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S&P: Detroit's Momentum Continues With Latest Fiscal Plan And Financial Review Commission Oversight Waiver.

CHICAGO (S&P Global Ratings) May 2, 2018–Following recent approval of Detroit's (B+/Stable ICR) latest four-year plan, the state-appointed Financial Review Commission (FRC) voted on April 30 to waive significant portions of its oversight powers. This action marks a major achievement for the city and serves as a good measuring stick for how far it has come on its long road to stability.

We consider the waiver a positive step for Detroit, although the reduced oversight in and of itself is unlikely to have a major effect on day-to-day operations, or a direct effect on the city's long-term financial trajectory. This is based on our opinion that the city's return to balanced operations is more a result of improved management and cost controls, along with reduced fixed costs coming out of bankruptcy, as opposed to direct oversight from the FRC. Given the city's recent financial performance and the terms under which a waiver could occur, we anticipated the FRC's action. In our view, the course Detroit takes going forward will continue to depend on effective city management and disciplined spending, and likely ongoing economic growth.

The FRC's decision to scale back oversight was triggered by three consecutive years of balanced budgets along with three years of projected balanced operations (as found in the latest four-year plan), among other areas. Despite the waiver, the FRC will remain in place for at least another 10 years, though in an effectively dormant state. Should Detroit revert to deficit spending, fail to meet outlined pension contributions, or show signs of fiscal distress (among other things), the FRC would have the authority to rescind its waiver. We believe the FRC's continued presence (albeit dormant) and its ability to return to full oversight will encourage continued balanced budgets and ongoing improvement to management practices.

We note that much of Detroit's improved budgetary performance was made possible by shedding some fixed costs during bankruptcy, including debt service and retiree costs for pensions and other postemployment benefits (OPEBs). While some of those costs are gone forever, the upward slope of debt service and pension contributions could pressure operations. From now on, the city's challenge will be to manage these rising costs in relation to economic growth, and the costs the city incurs to support growth. Post-waiver, the city reports its focus will remain on its long-term plan to prepare for increasing debt and pension obligations. It also plans to improve and update policies for budget reporting and monitoring, as well as those for debt, investment, and pension funding.

FINANCIAL PROGRESS REMAINS ON TRACK; PROJECTIONS REMAIN CONSERVATIVE

As dictated by the Home Rule City Act, Detroit is required to conduct biannual revenue estimating conferences and to annually adopt a four-year financial plan, the first year serving as the adopted budget (these requirements remain in place, regardless of the FRC). The fiscal 2019 general fund operating budget is balanced and totals $1.071 billion, a 4.6% increase from the $1.024 billion fiscal 2018 budget. Projections for fiscal 2020 through 2022 are balanced, with appropriations increasing to $1.114 billion.

Detroit's revenue forecasts remain conservative, without assuming increases from economic expansions which have been announced or are already in progress. Major components of fiscal 2019 general fund revenues include income taxes (28%), state-shared revenues (generated from Detroit's proportionate share of a statewide sales tax (19%); wagering taxes (generated from three local casinos (17%); and property taxes (12%).

The city forecasts income taxes to grow 2.5% annually through fiscal 2022, which is conservative when compared to the 3.5% average annual growth the past five years. Projections take into account modest increases in salary and wages along with improved collection methods, as the state completes its transition to processing the income tax on behalf of the city. With the ongoing employment growth in Detroit, these revenues should continue to increase.

Compared to fiscal 2018 estimates, the city budgeted each of the next three largest sources of general fund revenue to grow by only 1% or less. The projections show 0.5% annual growth in state-shared revenues. These projections are based on the state Treasury Department's most recent estimates. Growth in statewide sales taxes and moderation in the city's population decline should support steady state-shared revenues. Wagering taxes, which declined by 1.7% in fiscal 2017 before recovering for an estimated 1% increase in fiscal 2018, are projected to grow 1% annually. The city monitors gross receipts at the three casinos as part of its forecasting. Lastly, the budget includes a return to growth in property taxes, as the taxable values for fiscal 2019 collections increased for the first time in years. This is a significant indication of the ongoing development and stabilization of the tax base. It also follows the city's significant efforts to reassess properties to more accurately reflect true value.

