Response to Finance Committee Areas of Concern

February 2, 2010

Following is a response to a memo submitted by the Finance Committee to the Community Preservation Committee on January 25, 2010. Text from the original memo appears as plain, black text. A response prepared by Town staff appears in grey boxes.

Factors to Consider
Areas of Concern to the Finance Committee
As of January 25, 2010

1. FinCom has not yet reviewed in committee the details of the GLC report, nor have we yet had the opportunity to discuss the report with George Cole, the Town Administrator, nor the Board of Selectmen. We expect Mr. Cole to be present at our February 10th meeting.

2. FinCom has not yet reviewed in committee the projected revenues and available funds for CPA financing options prepared by Town Accountant Wendy Nightingale. This analysis was first presented to the Board of Selectmen January 11th. We will likely discuss this analysis at our February 10th meeting.

3. We have significant concerns and open questions regarding debt being issued by the Town to support the CPA.

   a. We question the legality of debt issuance from the CPA fund given certain sections of the State law. If debt issuance is a serious consideration (while holding significant CPA cash reserves) to fund the Shovel Works proposal (or any other proposal for that matter), FinCom believes that interpretation of State law is needed from the Attorney General.

Response:

According to the Massachusetts Department of Revenue (DOR), "We see nothing in this section that would prohibit the town, upon recommendation of the CPC, from borrowing for a permissible CPA project in anticipation of future CPA revenues, even though the town may have significant funds currently available to cover all or a portion of the costs of the project. The CPC may have other uses for the reserved funds planned, or wish to keep the reserve available for future opportunities…"

Municipalities routinely issue bonds for allowable purposes, in accordance with the requirements of Bond Counsel. According to Easton's Bond Counsel, Maureen C. Sullivan of Edwards Angell Palmer & Dodge LLP, the Town may borrow for the acquisition of a historic preservation restriction for a term of 20 years pursuant to G.L. c. 44 s 7(3) or G.L. c.44B s 11.

   b. The ability to pay long-term debt service from CPA funds appears questionable, due to:

i. Most of the Town Accountant's debt service scenarios indicate that in many years cash outflow will exceed cash inflow, especially considering that 30% of inflows must be set-aside in specific reserve funds.

Response:

The CPA fund currently has a $9M+ balance, so that although in some years payments may exceed revenues, the long term debt service payments will never exceed the amount available in any given year. The Town Accountant's analysis shows that surpluses in the account will continue to accumulated to an expected $16M (in the worst case scenario) by the time all debt is paid.

It is also important to note that the Town Accountant's projections are **very** conservative, and have excluded all interest income and State matching funds after 2011, important revenue sources that have contributed approximately 40% of the funds' current balance.

Finally, it is inaccurate to say that 30% of revenues must be placed in reserve accounts. The Community Preservation Act requires that *either* 10% of revenue each year must be spent on projects in each of the three main project areas *or* that the same amount must be reserved for that purpose at a later date. The project proposal assumes that the minimum historic preservation expenditure (10% each year)will be spent on debt service to pay for the historic preservation easement and not reserved.

ii. This inability to service debt would be exacerbated in a rising interest rate environment, as well as in the likely ongoing environment we've already experienced of lower and lower State match. (We believe State match should not even be considered in assessing CPA fund ability to service debt or its future levels of reserves.)

Response:

The Town Accountant has taken into account the potential for rising interest rates by calculating the various borrowing at rates ranging from 5 to 6%. Current bonds are issued at approximately 4%. Bonds would be issued at a fixed rate for 20 years in the next year, which would insulate them from a rising rate environment after they are issued. In an effort to be as conservative as possible, the state match was not considered when the analysis of CPA funds was conducted.

iii. Any shortfall or inability whatsoever of the CPA fund to service debt would fall to the general town government. If general tax revenues were ever needed to cover CPA debt funding, that would take away from operating expenses, including safety and school departments.

