FARGO'S FINANCIAL HEALTH IN QUESTION

City risks credit rating downgrade as spending rises, reserves stagnate

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FARGO

In July, when city leaders borrowed $43 million for street and sewer repairs, the city's credit rating agency revealed that the outlook for the city's rating had turned "negative."

Most of the city's bonds would still be rated at Aa1, the second highest possible, but Moody's Investors Service had put the city on notice that it was considering a lower rating.

That would raise the cost of borrowing for the city. For taxpayers, it would mean, among other things, higher special assessments, the already unpopular property tax used to pay for streets and sewers.

But more than just a rating of credit worthiness, Moody's report is also an independent assessment of the city's financial health.

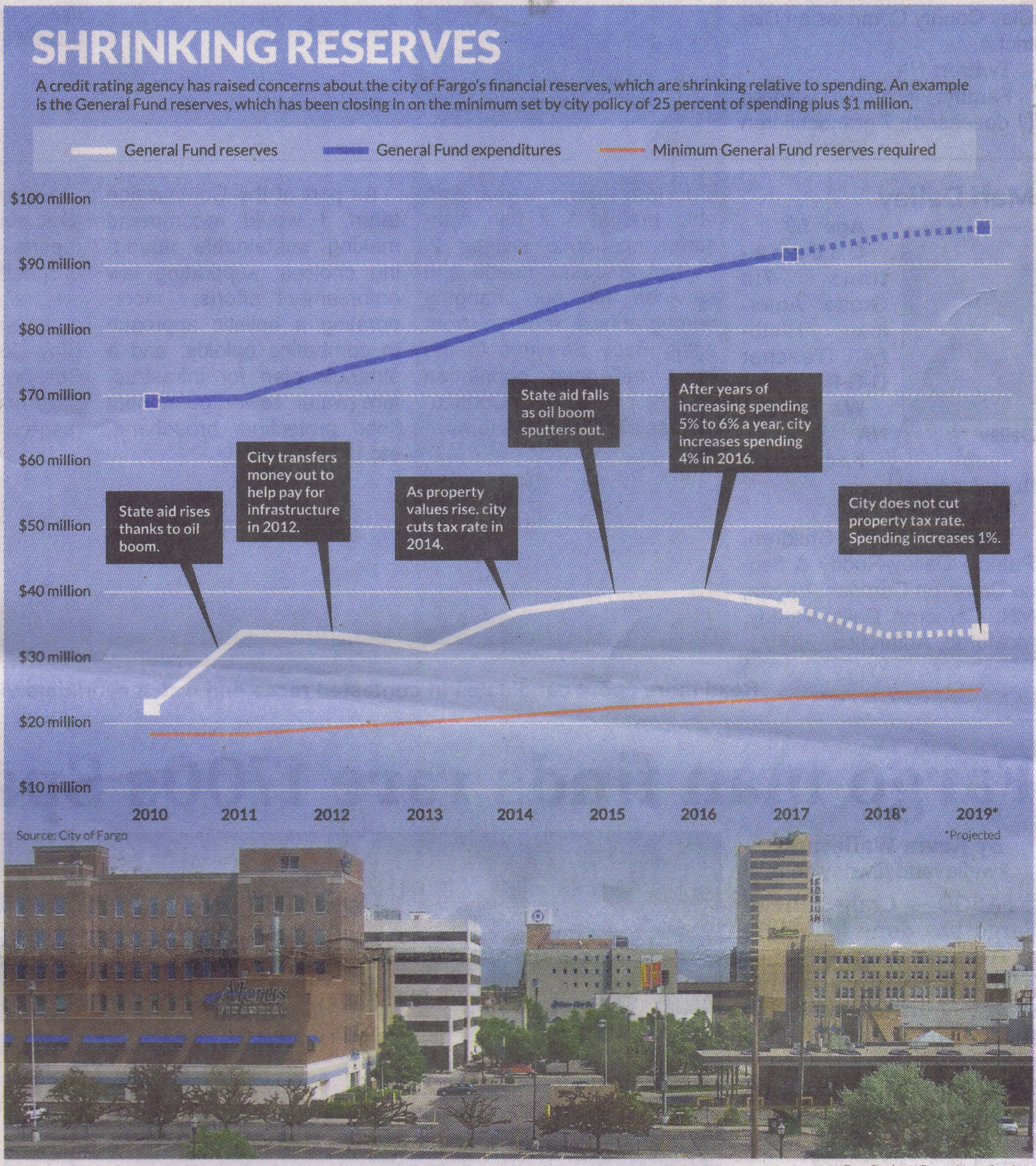
The agency's outlook didn't see much public discussion at the time, but city officials began talking about it more in recent months as they worked on the 2019 budget.

"I'm of the opinion — I'll say that straight out — that if we don't change the trajectory of our budget and maintain these reserves and things start to look a little brighter, we will get a downgrade in our bond rating," Finance Director Kent Costin warned at the end of the first budget discussion in late August.

