many of these bond rating agency discussions are perfunctory and ratings are decided for non-financial reasons. I firmly believe that Mecklenburg County's inability to manage its debt and to carry on intelligent conversations about annual debt limits will damage its ability to operate over the next 10 years.

As everyone is aware, the current financial meltdown regarding government bonds has created a situation where the rates to be paid on bonds will likely be almost 30% more than the previous year. Mecklenburg County has a significant amount of variable rate debt (about 35% compared to the NC local government sound practices estimate of 10%). Mecklenburg County's reliance on variable rate debt means that there will be significant interest rate risk on the bond portfolio and significant increases in the cost of debt service making the lack of any meaningful limit or conversation with CMS even more crucial.

Since I care for Mecklenburg County and don't want it to become another Orange County, Newark or New York City I concluded that contacting the rating agency representatives directly was necessary. The political climate in Charlotte is such that no change of this nature will occur on its own. Failure to control this tsunami of debt will damage the County's long-term credit abilities.

Regards,

Commissioner Bill James (R, District 6)

