Senate Finance Committee

Overview of State Debt: Implications for Transportation

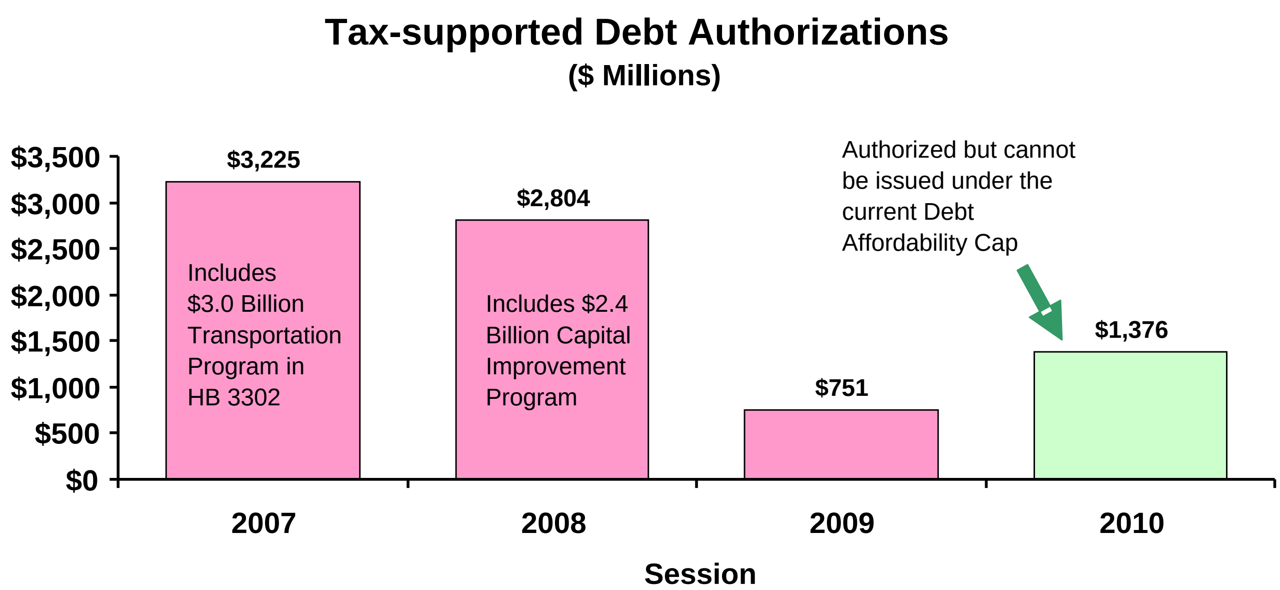
November 18-19, 2010
Staunton, Virginia

Virginia's Debt-Based Budgeting Model

- As a result of declining general fund revenues, and the absence of any long-term funding solution for transportation, the General Assembly has increasingly authorized the use of tax-supported debt as a mechanism for funding items traditionally funded with cash.

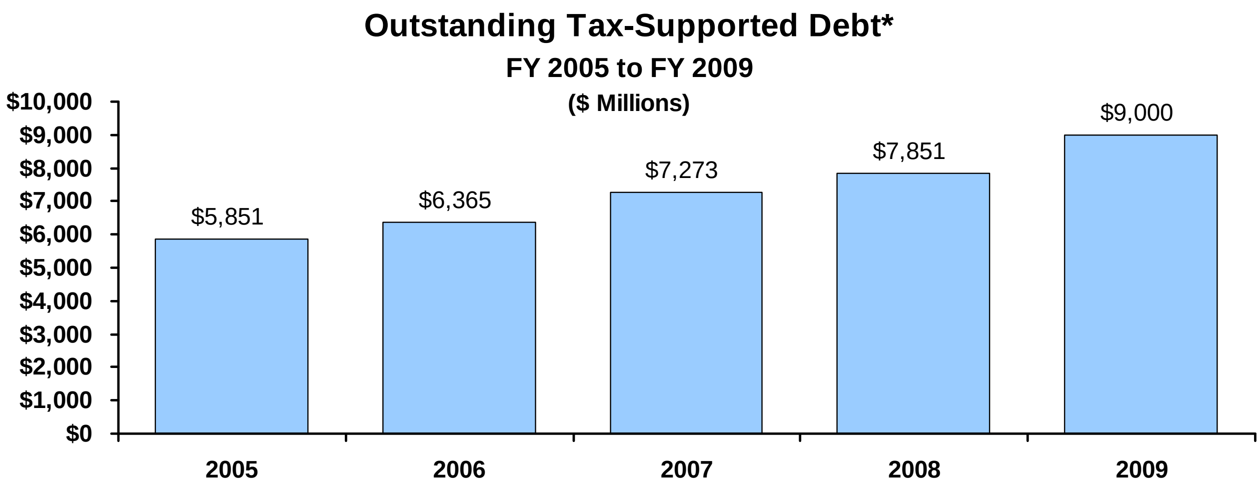
  - Highway construction
  - Maintenance reserve
  - Economic development
  - Museum conservation
  - Local and Regional Jails
  - Public broadcasting equipment
  - Water quality improvement

- In the face of softening economic conditions, the three largest debt authorizations in the history of the Commonwealth have occurred since 2007.



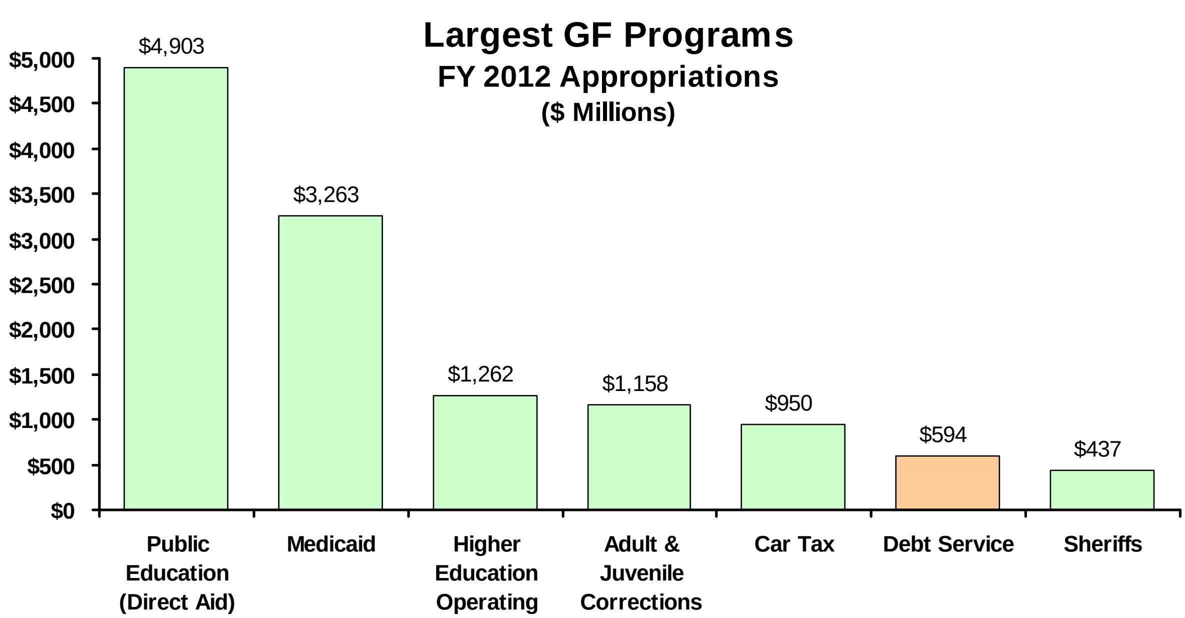
Virginia's Reliance on Debt has Increased

