Overview of Virginia's Use of Debt

November 18, 2011

The Public Debt Environment in 2011

- The past year has seen an increased focus on public debt.
  - Continued economic difficulties,
  - Federal deficit, and
  - European debt crisis.

- Some external factors have had a positive impact on the environment in which Virginia uses debt.
  - Interest rates are at historic lows.
  - Based on recent sale experience, GO bonds sold at 3.43%.
  - AA+ (VCBA/VPBA) bonds would expect to be 20-30 basis points higher at 3.63% to 3.73% .
  - Bids on state capital projects continue to come in under budget.
    - 2011 bids on two large projects authorized in Chapter 874 (2010) are 4 percent under the DGS project estimate and 16 percent below the 2010 target amount.
    - VCU reports that a dorm project is 25 percent under the cost of a similar project in 2007.
    - Construction costs are expected to begin increasing in the near future.

The Public Debt Environment in 2011

- Some external factors may adversely impact Virginia's use of its capacity for debt.
  - Potential federal budget reductions led Moody's to include Virginia among five AAA rated states assigned a "negative outlook".

States Rated AAA by Moody's	Negative Outlook	Reason					
		Employment volatility	Federal Employment %	Federal Procurement	Medicaid	Capital Market Risk	Available Fund Balance
Alaska							
Delaware							
Georgia							
Indiana							
Iowa							
Maryland	X	X	X	X			+
Missouri							
New Mexico	X		X	X	X	X	+
North Carolina							
South Carolina	X			X	X	X	-
Tennessee	X	X	X		X	X	-
Texas							
Utah							
Vermont							
Virginia	X	X	X	X			-

- Virginia's public finances remain well-managed and sound.

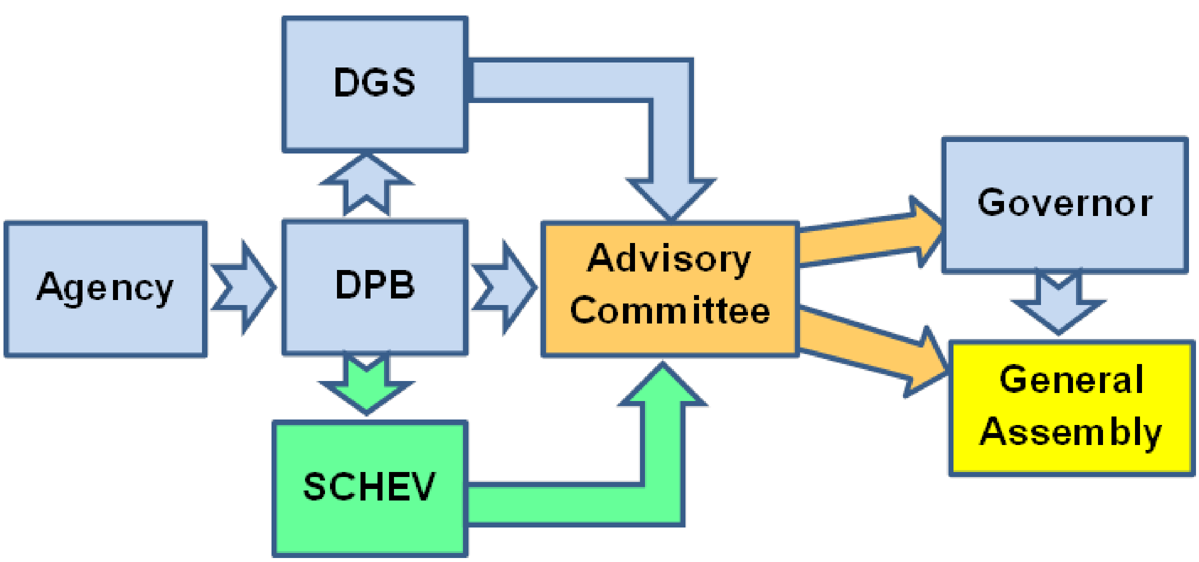
Public Debt Needs in 2011

- In the absence of General fund cash, the demand for general fund supported debt financing remains high.
- **Capital Projects:** State agencies and institutions of higher education requested $5.1 billion for capital projects in their revision to the Six Year Capital improvement plan.
- **Maintenance Reserve:** The funding level for the Maintenance Reserve varies but the target has been at least $50 million per year.
- **HEETF:** The traditional funding level for the Higher Education Equipment Trust Fund is $50 million per year.
- **Water Quality Projects:** The Commonwealth's share of local water quality improvement projects is estimated at $161.3 million.
- **Local and Regional Jail Projects:** Unknown
- **Transportation:** Unknown

