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February 19, 2009

MEMORANDUM

To: Chris Coons
Ed Milowicki

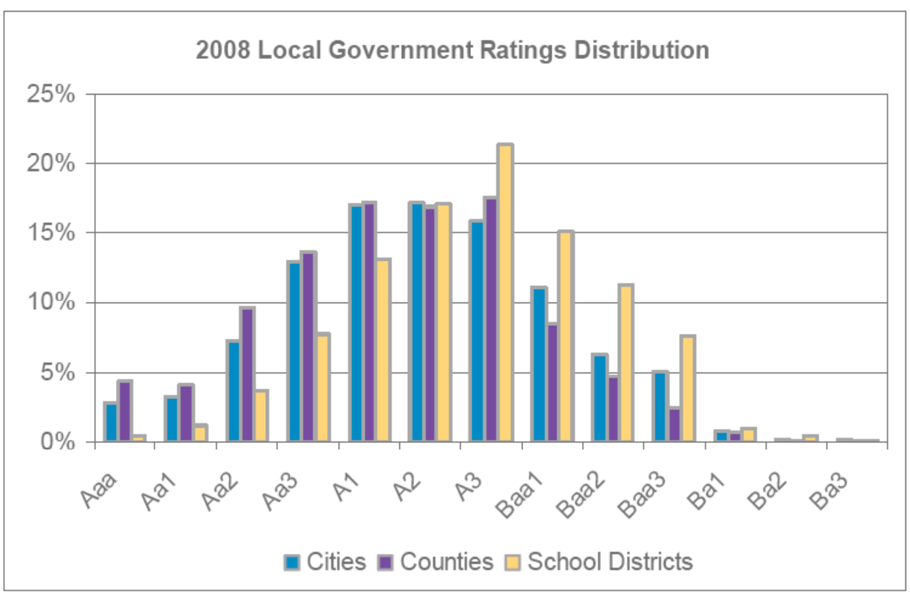
From: David Paul

Re: New Castle County Reserves and Bond Ratings

In advance of the sale of the New Castle County General Obligation Bonds, Series 2009A, each of the national bond rating agencies, Fitch, Moody's and Standard & Poor's, confirmed the *AAA* on the County's general obligation bonds. The triple-A credit rating is more valuable to the County in the current market than in prior years. However, to maintain its credit rating, the County must successfully achieve a "soft landing" in the decline in its fund balances, and sustain a level of undesignated reserves no less than 5-10% of annual expenditures, in addition to its mandated budget reserve levels.

Background

The outstanding County ratings are *AAA* from each of the three rating agencies. The ratings were upgraded to *AAA* from the *AA* level by Moody's and Standard & Poor's in 2001, and by Fitch the following year. For 20 years, the ratings from both Moody's and S&P were *AA*. As illustrated below, this rating places the County among a small group of elite credits in the municipal market.



The first step in the improvement in the County credit was the increase in sewer fees in the late 1980s to make the Sewer Fund a self-supporting utility enterprise. As a result, the sewer debt was deemed self-supporting and removed from County net debt ratios for credit rating purposes. The subsequent sale of the airport ended the General Fund subsidization of these two enterprises.

As a general matter, the bond upgrades reflected four factors:

- Increased undesignated fund balances and financial reserves
- Establishment of the Rainy Day Funds as a reserve floor
- Control in the growth in county employment
- Decreased dependency on regular property tax rate increases
- Demonstrated management effectiveness in financial management

<u>Threats to the County Bond Ratings</u>

Four years ago, in a memorandum to Michael Strine, dated May 14, 2005, we noted several potential threats to the County bond ratings.

- Declining fund balances.
- Unconstrained expenditure growth.
- Potential volatility and decline in the transfer tax.
- Continued deterioration in the County high-wage manufacturing base.
- Operating deficits.

We noted at the time that the growing operating deficits loomed as the single greatest problem facing the County. The rating analysts understood at the time that the reserve levels that had been built up were politically unsustainable. However, they also recognized that the use of those reserves to the General Fund operating budget was allowing a continuing imbalance in recurring revenues and recurring appropriations.

When you took office, your administration tackled this issue head on. With the support of County Council, you increased sewer rates to return the Sewer Fund to operating balance, and have increased property tax rates, in pursuit of a soft landing that will bring recurring revenues and recurring expenditures in the General Fund back into balance.