- Outstanding tax-supported debt grew by $3.1 billion (54 percent) from FY 2005 to FY 2009.



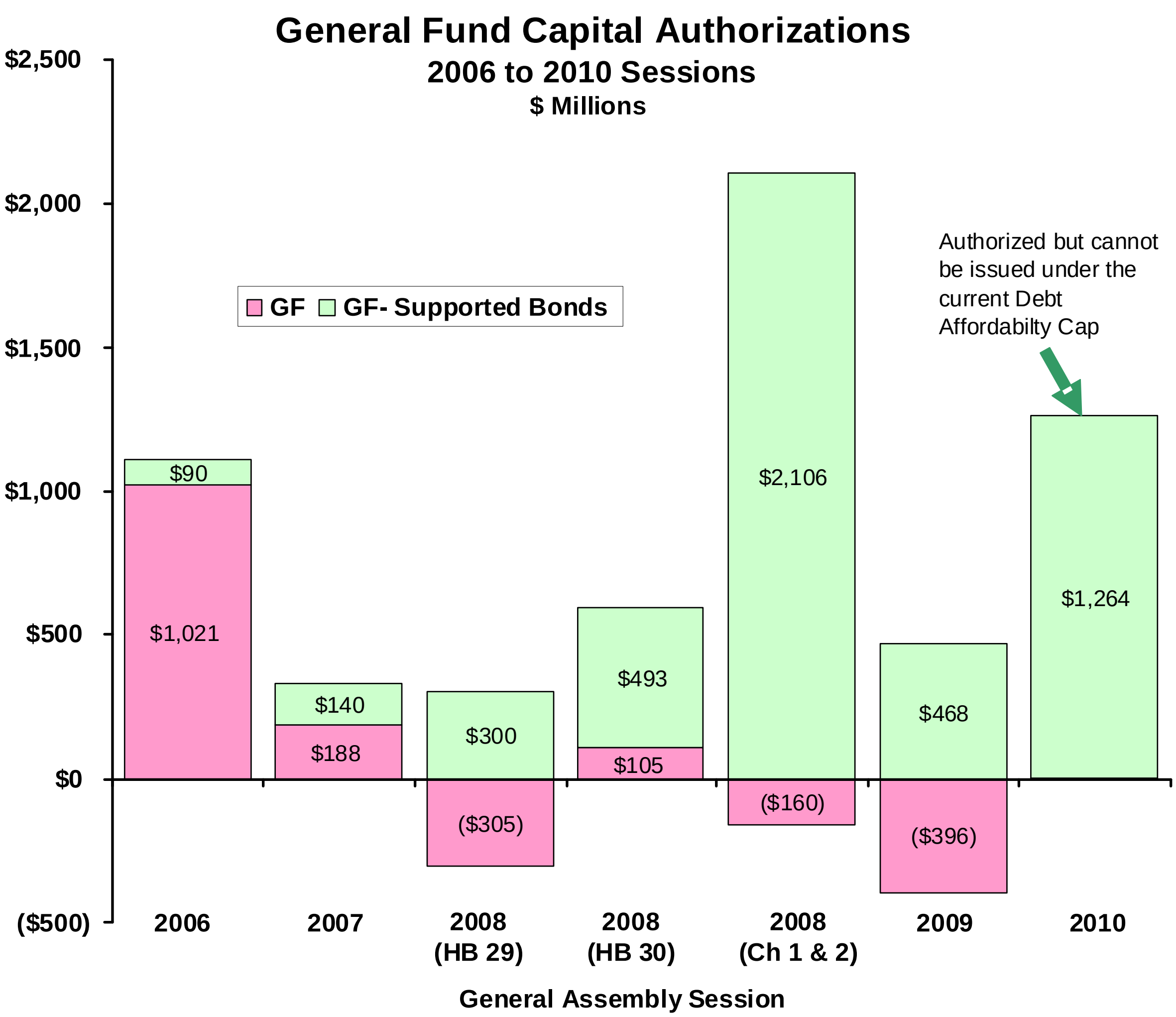
* Includes bonded debt and other long-term obligations.

- As a result, the required annual debt service payment is now the sixth largest general fund program.
  - Only **debt service** and **Medicaid** have grown during the recession.