Public Debt Needs in 2011: Capital Projects

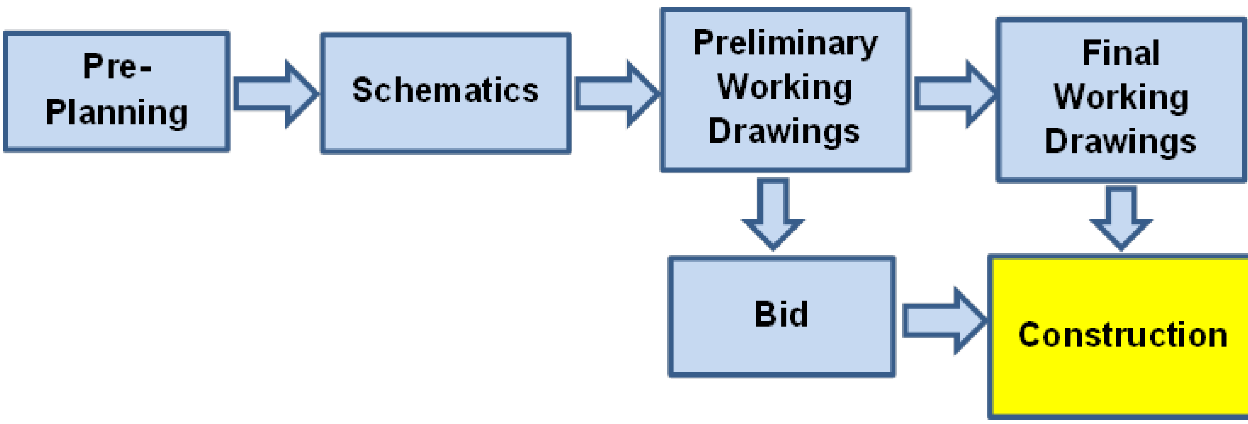
- State agencies and institutions of higher education requested $5.1 billion for capital projects in their revision to the Six Year Capital Outlay Plan.

- The Commonwealth's capital planning process requires multiple reviews to assure that projects stay within scope and budget:
  - **SCHEV:** Reviews higher education projects for need.
  - **DGS:** Reviews project cost estimates.
  - **Six-Year Capital Outlay Plan Advisory Committee:** Recommends a list of projects to the Governor an General Assembly.
  - **DPB:** Coordinates the process.



Public Debt Needs in 2011: Capital Projects

- If approved, funding is provided in steps to maintain control over project scope and cost.



- DGS review has reduced the estimated cost of requested projects to $4.5 billion.
  - 12 percent reduction.
  - 98 projects recommended at the same or higher amount.
  - 170 projects recommended at a reduced amount.
- SCHEV recommended 149 higher education projects.
  - Justified under existing guidelines.
  - $2.7 billion GF cost (Before DGS review).

