MEMO TO: Nathan A. Poore, Town Manager
FROM: John McNaughton
RE: Use of Fund Balance for Community Facilities Project
DATE: September 2, 2010 rev. 1

Per your request and that of Councilor Rodden, I am writing this memo to discuss the fiscal implications of the proposed use of $1 million in undesignated fund balance to offset some of the costs of the proposed Community Facilities project.

As you know, all use of the undesignated fund balance is governed by the Town's written Fund Balance policy, which was adopted by the Town Council in 2005. I have attached a copy of the policy to this memo for reference. The policy was adopted in accordance with national "best practices" standards and incorporates the minimum reserve standards recommended by the major credit rating agencies and the Government Finance Officers Association.

The policy basically allows that "available" fund balance (fund balance minus non-cash assets, receivables and the required reserve of two months of budgeted operating expenditures) can be used by the Town Council to offset "one-time" or non-operating costs, such as capital improvements.

The current "available" fund balance under the policy is approximately $3 million (we will have a more precise number in October, when the audit is complete). Thus, with the approval of the Town Council, the Fund Balance policy would allow for the proposed use of $1 million for the Community Facilities project, as it is a "one-time" capital expenditure. Obviously, the decision to do so is purely a discretionary policy matter for the Council.

It should be noted that the undesignated fund balance simply represents the accumulated excess of annual revenues over expenditures. It can not be "replenished" directly, other than through the Overlay mechanism at the time of tax commitment. This method of "replenishment" has not been used in the Town of Falmouth nor do I expect that this will be considered in the future based on our overall excellent financial condition.

In response to Councilor Rodden's inquiry, the current interest rate projection on a 10-year bond would be 2.5% and 3.5% for a 20-year bond. On a $1 million bond, this would result in total interest costs of $137,500 for a 10-year bond and $367,500 for a 20-year bond. The current return on short-term investments is about 0.4%. This low rate reflects the necessarily short-term nature (one year or less) of the Town's operating investments. As a benchmark the current 3-month Treasury rate is 0.14% and the one-year rate is 0.25%.

The decision whether or not to borrow $1 million or to use fund balance is a complicated one, largely dependent on the interest rate environment (both the borrowing rate and the rate of return) and on the Town's long-term financial objectives. In a positive arbitrage environment such as we had five to ten years ago (when investment return rates were higher than the borrowing rate), it was certainly advantageous to borrow the funds at the relatively lower rate and earn higher returns that could be credited to the benefitting project (this was done on the high school project).

In the current negative arbitrage environment, however, the borrowing costs cannot be recovered through investment earnings. The one positive argument for borrowing, however, would be to take advantage of today's historically low interest rates, spreading them out over the life of the bond, thereby preserving the fund balance for use at a time of higher borrowing rates. As noted, this decision is not a simple one, but depends on a number of various factors.

In summary, the proposed $1 million use of fund balance does fall within the limits of the Town's written fund balance policy. But as noted above, the actual decision to appropriate these funds is purely a discretionary matter for the Town Council, based on the Council's evaluation of the Town's policy needs and financial position.

Please let me know if you have any additional questions.