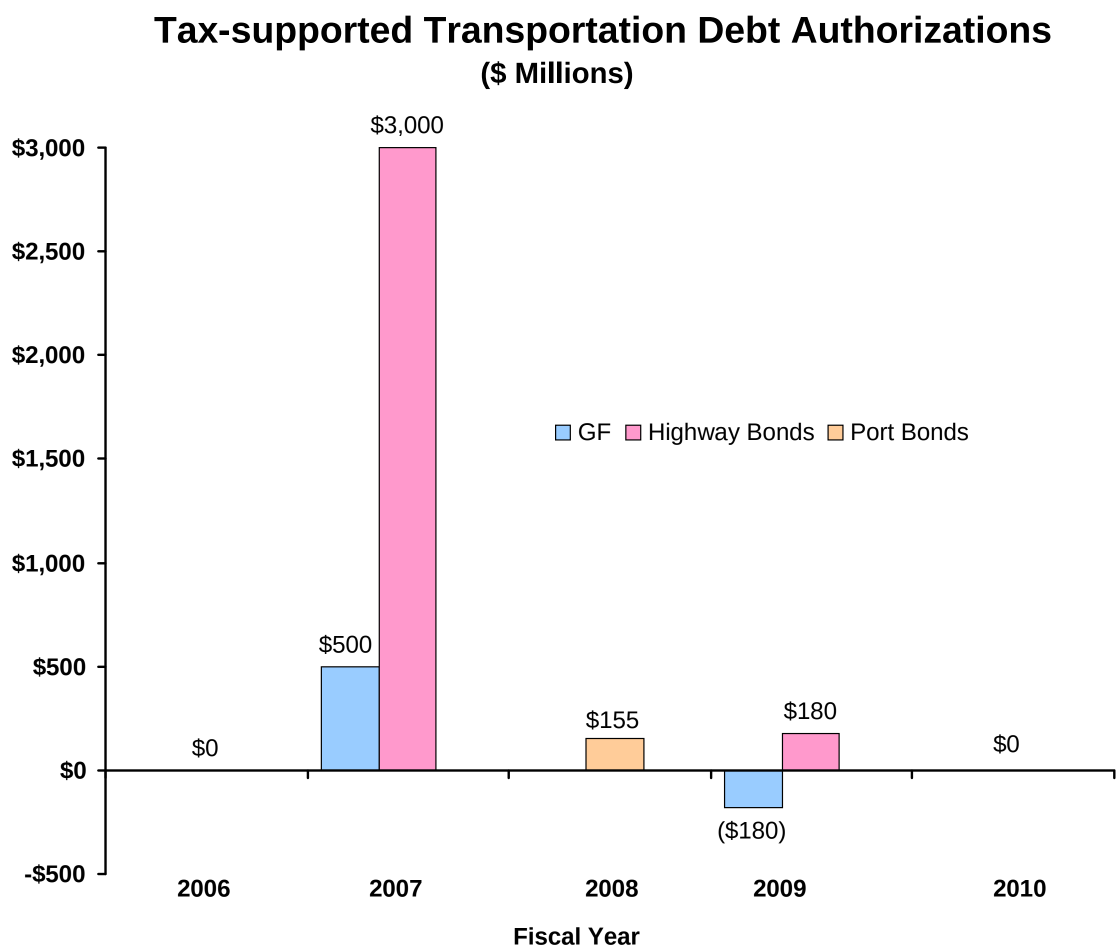
The Move to Debt for Capital Projects

- The last major general fund capital program funded with cash was authorized in 2006, but much of that has been replaced with tax-supported debt.
  - In 2008 the General Assembly replaced a total of $861 million previously appropriated from general fund cash with general fund supported debt. (Shown as negative numbers in the chart below.)
  - The 2010 session authorization of $1.3 billion cannot be issued this biennium under the self-imposed 5 percent cap in the Commonwealth Debt Capacity Model.



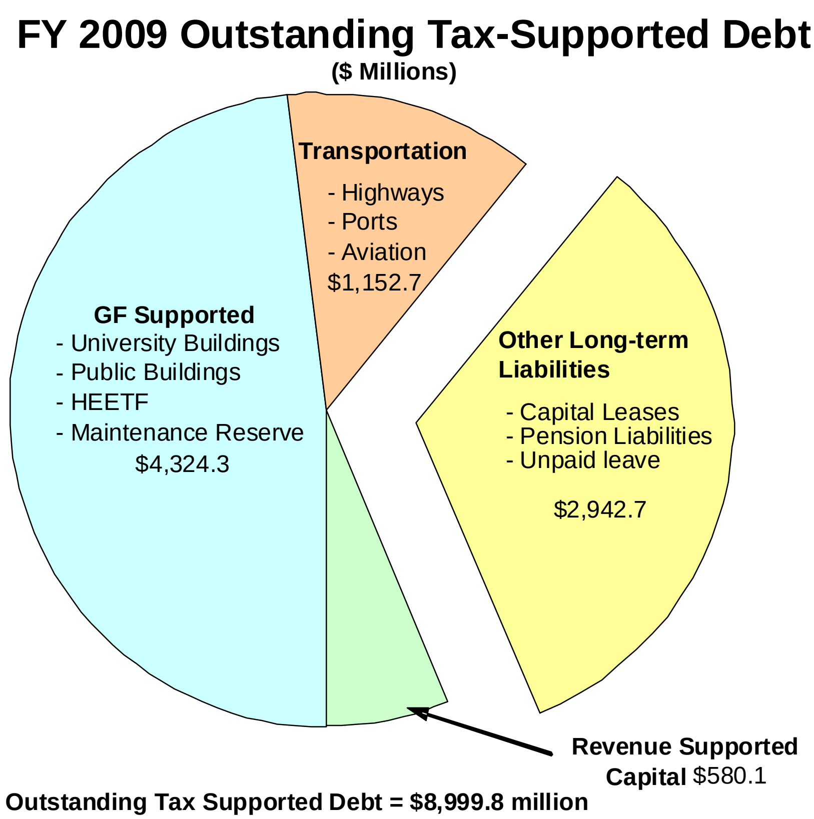
The Move to Debt for Transportation

- Fundamental transportation funding challenges have not improved in the past decade. Legislative actions to address these funding pressures have been primarily through the authorization of debt.
  - The Virginia Transportation Act of 2000, as amended, authorized up to $1.2 billion in revolving debt backed by future federal revenues (FRANs).
  - HB 3202 (2007) and Chapter 781 (2009) authorize the issuance of up to $3.18 billion of Capital Projects Revenue (CPR) bonds.



What is Tax-Supported Debt?

- Tax-supported debt is debt of the Commonwealth on which payments are made, or pledged to be made, from funds derived from tax revenues or general government funds, including:
  - *General-Fund Supported Debt*: Individual income, corporate income, and sales taxes;
  - Certain NGF revenues when the debt is backed by the full faith and credit of the Commonwealth (§ 9(c) debt);
  - Tax-derived Transportation Trust Fund revenues; and
  - Insurance premium tax authorized for transportation.
- Virginia's $9.0 billion of tax-supported debt (FY 2009) has been used for general fund capital, transportation, revenue-supported projects, and other purposes.



What is Tax-Supported Debt?

- **General Fund Projects** include building construction, major maintenance (maintenance reserve), building equipment, higher education equipment (HEETF), the state share of jails, conservation of major museum artifacts, public broadcasting equipment, water quality improvement, and major economic development.

- **Transportation Projects** include highway, bridge and tunnel construction – including toll supported projects; mass transit projects and equipment; rail projects and equipment; port construction; and airport construction.

- **Revenue-Supported Projects** include university dormitories, cafeterias, and student centers, and fee-supported parking facilities. These are only counted as tax supported debt when backed by the full faith and credit of the Commonwealth (§ 9(c) debt). § 9(c) debt has no impact on debt capacity as calculated by the Debt Capacity Model.

- **Other** includes capital leases, long term obligations, unpaid leave balances, and retirement liabilities.

What is Virginia's Debt Capacity Model?