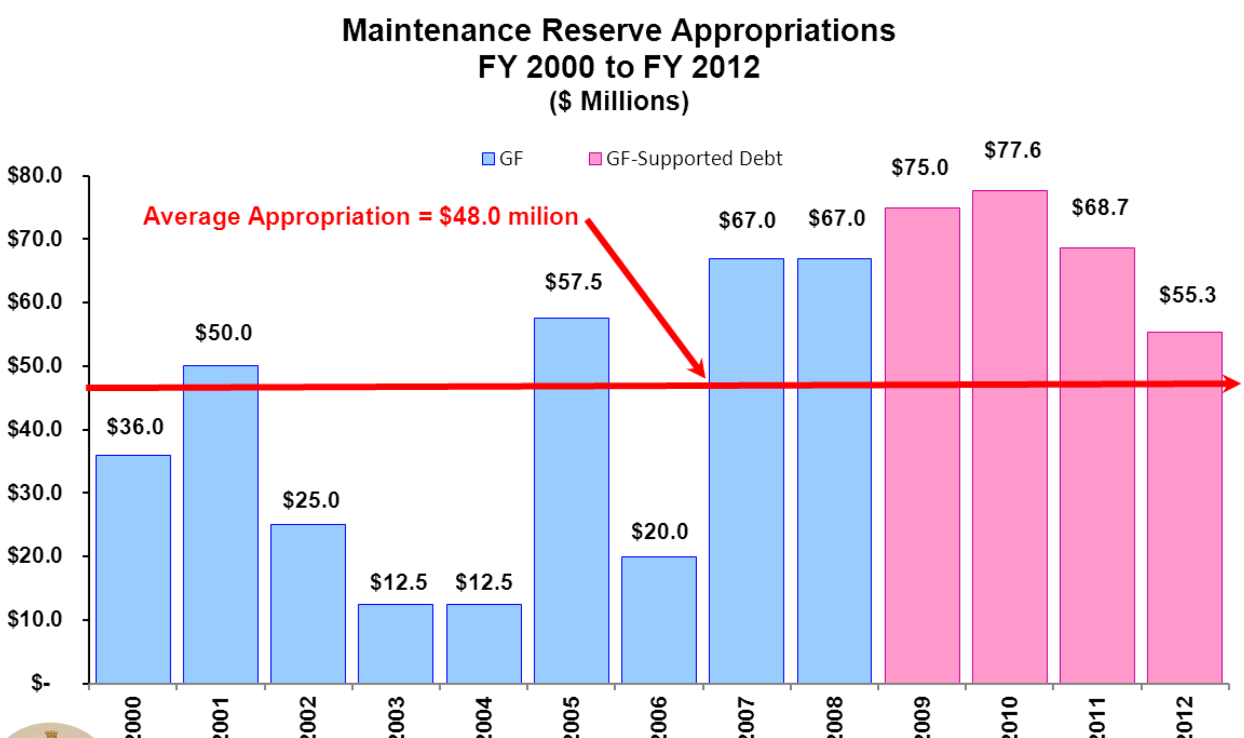
Public Debt Needs in 2011: Capital Projects

- Selected examples of project requests for the 2012-14 biennum include:

Category and Examples	GF Requests 2012-14
Improvements	**$2,138.2**
DBHRS: Repair/Replace Boilers, Heat Distribution and HVAC Systems	$26.4
UMW: Repair/replace underground utilities	$6.2
DOC: Replace Security and Detention System -- Marion	$10.6
UVa: Renovate the Rotunda	$15.6
New Construction	**$1,843.1**
VCCS: Phase VII Academic Building, Annandale Campus, Northern Virginia	$30.2
ODU: New School of Education	$44.5
VCU: Construct and Renovate Information Commons and Libraries	$42.7
Equipment	**$28.2**
LU: New University Technology Center - Equipment	$4.1
Planning	**$13.1**
Powhatan Replacement Planning	$6.7
Acquisition	**$14.5**
VCCS: Acquire Lease Purchase Option, Phase I, Regional Visual Arts Center, Portsmouth Campus, TCC	$2.1
Total	**$4,037.1**