<u>Importance of Reserve Floor to Retaining the *AAA* Rating</u>

It is critically important that the County continue down the path of restoring balance of recurring revenues and recurring expenditures in the General Fund if it is to retain its *AAA* ratings. The importance of restoring balance and avoiding continuing erosion of financial reserves was raised by all three rating agencies in the recent credit review, and Fitch went so far as to change their outlook on the rating from stable to negative, and specifically emphasizing this issue in their report:

> *As the county seeks to achieve structural balance, further draws on reserves beyond fiscal 2009 are projected. Fitch will continue to monitor the county's progress in obtaining budgetary stability while maintaining sufficient financial flexibility.*

Fitch has emphasized the importance of the level of reserves being established in policy, as the County has, that specifies the reserves as a percentage of annual expenditures. Moody's takes this suggestion one step further, and in our recent discussions noted the importance of not changing a policy that is in place for exigent reasons.

While the Rainy Day Funds have established the reserve floor for the County, we would recommend, as we did in 2005, that the appropriate reserve goal for the County General Fund should be maintain undesignated reserves of at least 5-10%, over and above the 20% Rainy Day Fund. The following chart sets forth Moody's medians for the cohort of counties comparable in size to New Castle County. As illustrated here, the median general fund balances and undesignated reserve balances for *AAA* rated counties are 22-29%.

Municipal Financial Ratio Analysis - U.S. Counties (250,000 < Population < 1 Million)

Selected Indicators	Group Medians (Most Recent Available)				
	Aaa	Aa	A	Baa	Ba
Total General Fund Revenues	$339,057	$201,948	$100,903	N/A	N/A
General Fund Balance as % of Revenues	28.87	26.85	17.60	N/A	N/A
Unreserved, Undesignated General Fund Balance as % of Revenues	22.17	23.76	15.96	N/A	N/A
Direct Net Debt as % of Full Value	0.51	0.55	0.71	N/A	N/A
Debt Burden (Overall Net Debt as % Full Value)	1.57	2.24	2.49	N/A	N/A
Debt Service as a % of Expenditures	8.17	7.66	4.17	N/A	N/A
Total Full Value ($000)	$68,511,034	$41,038,088	$23,201,330	N/A	N/A
Population 2000 Census	607,751	404,119	374,045	N/A	N/A
Full Value Per Capita ($)	$119,572	$93,348	$65,132	N/A	N/A
Top 10 Taxpayers as a % of AV	3.81	4.94	4.55	N/A	N/A
Per Capita Income (2000 Census)	$27,352	$22,863	$19,960	N/A	N/A

Value of the *AAA* Rating

New Castle County is one of the premier county credits in the country, among the top 2% of the over 1,000 counties nationally that have three triple-A ratings. While in some years, the economic value of the *AAA* is marginal, when credit spreads are narrow and the all in cost difference between a *AAA* and a *AA* transaction in five basis points or less, in today's market these difference have become extreme.

As illustrated below, the savings to New Castle County in the cost of the Series 2009A Bonds was conservatively estimated to be $1.2 million on a present value basis. However, this estimate was a conservative one based on a spread of twelve basis points.

New Castle County
General Obligation Bonds

Total Debt Service Results : General Fund, Sewer & Refunding Bonds

	AAA Series 2009A Bonds	AA Hypothetical Bonds	Difference
Total Debt Service	189,351,591.25	191,489,477.19	(2,137,885.94)
PV Debt Service	107,393,082.44	108,576,639.50	(1,183,557.06)
True Interest Cost	4.572%	4.677%	(0.11%)

Refunding Savings Results

	AAA Series 2009A Bonds	AA Hypothetical Bonds	Difference
Total Savings	1,907,029	1,795,329	111,700.42
PV Savings	1,795,274	1,690,249	105,024.83
True Interest Cost	2.831%	2.955%	(0.12%)

Note:
Present value amounts are calculated based on a 4.5% discount rate.

As illustrated in the summary of transactions attached to this memo, the trading levels of non-*AAA* bond transactions sold this year indicated that yield spreads off of the triple-A Municipal Market Data benchmark scale were significantly wider for transactions as credit quality declined.

For example, as illustrated here, the State of Washington Aa1/AA+ bonds traded fifteen basis points off the MMD, while other *AA* bonds traded at spreads in the forty basis point range. According, the range of savings to the County from its pure *AAA* status on this transaction was realistically in the range of $1.2 million to up to four times that amount.