- The **Debt Capacity Model**, administered by the **Debt Capacity Advisory Committee,** is an estimate of Virginia's capacity to authorize and issue new tax-supported debt.
- The Debt Capacity Model is the tool used by the Debt Capacity Advisory Committee to annually assess the capacity of Virginia to take on additional tax-supported debt.
  - Apprises the Governor and the General Assembly on the amount of additional tax-supported debt that could prudently be authorized and issued in each of the next two years.
  - Is designed to be conservative in that it considers a 10 year time horizon, but maintains two years capacity unutilized.
  - Uses 5 percent of the official forecast for blended tax revenues for **each** year as the upper limit for tax-supported debt service in that year.
  - Considers all authorized tax-supported debt that is either outstanding, *<u>or will be issued</u>* within the model's ten year time horizon.
    - General Fund projects.
    - Tax-supported transportation projects.
  - Does **not** include the Other Long-term Obligations category. (Unpaid leave balances, retirement liabilities.)
- In recent years, actual issuance of authorized debt has been limited to keep projected debt service payments under the 5 percent limit each year incorporated in the Debt Capacity Model.

A Fresh Look at Tax-Supported Debt

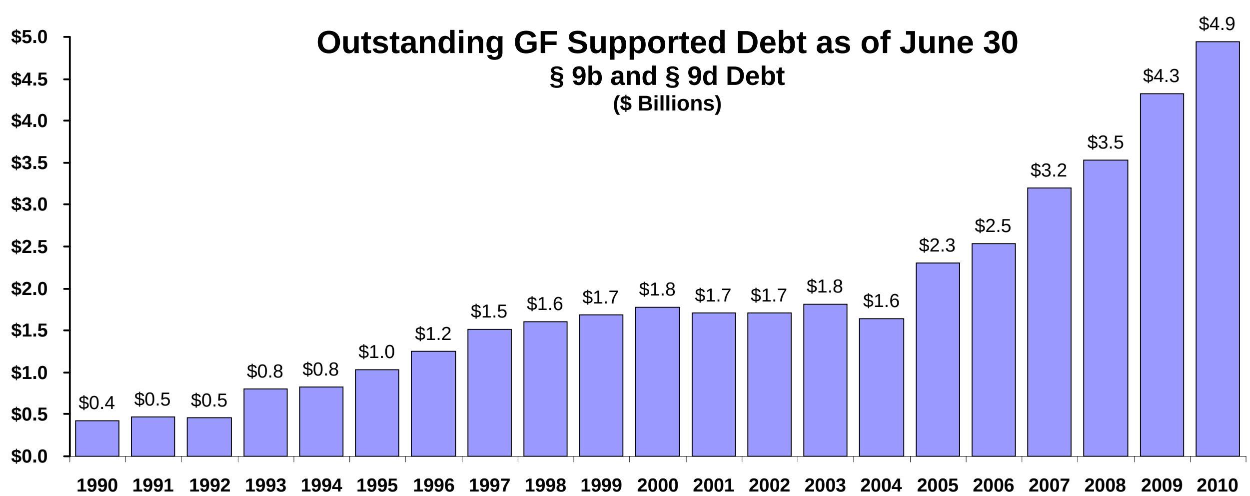
- The current recession has brought the increased reliance on tax-supported debt to the forefront of policy issues.
  - The economic climate created by the recession makes this a good time to utilize debt for financing capital facilities, **however** the authorization and issuance of new debt is constrained by the Commonwealth's **Debt Capacity Model**.
  - Government programs that once relied on cash now compete for authorization and issuance of new tax-supported debt.

- The issuance of new debt is also constrained by the Commonwealth's ability to budget for future debt service payments.
  - Debt service payments have begun to crowd-out funds available for both general fund and highway programs.

- At present, there is **no capacity** for authorization and issuance of new tax-supported debt under the Debt Capacity Model for FY 2011, FY 2012, and FY 2013.
  - Because of the decline in revenues due to the 2010 recession, actual issuance of existing debt has been managed to stay within the 5 percent limit.
  - The model assumes that there is zero capacity for additional tax-supported debt in any year in which debt service would be above 5 percent of tax revenues.

A Fresh Look at Tax-Supported Debt

- The voluntary restrictions embodied in the Debt Capacity Model were first adopted in 1991, in large measure to gain support for a proposed General Obligation Bond issue.
  - Since the creation of the Debt Capacity Model, outstanding General Fund supported debt has increased by almost $4.5 billion – just over ten times the 1991 level.
- This perceived limitation on the Commonwealth's capacity to continue to use tax-supported debt has raised three questions:
  - Why does Virginia impose a voluntary restriction on its ability to issue tax-supported debt?
  - Why is Virginia constrained in authorizing and issuing additional tax-supported debt?
  - Should the Debt Capacity Model be updated?



Why Restrict Tax-Supported Debt?

- **The self-imposed restriction on tax-supported debt is valuable to retaining Virginia's AAA bond rating.**
- Virginia has had an historical aversion to the use of debt financing that dates to the late 19^{th} century.
  - Resulting in a tradition of sound debt management.
  - Virginia's tradition of sound debt management has yielded it a AAA rating on its General Obligation Bonds since 1934.
  - Virginia is one of only eight states with a AAA bond rating from all three bond rating agencies.
- The AAA bond rating is important for two reasons:
  - AAA rated bonds yield a lower interest rate – saving the Commonwealth money.
    - In FY 2009 about 17 percent of Virginia's outstanding tax-supported debt is rated AAA. The remainder is rated one notch lower – AA.
    - At present there is approximately a 25 basis point (0.25 percent) advantage over AA rated bonds. Historically this spread has varied.
  - The AAA rating is a potent **symbol** of Virginia's business-like approach to government.
    - Can be a useful marketing tool in attracting business to the Commonwealth.
- **The self-imposed restriction on tax-supported debt helps assure that Virginia will be able to make its mandatory debt service payments <u>and</u> meet its other pressing budgetary needs.**

What Factors Constrain Debt Capacity?

- Virginia's Debt Capacity Model focuses only on tax-supported debt, traditionally comprised of general fund supported debt for capital projects and equipment as well as transportation and port construction projects supported by Transportation Trust Fund revenues.