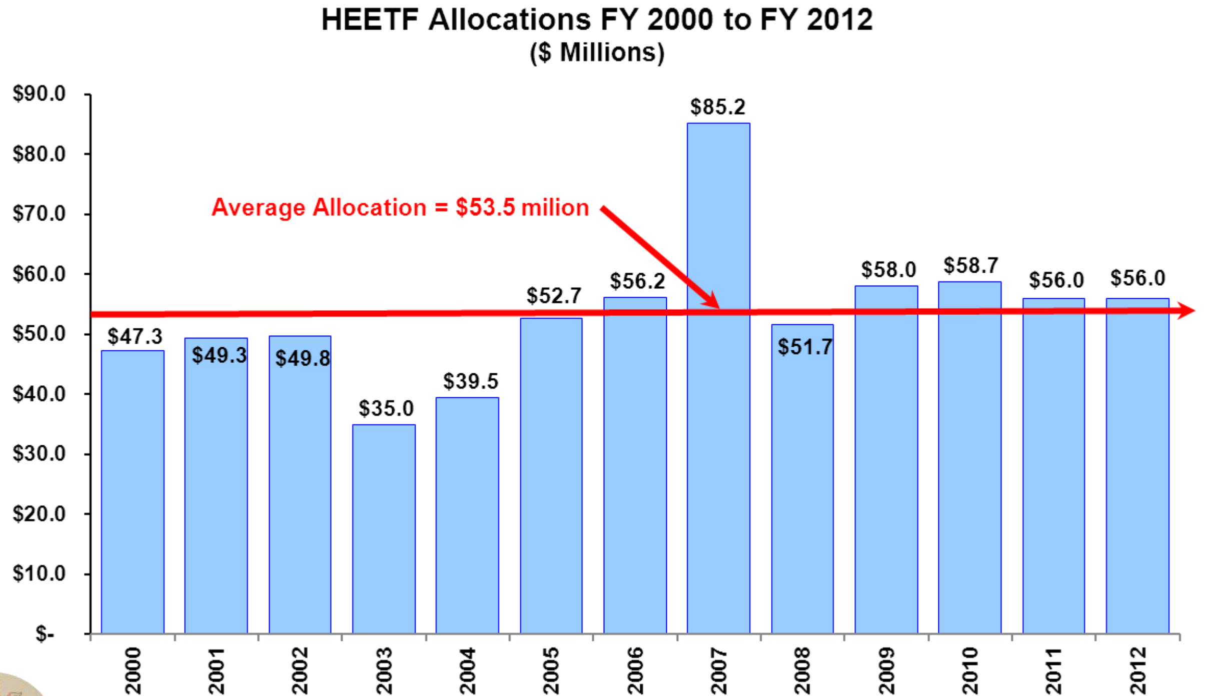
Public Debt Needs in 2011: Maintenance Reserve

- **Maintenance Reserve** funds major repair or replacement to plant, property, or equipment.
- Maintenance Reserve projects typically cost from $25,000 to $500,000.
  - Routine maintenance and custodial services are included in agency operating budgets.
- Agencies report over $3.9 billion of deferred maintenance.
- The amount budgeted for Maintenance Reserve varies but the recent target has been $50+ million per year.