Response:

The analysis performed by the Town Accountant shows that, even under the most conservative projections, no shortfall would occur. This takes into account meeting all current obligations of the fund,

the purchase of the three priority parcels, and fully funding the Shovel Shops proposal. In fact, significant surpluses would be available to fund other needs as they arise in the future.

c. Issuing debt from the CPA fund, especially for significant amounts and long-term financing, potentially takes away an inherent right of the taxpayer to eliminate the CPA tax in the future.

Response:

The taxpayers *also* have a right to encumber debt to fund projects that are of value to the Town, which can be exercised by obtaining a two-thirds vote of the Town Meeting.

Furthermore, financial projections can only be made based on the current reality in the community. For example, the taxpayers also have the right to vote on an "underride" of Proposition 2½ to decrease the tax levy in any given community. The Town and bond counsel do not consider these scenarios when preparing long goals or projections, or when issuing debt.

d. The Town's borrowing for non-core needs could negatively impact our debt rating, which would then result in higher borrowing costs and more burdens on the taxpayer.

Response:

This bond issuance would also have a separate and distinct bonding source (CPA funds), which will not impact our bond rating. Bond rating agencies, such as Moody's, take into consideration the funding source for debt repayment when rating bonds. The significant amount of borrowing for the recent school construction project, for example, did not negatively impact our bond rating, as the debt- exclusion override provided a secure funding source. In addition, there is no legal meaning attached to the phrase "non-core needs." A borrowing is either authorized by the statute or not. There is no hierarchy of need recognized by the law or the rating agencies.

4. Risk of loaning $4.5 million to the developer –We believe that the debt structure of the proposal carries extremely high risk that would be unacceptable to any bank yet we are potentially asking Easton residents to accept this risk.

a. Risk of default and the true costs of this loan are serious considerations in assessing this proposal.

Response:

The Town is investing $4.5M of its available CPA funds in the form of a second mortgage on the property. Any loan carries with it a certain amount of risk; however, the Town will make every effort to mitigate that risk through the structure of the loan.

First, the total cost of the project is estimated at $46.9 million dollars. **Over half of that money will come from Federal and State Historic Tax Credits and other affordable housing subsidies.** Because of the large amount of tax credits and subsidies, the developer will have to borrow less than half the total

amount needed to complete the project. Of the overall development cost of $46.9 million, the projected first mortgage debt is $17.1 million, or about 36% loan to costs. With the Town's second mortgage loan of $4.5 million, the overall debt totals $21.6 million, or about 46% loan to costs.

Second, there will insurance on the project in the form of a construction bond, to insure completion of construction. This means that **even if the owner becomes insolvent during construction, the project will be completed**. After construction, the property will be worth significantly more than it is now, thus building in protection for the Town's investment. At a minimum, the Town would have a historic preservation restriction, protecting the property forever, and a finished project, enhancing our downtown. This is the worst case scenario. (This actually occurred during the high school construction project, and the bond insurance allowed the town to quickly hire a new contractor at no additional cost.)

Third, the loan will be placed in escrow when all other financing is in place. Distribution will take place on a schedule that will be negotiated to protect the Town. The Town would require the developer to be subject to financial review at several points throughout the process, and release money from escrow as appropriate. The developer will also face the scrutiny and vetting of the first mortgage lender, which, in the current economic environment, has significantly increased.

If there was a default on the loan, it would occur after the completion of the project. This is a risk, but the Town's $4.5M investment is further protected by the self-interest of the developer. In the structuring of the transaction, the ability of the developer to reap significant financial returns from the development is tied to the repayment of the Town's funds. If the Town is not fully repaid, then the developer's returns are capped and relatively small, essentially equal to their fee and investment of time and money. Finally, the track record of the developer, Beacon Communities, is excellent relative to the repayment of development debt.

b. Source of repayment is the sale of assets, which are clearly not guaranteed let alone guaranteed for any minimum amount that is needed to assure the taxpayers we will be repaid.

i. Exacerbating the potential sale of assets is the worse national and local economic environment and real estate market seen in most people's lifetime. Assuming this market will significantly improve in 5 to 7 years is a deep concern when considering the risk to the Easton taxpayer of potentially losing $4.5 million of their tax dollars.