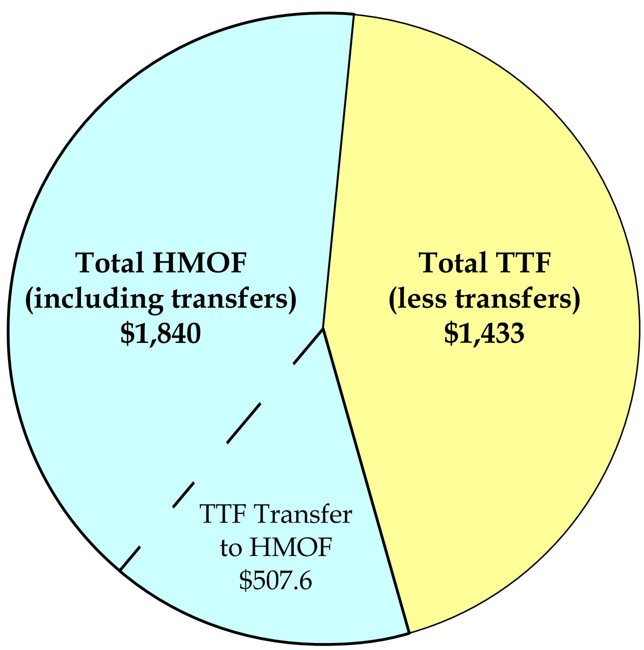
- Since 2007, several changes have occurred that were not envisioned when the model was developed in 1991.
  - Tax-supported transportation debt has been increasingly used to support highway and transit projects.
  - Actual and projected rate of growth in tax revenues supporting the Transportation Trust Fund has declined.
  - Debt for traditional general fund supported capital projects has increased dramatically.
  - Tax-supported debt is now used for non-traditional items once supported with general fund cash.
  - General fund tax revenues experienced the sharpest decline in recorded history in FY 2009, and decreased for two consecutive years for the first time in history.

FY 2012 Capacity = 5.13% of Tax Revenues (0.13% Over Capacity)	
Capital = 4.18% of Tax Revenues	Transportation = 0.95% of Tax Revenues

Transportation Debt is an Increasing Constraint on Debt Capacity

- The Commonwealth Transportation Fund (CTF) is the revenue repository that supports both long-term transportation investments as well as daily operations.
  - CTF is statutorily divided into two primary accounts; the Highway Maintenance and Operating Fund (HMOF) and the Transportation Trust Fund (TTF).
  - Federal transportation revenues are also deposited into the TTF. Increasingly these revenues are being diverted to HMOF to address maintenance program needs.
- Debt service for **all** transportation program bonds are ultimately paid from the revenues of the TTF. HMOF revenues are <u>not</u> used to support debt issues.

2010 Commonwealth Transportation Fund Revenues
($ in millions)



Total =$3.3 Billion

Role of Transportation Debt is Evolving

- The Commonwealth Transportation Board (CTB) has the power to issue bonds for financing the cost of construction projects.
  - Most transportation debt is **<u>not</u>** legally backed by the full faith and credit of the Commonwealth.
  - However, most transportation debt **<u>is</u>** classified as tax-supported and included in the Debt Capacity Model.
  - CTB bond issues have a term of 25 years or less.
  - The CTB must authorize the sale of transportation debt and the terms and structure of the bonds must be approved by the Treasury Board.
- Prior to 1986, bonds were only issued for toll roads with dedicated toll revenues to repay the debt service. Since then, the General Assembly has increasingly authorized debt with repayment from General Fund sources -- such as recordation tax revenues -- or other TTF sources.
- Since 2000, transportation debt authorizations have been primarily used as cash-flow to support projects approved within the normal six year planning process.
  - The current Six-Year Improvement Plan incorporates more than $1.3 billion in debt proceeds as revenue across the six years.
- As more debt has been issued, Virginia has moved further away from a "pay-as-you-go" transportation program.

Authorized Transportation Debt has Increased Significantly in the Last Decade

- The Virginia Transportation Act of 2000 (VTA) authorized the issuance of Federal Highway Reimbursement Anticipation Notes (FRANs) and established the Priority Transportation Fund (PTF).
  - Additionally, the VTA 2000 provided general fund revenues to advance specific transportation projects.
  - Directed the transfer of one-third of the insurance premium taxes to the PTF as well as dedicating certain existing transportation revenues to the PTF.
- The VTA 2000 included two separate lists of projects to be funded by FRAN proceeds and PTF revenues, as well as General Funds.
- FRAN debt service is to be provided first from federal reimbursements, then from available TTF revenues or other funds designated by the General Assembly.
  - Because federal funds are provided to Virginia on a reimbursement basis, the expenditure of state dollars is required prior to receiving federal funds for debt service payments.
  - In order to facilitate the construction of projects identified in VTA 2000, more than $550 million in general fund revenues have been transferred to the PTF since its inception; including estimated insurance premium revenues and other supplemental funding.

Challenges with the VTA 2000 Debt Program

- Economic downturn in 2002 disrupted implementation of VTA 2000 provisions.
  - General Funds were not available to support the general fund project list and dedicated funding for these projects was rescinded.
  - Insurance premiums were not consistently provided as anticipated.
  - Dedicated TTF revenue from State sales tax was temporarily diverted.
- In order to offset the TTF reduction, the original $800 million FRAN revolving authorization was increased to $1.2 billion.
  - General funds were initially provided to address the debt service on this increased debt.
- Given the implementation difficulties, Appropriation Act language has permitted the use of the PTF revenues to offset the impact on the TTF.
  - While the FRANs are being repaid indirectly from revenues of the PTF and have been supported by general funds, the obligations have not been included in the Commonwealth Debt Capacity model.
  - Current issues should be retired by 2016, although the $1.2 billion authorization remains in place.
  - Because the bonds are structured as 10 year notes, the covenants prohibit early refunding.
  - Similarly, financing costs under this program are very low.

Increase in Debt Financing Resulted in Creation of Priority Transportation Fund

- The Priority Transportation Fund (PTF) is established as a special non-reverting fund of the TTF.
- The PTF receives revenues from several sources, including:
  - One-third of the revenues of the annual license tax imposed on insurance companies doing business in the Commonwealth (previously a GF revenue source),
  - Revenues attributable to implementation of the motor fuels "rack tax" -- now $20 million in dedicated TTF revenues annually,
  - HMOF, highway construction and transit revenues that exceed the official forecast -- $64.4 million from FY 2010,
  - Any other such funds that may be transferred, allocated or appropriated, and
  - Interest income.
- The PTF is the primary vehicle for receiving state revenues for debt service payments on transportation debt issues for both VTA 2000 and HB 3202 (2007) bonds.