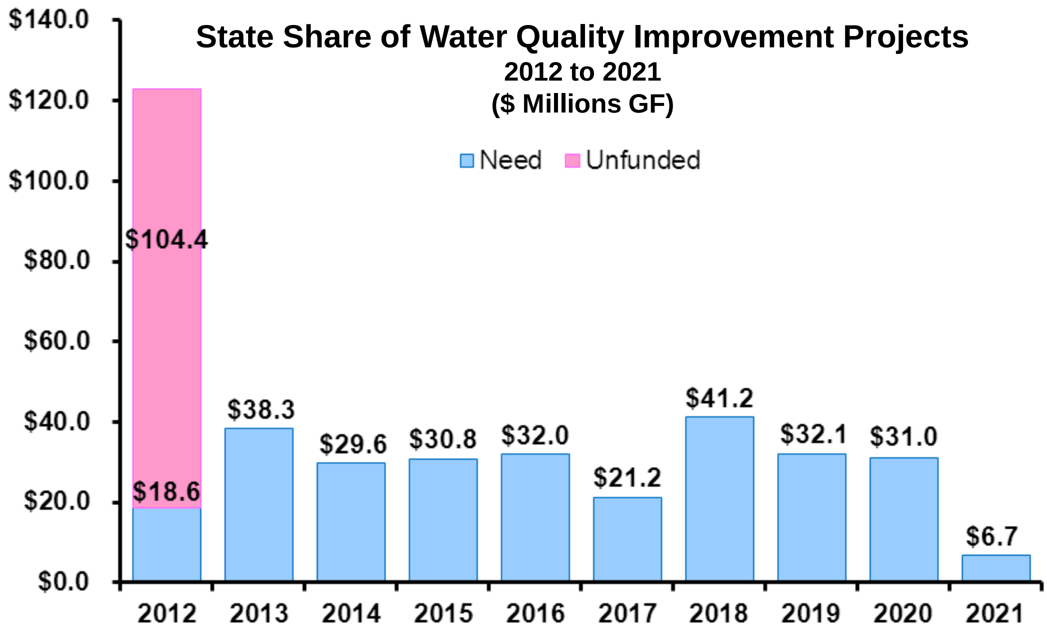
Public Debt Needs in 2011: HEETF

- The **Higher Education Equipment Trust Fund (HEETF)** was established in 1986 by the General Assembly to provide funding for equipment needed for instruction and research.
  - Distribution of equipment funds is based on recommendations from the State Council on Higher Education for Virginia (SCHEV).
  - Seven year debt arranged through the Virginia College Building Authority (VCBA).
- The amount varies but the recent goal has been $50+ million per year.



Public Debt Needs in 2011: Water Quality Projects

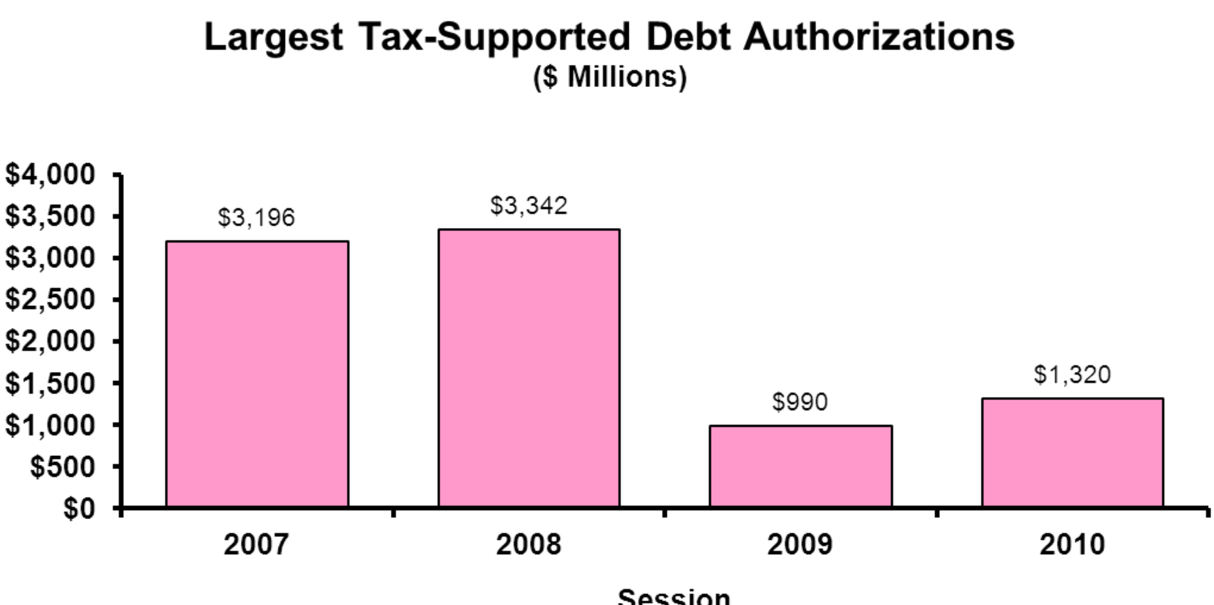
- **Water Quality Projects:** The contractually obligated state share of upgrading municipally owned wastewater treatment plants to meet water quality standards.
  - Since 1998, the Commonwealth has committed $752.0 million for its share of water quality projects.
  - The primary funding source is the general fund transfer to the Water Quality Improvement Fund.
  - VPBA debt is used when insufficient general funds are available. To date, $250 million has been issued.
- The state share of future upgrades is estimated at $281.6 million.