The budget city leaders passed last month reflected these concerns.

"What we elected to do is not do another mill levy reduction and just keep our budget tight, and that's what we have done," Mayor Tim Mahoney said Sept. 24 as he asked city leaders for final approval.

The budget includes a 1 percent increase in the General Fund, the city's main operating fund, which is less than the rate the city's estimated population has been growing and less



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than inflation. In prior years, the city has increased spending 3 percent to 6 percent a year.

Negative outlook

When the city issues bonds, essentially IOUs sold to investors, it hires Moody's to rate how likely it will be able to repay those IOUs. The higher the rating, the more assured investors are and the more agreeable they are to a low interest rate. In July, the city's bonds got an average interest rate of 3.37 percent.

April 2011 was the first time Fargo received the Aa1 rating. Back then, Moody's cited the city's strong economy, meaning a strong tax base that can pay taxes to repay debt, and its "sound" finances with "healthy" reserves. Debt was "elevated" but "manageable."

In July, Moody's said the economy was not as hot as it once was, as shrinking sales tax revenues in 2017 showed, and the tax base may not grow as fast as the city's debt. A rating downgrade was possible if debt grows too fast (the city's share of the $2 billion-plus flood diversion project is a factor), if the tax base declines signaling a "reversal" in the city's economic trends and if operating reserves shrink too much, the agency said.

Moody's says that, historically, about a third of bond issuers with a negative outlook get a downgraded rating within 18 months.

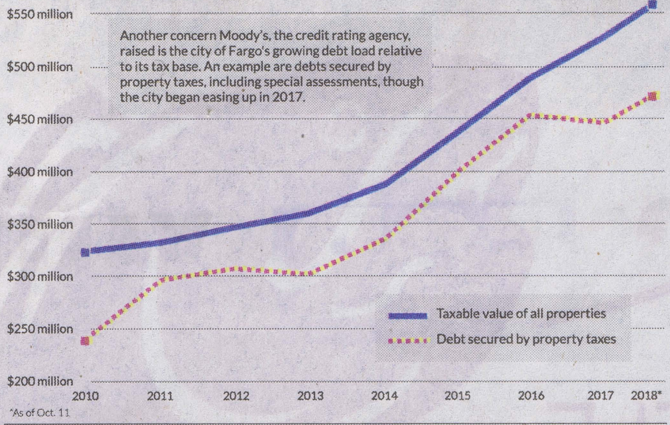
"During our bond rating with Moody's, they watch us like a hawk," Costin told city leaders in August. "They do analytics of our numbers, they do analytics of our fund balances."

Narrower reserves

The reserves Moody's referred to are what's in the General Fund at the end of each fiscal year.

The city's policy is to ensure that amount is no less than 25 percent of

RISING DEBT LOAD



Source: City of Fargo

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the spending budgeted for the year plus $1 million. Spending will always be greater because the city expects, over the course of the year, to collect taxes and fees and receive federal and state funding.

Costin said in an email that the reserves are "the most common method of measuring our financial strength." A portion of the reserves, that minimum $1 million, is set aside for financial emergencies, such as a sudden decrease in state aid, he said.

At the end of 2019, the reserves are projected to be $33.8 million or 35 percent of spending. At the end of 2011, the year the city first got the Aa1 rating, the reserves were $33.6 million or 48 percent of spending. It's been more than 40 percent every year since, but is projected to be 36 percent this year and 35 percent in 2019.

Overall, that's a sign the city's General Fund spending has been outpacing revenues, particularly state funding. At one point during the oil boom, state funding was the General Fund's largest revenue source, but it has shrunk dramatically since. Property taxes, usually the largest revenue source, have taken back the lead.

Debt load rises

Fargo's debt load, another concern for Moody's, had grown rapidly as the city's footprint grew.

Most of the debt is secured by property taxes, such as mill levies and special assessments.

Compared to the growth in the taxable value of all properties in the city, this debt load has gotten a bit heavier than in 2011, when Moody's thought it was "manageable." At that time, the size of the debt was 89 percent of taxable value. The ratio got as high as 93 percent in 2016 but the city eased up starting in 2017, lowering it to 85 percent.

Costin said that if specials ever fell short, the city would have to raise the mill levy. He said Moody's keeps a close eye on the General Fund because it wants to know the city has the capacity to do so; bigger reserves means the city doesn't have to lean as hard on taxpayers.

The other major kind of debt is the kind secured by sales taxes, which are mostly used for flood-control projects. Here the trend is not as good. In 2011, with a robust state economy, the debt load was 52 percent of sales tax revenues for the year. In 2017, it was 152 percent of revenue.

Despite the negative outlook, Costin told The Forum recently, "We still have a very strong financial position."

The state economy is turning around with oil production rising again, which means more state aid, he said. Locally, the city expects to collect more sales taxes, too, as a recent Supreme Court ruling requires online retailers to pay local sales taxes.

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