Significant Debt Authorization in 2007 Supports Highway and Transit Operations

- HB 3202 (2007) and Chapter 781 (2009) authorized the issuance of up to $3.2 billion of Capital Projects Revenue (CPR) Bonds.
  - 24.3 percent for transit and rail capital projects,
  - Balance to be used for highway construction.
- However, more than $1.2 billion (38 percent) of CPR proceeds are planned to be used for rail and transit projects including Metro capital improvement needs and Dulles Metrorail Project obligations.
- The balance of this debt authorization is planned to be used as cash-flow for existing projects in the Six-Year Improvement Program and is not dedicated to specific high-priority, or large dollar projects.
  - Bond proceeds are specifically budgeted to meet federal matching funding requirements as state TTF funds are increasingly used for funding the maintenance program.
- Bonds are scheduled to be sold through 2028, with final retirement of payments in 2053.
  - Amount issued in any one fiscal year <u>cannot</u> exceed $300 million unless prior year balances are not allocated.
- Total principal and interest payments on these bonds, by 2053, is expected to be more than $5.5 billion.
  - Interest payments of **more than $2.3 billion** in state transportation revenues means less funding that is available for addressing future construction needs.

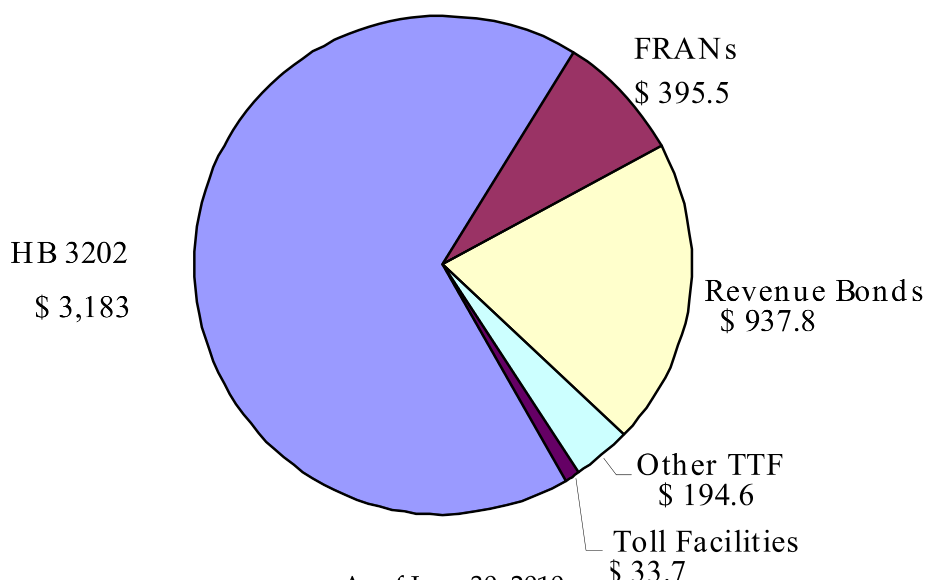
Legal and Economic Challenges Delayed Issuance of 2007 Debt Authorization

- The *Code* requires that CPR bonds may not be issued if revenues of the PTF are not by themselves sufficient to make 100 percent of the contractually required debt service payments on all debt supported by the Fund.
  - When all commitments to the PTF from FRAN and CPR issues are included, the FY10 coverage amount is 105 percent of the required debt service payment amount.
  - Should erosion in insurance premium revenues occur, issuance of additional authorized debt could not occur and additional TTF revenues would be required to meet mandatory debt service payments.
- Revenues required to support the debt service, primarily insurance premium revenues, were insufficient to support the planned issuance schedule; current FRAN debt service has first call.
  - Legal challenges to constitutionality of certain components of HB 3202 delayed the planned sale of the first tranche from summer 2007 ($100 million).
  - The first issuance of $492 million sold in May 2010, AA+ rated.
  - In order to maximize matching of federal revenues, it will take through 2028 to issue the full authorization -- 11 years longer than contemplated by the authorizing legislation.

Authorized and Outstanding Transportation Debt Totals More than $4.7 Billion

- HB 3202 bonds and FRANs are supported by insurance premiums and TTF revenues.
- Revenue Bonds are supported by both TTF and GF revenues, including some dedicated local recordation taxes and transportation formula distributions.
- Toll Facilities bonds issued by the Commonwealth are supported by dedicated toll revenues and **<u>are</u>** backed by the full faith and credit of the Commonwealth.
- Other TTF supported debt includes debt secured by the allocations to the Virginia Port Authority and the Department of Aviation.

Authorized and Issued Transportation Debt
($ in millions)



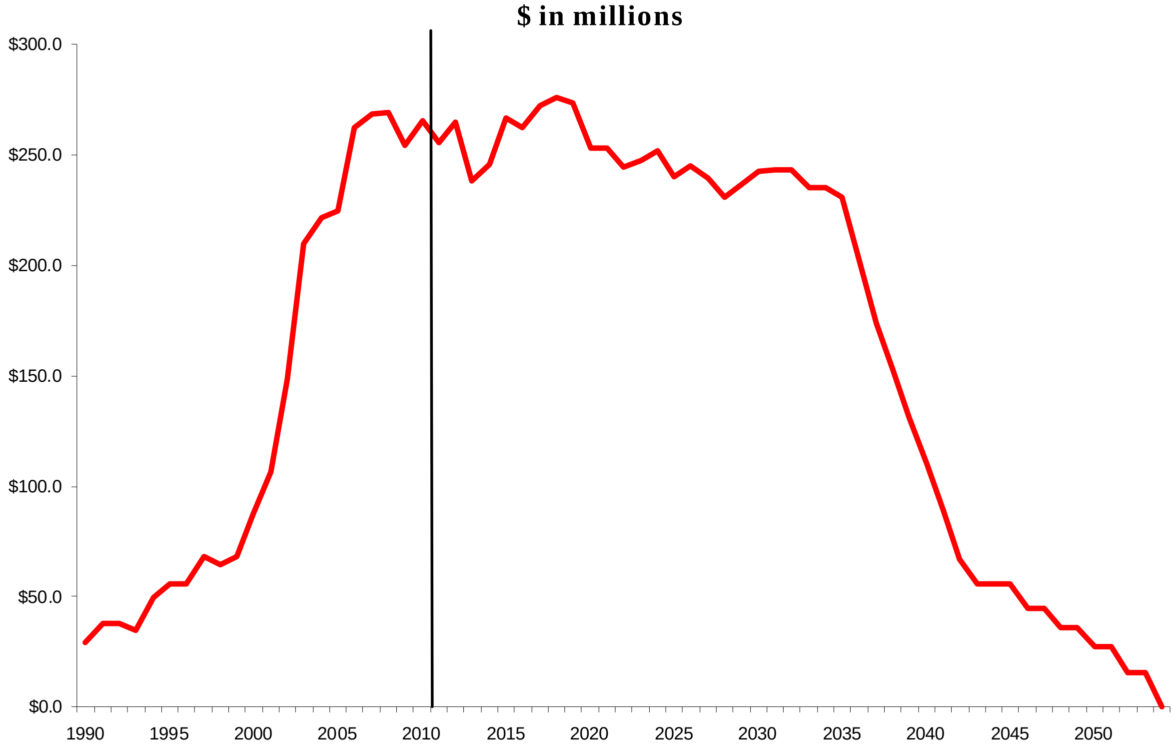
As of June 30, 2010

Transportation Debt Service Payments Are Approximately $250 Million Through 2025

- As debt financing became one of the primary funding mechanisms for Virginia's transportation and transit programs since 2000, annual debt service has become a larger portion of annual expenditures. This increase was exacerbated by economic conditions.
  - Annual expenditures for debt service have more than doubled in the past 10 years.
  - Annual debt service expenditures now exceed annual motor vehicle license revenues.
- The annual debt service payment for all TTF supported debt for FY 2011 is $255.5 million.