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 to fund items traditionally funded with cash.
  - Highway construction
  - Maintenance reserve
  - Economic development
  - Museum conservation
  - Local and Regional Jails
  - Public broadcasting equipment
  - Water quality improvement.

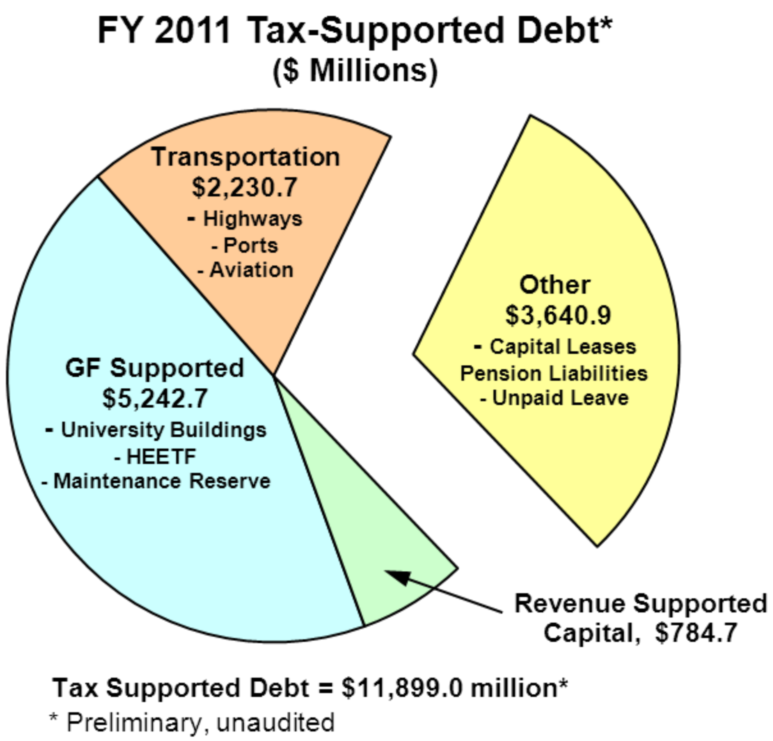
- In the face of softening economic conditions, the **four largest tax-supported debt authorizations** in the history of the Commonwealth have occurred since 2007.



What is Tax-Supported Debt?

- Tax-supported debt is debt on which payments are made, or pledged to be made, from funds derived from tax revenues or general government funds, including:
  - Individual income, corporate income, and sales taxes;
  - Tax-derived Transportation Trust Fund revenues; and
  - Insurance premium tax authorized for transportation.

- Virginia's $11.9 billion of tax-supported debt (FY 2011) 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.

