TOWN OF NATICK FINANCE DEPARTMENT

John M. Townsend ◆ Deputy Town Administrator/ Director of Finance ◆jtownsend@natickma.org ◆

April 29, 2025

To: Select Board

From: John Townsend, Deputy Town Administrator/Director of Finance

CC: Jamie Errickson, Town Administrator

RE: Response to Article 25 – Proposed Changes to Stabilization Funds

<u>Summary:</u>

In response to **Article 25**, a citizen petition proposing to expand the stated purposes of the **Capital Stabilization Fund and Operational Stabilization Fund** to include "**any lawful municipal purpose**," we have conducted a thorough financial and policy analysis of the implications such changes would bring.

The proposed revision would fundamentally alter the fiscal discipline and intent behind these two funds. Specifically, it would eliminate the long-standing purpose-based restrictions that currently help ensure the funds are preserved for capital investments and stabilization during economic downturns.

<u>Recommendations:</u>

- Maintain current language and purpose-based restrictions
- Preserves:
    - AAA credit rating
    - Fiscal discipline
    - Long-term financial health and capital infrastructure investment

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Below is the overview of the Town's stabilization funds excluding I&I stabilization fund, OPEB Trust, and FAR Bonus Stabilization Fund.

Applicable Funds	Target Balance	Actual Balance	Purposes
General	$3,756,821	$3,699,202	Unforeseen and catastrophic emergencies
Operational	$4,270,916	$4,371,497	Augmenting operations in case of sustained economic downturn and associated revenue loss
Capital	NA	$974,815	Funding capital related projects, pieces of capital equipment, debt service payments
One-to-one Technology	NA	$8,394	Funding one-to-one technology programs for Natick High School Students
	Total Balance	**$9,053,908**	

Capital Stabilization Fund Analysis

As of today, the Capital Stabilization Fund has a balance of **$974,815**. Following the Town's planned appropriation at SATM 2026, the balance is projected to increase to **$3,858,700**, of which **$1,000,000** is anticipated to be used to **supplement next year's debt service**, in

order to facilitate the Town's scheduled July borrowing. This use is consistent with the fund's established purpose and fiscal practice.

With the proposed change to broaden the purpose of the Capital Stabilization Fund–and the potential use of the fund to support FY 2026 operations–the balance would become insufficient to support the $1,000,000 allocation to fund the FY 2027 debt service payment and planned for capital projects. This would jeopardize the Town's ability to move forward with approximately **14 capital projects**, including **roof replacements, improvements to parks and athletic spaces, and roadway and sidewalk reconstruction**.

Over the past five years, the Town has responsibly utilized **$5,255,886** from the Capital Stabilization Fund to support **56 capital projects**. These projects span a wide range of infrastructure needs, including **street acceptance planning, park and field renovations,**

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roof replacements across schools, the library, and public safety facilities, as well as **IT upgrades**. The inflows and outflows have remained healthy, reflecting sound financial stewardship and adherence to the fund's original intent.

TM	$ Appropriation / Outflow	# of project funded	Category
2020 SATM	$388,500	9	School Roof, Vehicle, Energy Efficiency, Playground & Field Renovation
2021 SATM	$1,761,386	15	Library HVAC, Public Safety Building Roof, School Laptop, IT firewall, Street Plan Acceptance
2021 FATM	$850,000	10	IT upgrade, Fire Alarm, Dumpsters Replacement
2022 FATM	$1,000,000	10	Roadway, Pickup Truck, Park Renovations, School Lab & Server
2023 FATM	$781,000	8	Vehicle, Street Acceptance Plan
2024 FATM	$475,000	4	Parks Renovation, Roof Replacement, Custodial Equipment
Total	**$5,255,886**	**56**	

From a financial perspective, **maintaining a distinct stabilization fund dedicated to capital** provides multiple advantages:

- It diversifies the Town's overall financing strategy.
- It reduces pressure on long-term debt service.
- It allows the Town to respond quickly to smaller-scale or time-sensitive capital needs.