Total TTF Debt Service

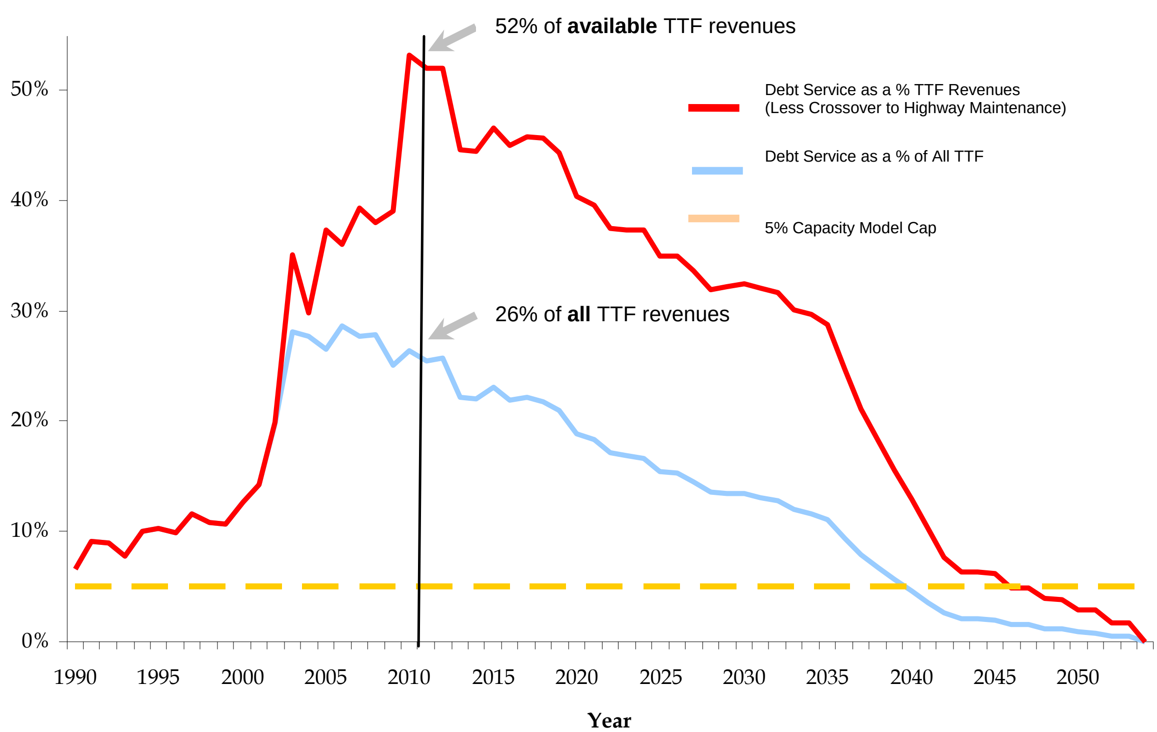
$ in millions



Transportation Debt Service Amounts Outpace Statewide Percentage

- Total debt service for all transportation program issuances supported by the TTF is 52 percent of <u>available</u> TTF revenues for FY 2011 and does not drop below 40 percent until after FY 2020.
  - However, this is based on four assumptions: (1) annual growth of TTF revenues of 3 percent, (2) growth of HMOF transfer of 4 percent, (3) interest rates of 5 percent, and (4) no additional TTF secured debt authorizations.
  - <u>Available</u> TTF revenues are the funds available for programming after any required transfer to the HMOF. Since 2003, more than $2.0 billion has been transferred from the TTF to the HMOF. The total transfer for FY 2011 is $511.0 million.

Transportation Trust Fund Supported Debt Service
% of TTF Annually



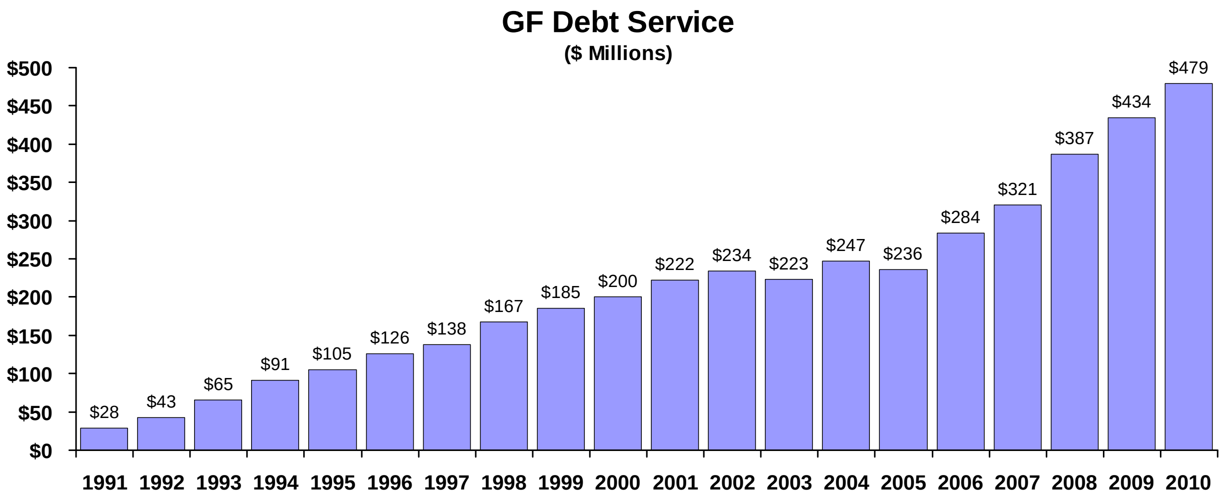
What Factors Constrain Debt Capacity?