The budget funds all debt service requirements and continues to fund the Retiree Protection Fund (RPF) as scheduled, which includes a voluntary contribution of $20 million, up $5 million from fiscal 2018. The RPF currently totals $105 million, and the city estimates it will grow to $125 million (plus interest) by the end of fiscal 2019. The city expects to continue funding the RPF at an incrementally increasing level throughout the four-year plan and thereafter, effectively setting aside dollars that will assist in phasing in a return to actuarially driven pension contributions beginning in fiscal 2024. Salaries and wages are the largest general fund cost, and are budgeted for a 6.7% increase, which reflects scheduled wage increases and additions to staff. Citywide, the total staff headcount is budgeted to increase 5% as the city works to fill vacant positions.

RESERVES REMAIN VERY STRONG, AMID FOCUS ON CAPITAL

The city's available reserves increased significantly in recent years following operating surpluses, and while the city anticipates balanced results to continue, these reserves are likely to decline due to targeted spending on rebuilding and revitalizing the tax base, particularly through blight removal, capital spending, and public safety.

The city projects a general fund operating surplus of $35.8 million in fiscal 2018, and balanced operating results for fiscal 2019. These results will be offset by one-time spending, however, and likely lead to declines in the available fund balance. The city estimates spending $50 million in accumulated general fund surplus dollars on one-time blight removal and capital spending in fiscal 2018, and another $100 million in fiscal 2019. This follows $68 million of one-time spending on these purposes in fiscal 2017. Additionally, in fiscal 2018, Detroit used $54 million of fund balance for early debt redemption on a portion of its Financial Recovery Bonds issued in 2014. One of the pending budget pressures is increasing annual debt service costs, and by using fund balance to pay off this debt, the city freed up about $10 million in annual spending. Currently, combined debt service and pension expenditures paid from the general fund account for about 10% of its expenditures, and these costs are projected to increase by $24 million in fiscal 2020 and by another $10 million in fiscal 2021. This amount remains manageable within the current plan, but the increases will continue to present future challenges. Aside from using accumulated fund balance, the city's remaining capital budget is almost entirely funded through annual operating revenues. Subsequently, as annual surpluses lessen, Detroit's ability to fund one-time capital spending with these dollars may lessen.

In our view, continued maintenance of very strong reserves will be a significant credit factor for the city. We also view Detroit's reinvestment in the tax base as an important generator of its economic recovery. Continued revenue growth will be important so that the city can address looming increases in debt and pension expenditures, along with routine capital needs. A very strong reserve position will provide the city additional cushion, if needed, as costs escalate, and if there is economic stagnation.

Detroit ended fiscal 2017 with a general fund available balance of $389 million, or about 44% of general fund operating expenditures. This balance includes $169 million in unassigned reserves, $62 million in the (required 5%) budget reserve, and $158 million in other assigned reserves. Comparatively, the fiscal 2016 available balance was $356 million (40%). Neither of these amounts include the city's RPF, which grew to $90 million in fiscal 2017, from $30 million in 2016. The RPF will be used solely for future pension contributions.

FINANCIAL REVIEW COMMISSION AND OVERSIGHT

Created in 2014, the FRC was tasked with providing oversight for the city, including review and approval of budgets and the long-term financial plan; review of revenue estimates; approval of contracts and collective bargaining agreements; monitoring the issuance and payment of debt; and ensuring adherence to the POA, statutory requirements, and overall sound fiscal practices.

On April 30, 2018, the FRC commission voted to scale back most of its oversight by eliminating the requirement for it to approve the budget, long-term plan, contracts, and collective bargaining agreements, in addition to other requirements. This follows the city meeting certain conditions, including three years of deficit-free budgets, a balanced four-year plan, adherence to all statutes and provisions of the POA, and timely servicing of debt.

Under the terms of the waiver, the FRC will continue to meet monthly to review city reports, and it will annually have to vote on the oversight waiver. Ongoing reporting requirements to the FRC will include budget-to-actuals, cash flows, and debt and pension status updates. The city will need to continue to meet the requirements that led to the waiver for 10 consecutive years before the FRC can completely dissolve. We understand that an added requirement for the continued oversight waiver is that the city adhere to its planned RPF funding strategy, specifically the voluntary contributions.

The FRC may rescind the waiver at any time if any of these requirements are not met, or if it determines the city is returning to fiscal distress; if the waiver is rescinded, the FRC will resume full oversight. Should that happen, the city would need to meet these conditions again for at least three consecutive years, after which the reduced oversight would return for 10 more years. We view the addition of the RPF funding plan to the waiver determination as a positive development, as even though the RPF funding is still not legally required, failure to adhere to the plan could trigger a return to full oversight.

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