During the financial constraints of the COVID years, the Town made a prudent choice not to issue long-term bonds. Instead, it relied more heavily on the Capital Stabilization Fund to finance projects–**reducing future debt obligations** while continuing to meet infrastructure needs. This strategic use demonstrates that the fund is serving its purpose effectively. We would recommend that the Town retain the current stated purpose and continue following its well-established practice.

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General & Operational Stabilization Funds Analysis

Both General & Operational Stabilization Funds are considered reserve funds and if the Town relies on its reserves to cover a structural deficit, it can have serious long-term impacts on the following three areas:

1. **Structural Deficit Risk**
   Using reserves to supplement the operational budget **worsens structural deficit**, especially when recurring expenses exceed recurring revenues. Since reserves represent one-time, non-recurring funds, they are not a sustainable revenue source. Without corrective action, the Town could eventually face the need for another **override request** to close the gap between revenues and expenditures.

2. **Credit rating downgrade**
   Expanding the stated purposes of the stabilization funds to include **"any lawful municipal purpose"** will likely lead to a **credit rating downgrade**. According to the **2024 S&P Global Credit Rating Criteria**, this action would negatively affect several rating components:

   - **Institutional Framework**: Reduced revenue predictability and weakened financial accountability.
   - **Reserves & Liquidity**: Material drawdowns in fund balances would indicate fiscal stress.
   - **Financial Performance**: Reliance on non-recurring revenues (like reserves) obscures the Town's true operating condition. Rating agencies view consistent reliance on reserves as a sign of structural deficit and greater fiscal risk.

   We have consulted with the Town's Financial Advisors, Hilltop Securities, regarding the proposed changes to the structure of the stabilization funds proposed by Article 25 and they have advised us that the implementation of the changes will almost certainly result in a reduction of the Town's credit rating to at least AA. They also advised us that once an AAA rating is lost, it is extremely difficult to get it back.

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The credit spread between AAA and AA is from 0.20% to 0.50%, and the spread is currently widening. For example, the Roadway & Sidewalk improvement project planned for FY 2026 is budgeted at $3,200,000. The borrowing costs for this project, with a 20-year note will potentially increase by $134,613. The Town also has several larger debt exclusion projects in the pipeline where the impact on the residents will be even greater. The proposed Memorial School project, currently in development with the Massachusetts School Building Association, with an estimated cost of $70,000,000 would be impacted. The additional borrowing costs for this project caused by the credit spread are as follows:

Credit Rating	Credit Spread 10-year	Credit Spread 15-year	Credit Spread 20-year	Project Example $	$ Additional Borrowing Costs - 20yr
AA	0.11%	0.19%	0.21%	$70,000,000	$2,940,000
A	0.35%	0.42%	0.44%	$70,000,000	$6,160,000
BBB	0.83%	0.86%	0.88%	$70,000,000	$12,320,000

(Data is updated as of April 15, 2025)

Allowing the unrestricted use of the reserves, while not utilizing the levy capacity is not a prudent fiscal policy. Levy capacity is not considered as the reserve by the credit rating agency and leaving it untouched while drawing down on funds that were initially designated as reserves sends a negative signal to rating agencies and may trigger a downgrade.

3. Reserve Balance Sustainability

The newly revised **S&P methodology for U.S. government ratings** emphasizes the importance of reserves and liquidity. According to S&P:

- Available reserves (including budget stabilization funds) should be above 15% of total revenues to be considered “very strong.”
- 8%-15% is considered “strong.”

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- Excess levy capacity is not counted toward these reserve metrics.

- Lacking clear usage limitations is perceived as more vulnerable to being used for non-emergency purposes

If the Town were to use the two stabilization funds to replace the $7M override, the combined balance would drop from $8,070,699 to $1,070,699. **The reserve ratio is estimated to drop to 9.3%. This balance would not meet the thresholds established by the rating agencies for an AAA community (>15%).** This leaves little to no capacity to address future emergencies, capital needs, or unexpected downturns. In today's uncertain economic environment, such an action would not be advisable.