Response:

The assumptions used to project the sale price of the assets (the units), were very conservative.

c. Easton stands fourth in line in the repayment of the developer's debt, including behind first and second mortgages, as well as behind the developer's fees and profits.

Response:

Under the most recent agreement, payment of the loan begins in year one with a sharing of rental income. Under the most recent proposal, the Town is the second mortgage holder. It is important to note that the developer's ability to make a profit is linked to the repayment of the loan to the Town. If the Town is not fully repaid, then the developer's returns are capped and relatively small, essentially equal to their fee and investment of time and money. This links developer's profit potential with the repayment of the Town's funds.

d. The developer's ability to pay all their debt service is not only contingent upon the sale of condominiums at certain minimum prices, but also on their ability to profitability manage historical and affordable housing tax credits in this environment which is unlikely to change in the near term.

Response:

The developer has a long- standing and unblemished history of doing just that. Beacon's ability to procure and sell the Tax Credits will be necessary for the development to proceed, and the Town's investment would be conditioned on their success in doing so.

5. The current and future costs to Easton residents of the Shovel Shop proposal and its currently recommended funding are incredibly high and we are concerned that not all aspects of these costs are being sufficient considered.

a. The overall $9 million price tag of core costs, which does not include all true costs

b. Opportunity costs –we believe that many current and potential future projects that could be funded with CPA funds will not be able to be funded given the cost of this one project (lost opportunity for alternative uses of CPA funds).

i. This point is a higher concern without debt financing (see points above regarding debt financing concerns)

Response:

The analysis conducted by the Town Accountant shows that the highest priority goals of the CPA committee could be achieved, with significant room for other, smaller project, whether or not debt is issued for this project.

c. Holding the tax rate on the property for five years is an incremental cost

d. Potentially paying out 5% to carry debt, yet receiving only 3% on providing a loan to the developer, is a true cost.

Response:

A 3% interest rate, in these economic times, is a reasonable rate of return, and higher than what is earned by the CPA fund currently. The current rate of interest for funds held by the CPA is 2.3%.

The 5% rate used in the projections for the bond issuance was a very conservative projection. Bonds issued today by communities with similar bond ratings are coming in under 4%.

e. As even stated in the GLC report, a 5% development contingency is the minimum of a project of this size. A more normal contingency is 10%. This risk/cost needs to be seriously considered.

Response:

According to the financial consultant hired by the Town, 5% is standard for this type of project. This is also a common contingency amount successfully used by Beacon on other projects, such as the Wilbur School in Sharon. This has no bearing on the loan from the Town, however, as the developer would be responsible for any overages.

6. We question the value of historic preservation of $3 million and the method of calculation. Further input should be received, for example, from the Historic Preservation Committee and any similar projects in other towns.

Response:

The preliminary analysis conducted by the Town's financial consultant indicates that $3M is an appropriate value to assign to the lost revenue that the owner will forgo as a result of the historic preservation easement; however, both the Town and the developer will require that this *will* be subject to an independent appraisal. The Historical Commission has issued a letter of support for the project as proposed.

7. Questions still exist regarding the structure of the $1.5 million debt for the sewerage treatment plant, user fees to the development and the downtown business district, and debt servicing.

Response:

The wastewater treatment plant would be funded through a Wastewater Enterprise Fund. Under the law governing such funds, the users of the service would be required to pay fees to cover all costs of the service provided. Any upfront costs paid by the Town would need to be reimbursed from the Enterprise Fund. Enterprise Funds for wastewater treatment are standard throughout the Commonwealth.

The above, as well as other, factors to consider/areas of concern to the Finance Committee are what we will be seeking to understand more/get answers to in the coming months should this proposal move forward. The Finance Committee has not at this time voted on any aspects of the Shovel Works proposal presented by Beacon, including the sources of financing.