- Authorized transportation debt has begun to limit the Commonwealth's ability to authorize and issue debt for traditional capital projects under the current debt affordability model.
  - HB 3202 (2007) did not contemplate the impact of authorization on the Debt Capacity Model, overall state debt capacity, or the impact of annual debt service requirements on transportation budgets.

FY 2012 Capacity = 5.13% of Tax Revenues (0.13% Over Capacity)	
Capital = 4.18% of Tax Revenues	Transportation = 0.95% of Tax Revenues

What Factors Constrain Debt Capacity?

- Virginia's General Fund operating budget has declined by $2.2 billion (-13 percent) since FY 2007, however GF debt service has actually increased by 50 percent.
  - Driven by increased reliance on debt for capital projects.



- Virginia's ability to issue additional tax-supported debt is also restricted by the **availability of revenues** for payment of debt service.
  - GF debt service on current issues, as well as authorized but not yet issued debt will likely be over $700 million by FY 2015.
  - At current budgeted interest rates (4.2 percent) the annual debt service on each additional $100 million amortized over 20 years is $7.5 million annually.
- In the absence of substantial revenue growth, the need to fund additional GF debt service payments will require budget reductions in other areas.

Should the Debt Capacity Model be Updated?

- The lack of available debt capacity and wide fluctuation in annual capacity limits prompted:
  - The Debt Capacity Advisory Committee to authorize a complete review of the Debt Capacity Model, and
  - The General Assembly to require development of a plan for the issuance of the new debt authorized in 2010.
- Preliminary staff recommendations indicate that the model should be updated in several ways.
  - General Fund revenues that are routinely appropriated should be included in the blended revenues used in the model, including:
    - The 0.25 percent sales tax for education, and
    - An estimate of routine transfers from nongeneral fund sources to the general fund.
  - The nongeneral funds generated by the capital outlay fee charged to out-of-state students.
  - Additional capacity could be based on the **average** of the available capacity over the ten year period.
    - No change in 10-year debt capacity.
    - Smoothes annual fluctuations in debt capacity.
- These recommendations may allow an additional $436 million of annual tax-supported debt capacity.
  - Some portion of this new capacity will be needed to move forward the $1.3 billion of new debt authorized in 2010.
  - **Can the Commonwealth afford the debt service payments?**

Should Transportation be Removed from the Debt Capacity Model?

- Another option that was reviewed by the Debt Capacity Advisory Committee would limit or remove transportation debt from the model.
  - The Public Resources Advisory Group, the state's financial advisor, cautioned against this because it may be negatively perceived by the investment community.
- Retaining transportation debt in the model may enable the Commonwealth to get a better interest rate as a subordinate debt issue.
  - Also keeps issuance levels constant by adding discipline to the issuance of existing authorizations.
- There is no formal guideline for the appropriate level of annual transportation revenues used for debt service. The Commonwealth debt capacity target of 5 percent does not apply directly to TTF supported debt.
  - If transportation debt was removed from the model, there would be fewer constraints on the issuance of TTF supported debt.
- The overall policy question is what is the appropriate percentage of TTF revenues to be used for debt service?
- There was no consensus from the Debt Capacity Advisory Committee to remove tax-supported transportation debt from the Debt Capacity Model.

Summary

- Debt can continue to be a useful financial management tool **<u>if</u>** it is authorized as part of a comprehensive funding plan that prioritizes sources of revenues for the long-term retirement of existing authorizations.

- Debt authorizations are typically made by the General Assembly in isolation. However, the Commonwealth has attempted, through the Debt Capacity Advisory Committee, to overlay discipline and fiscal restraint with regard to timing the affordability of debt.

- Virginia's reliance on debt is increasing.
  - Debt service on already authorized GF debt will soon be over $700 million annually.
  - Growth in transportation debt is limiting the availability of capacity for traditional capital projects.

- All future debt authorizations should consider the effect on cash flow, as increased debt service costs reduce available funds for other General Fund and transportation purposes.

- In the absence of any debt benchmark, the Commonwealth should consider establishing a benchmark for making transportation debt decisions.

- What budget trade-offs are appropriate if additional GF debt service payments must be met?

Appendix A: The Constitutional Basis of Virginia's Debt

- Virginia's ability to utilize debt is found in Article X § 9 of the Constitution.
  - There is little functional difference between 9(b) General Obligation and 9(d) Other debt.
  - Virginia's current practice provides better interest rates for § 9(c) NGF debt than for 9(d) debt paid from tax revenues.

Type	Approved by Voters	Full Faith & Credit	Paid From Tax Revenues	Va. Retains Title	AAA	AA
§ 9(a) Emergencies	X	✓	✓	✓	✓	X
§ 9(b) General Obligation	✓	✓	✓	✓	✓	X
§ 9(c) Revenue Producing	X	✓	X	✓	✓	X
§ 9(d) Other (VPBA & VCBA)	X	X	✓	✓	X	✓

Appendix A: The Constitutional Basis of Virginia's Debt

- Debt service is directly related to both the repayment period and interest rate on the bonds.
  - Virginia typically uses a repayment period of twenty years on debt for capital projects.
  - Over three-fourths of Virginia's tax-supported debt is issued by the VPBA and VCBA, at a higher interest rate.
  - This preference for AA rated authority debt results from the constitutional restrictions on Virginia's use of General Obligation Debt, which requires a referendum.
  - As authorities without inherent revenue generating capacity, bonds of the VPBA and VCBA are rated AA+ instead of the AAA rating for Virginia's General Obligation Debt.
  - Debt service will be higher over the twenty year life of the AA rated bonds when compared to AAA rated GO debt of the Commonwealth.
  - The higher debt service costs reduce Virginia's capacity under the Debt Capacity Model.

Appendix A: The Constitutional Basis of Virginia's Debt

- Five AAA rated states can issue GO Debt without voter approval.

Approval of General Obligation Debt in AAA States	Virginia	Delaware	Georgia	Maryland	Missouri	North Carolina*	Utah
Legislature		✓	✓	✓		✓	✓
Voters	✓					✓	
Constitutional Amendment					✓		

* North Carolina is authorized to issue general obligation debt without voter approval under limited circumstances.

- These five states make proportionately more use of the better rated General Obligation debt.
  - Debt service savings result from the better interest rates.

FY 2009: Outstanding Tax Supported Debt		
State	$ Millions	
	General Obligation	Other Tax-Supported
Virginia	$ 1,078	$ 3,924
Delaware	$ 1,469	$ 1,145
Georgia	$ 9,242	$ 1,560
Maryland	$ 5,874	$ 2,681
Missouri	$ 600	$ 3,350
North Carolina*	$ 5,169	$ 2,038
Utah	$ 1,493	$ 168

- As of 2010 Iowa's General Obligation debt is also rated AAA.