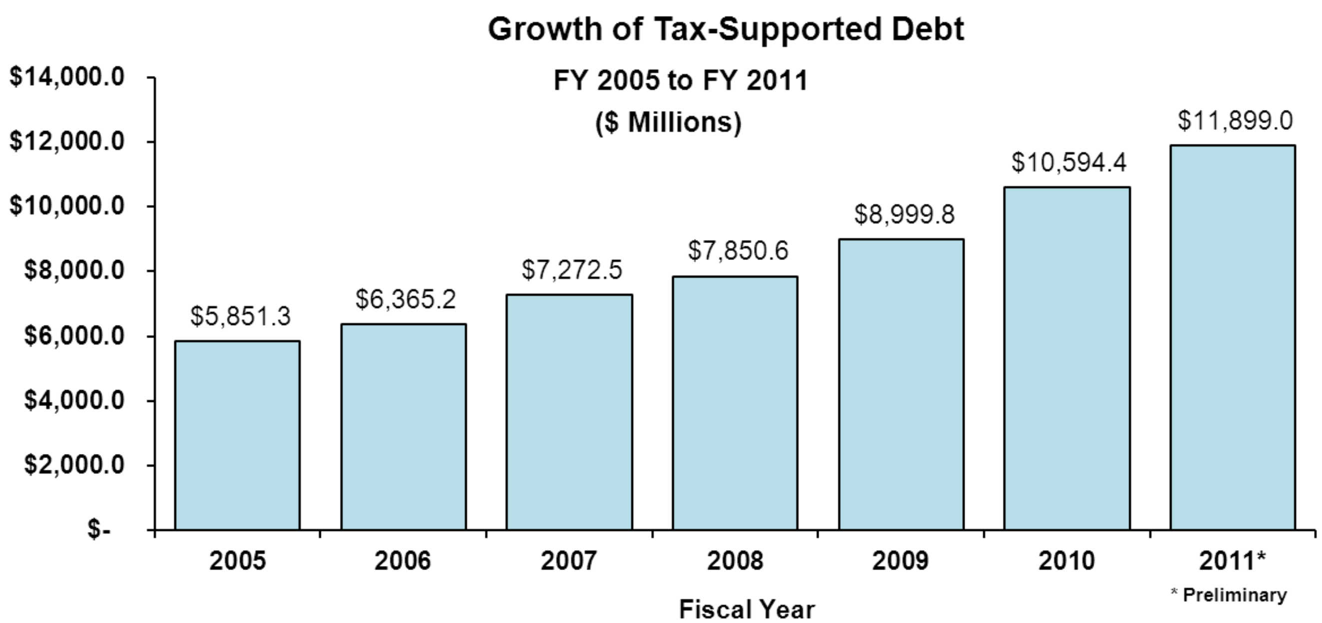
- **Other** includes capital leases, and other long-term obligations.

What is Tax-Supported Debt?

- Only the General Assembly can authorize debt obligations.
- The Executive Branch is responsible for the issuance of authorized debt.

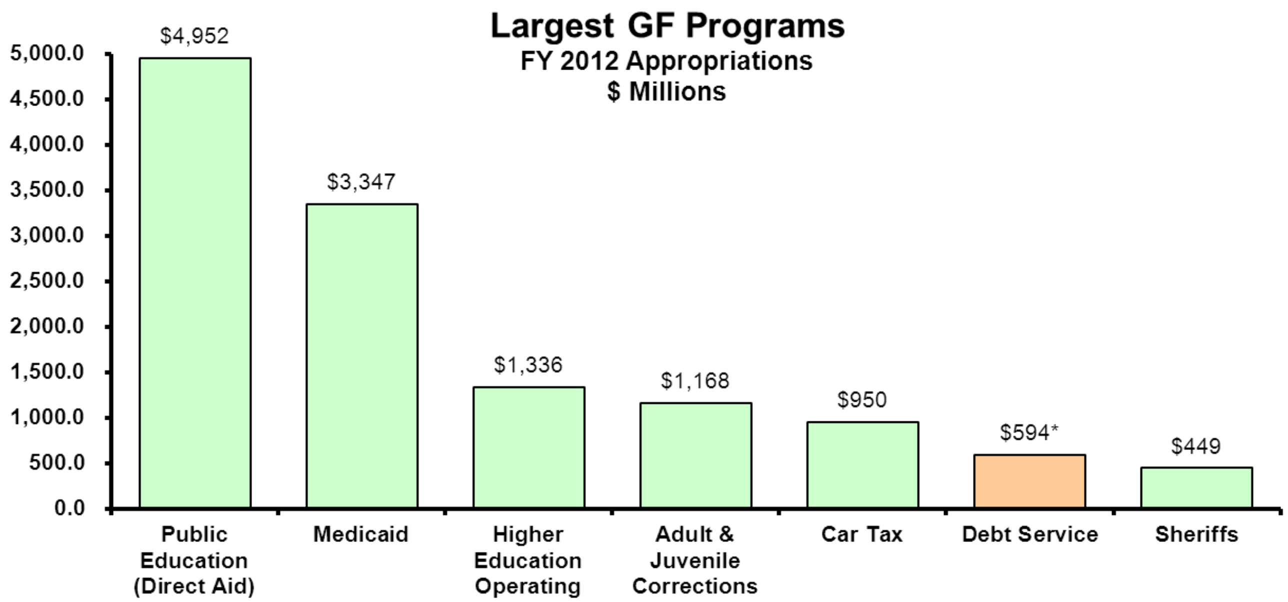
Virginia's Reliance on Debt has Increased

- Outstanding tax-supported debt grew by $5.7 billion (98 percent) from FY 2005 to FY 2011.



Virginia's Reliance on Debt has Increased

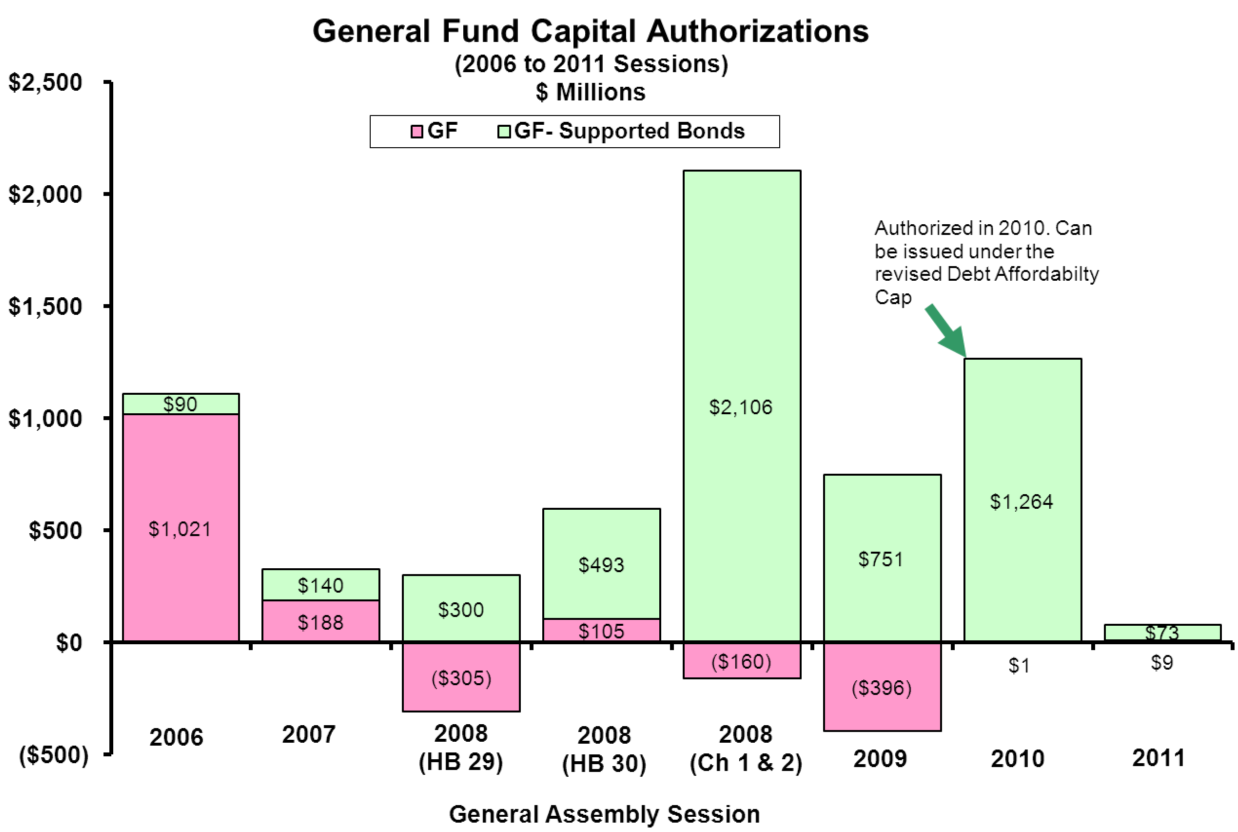
- As a result, the required annual debt service payment is now the sixth largest general fund program.
  - Only debt service and Medicaid have grown during the recession.



* includes $8.9 million GF interest payment on VEC debt to the Federal unemployment program.

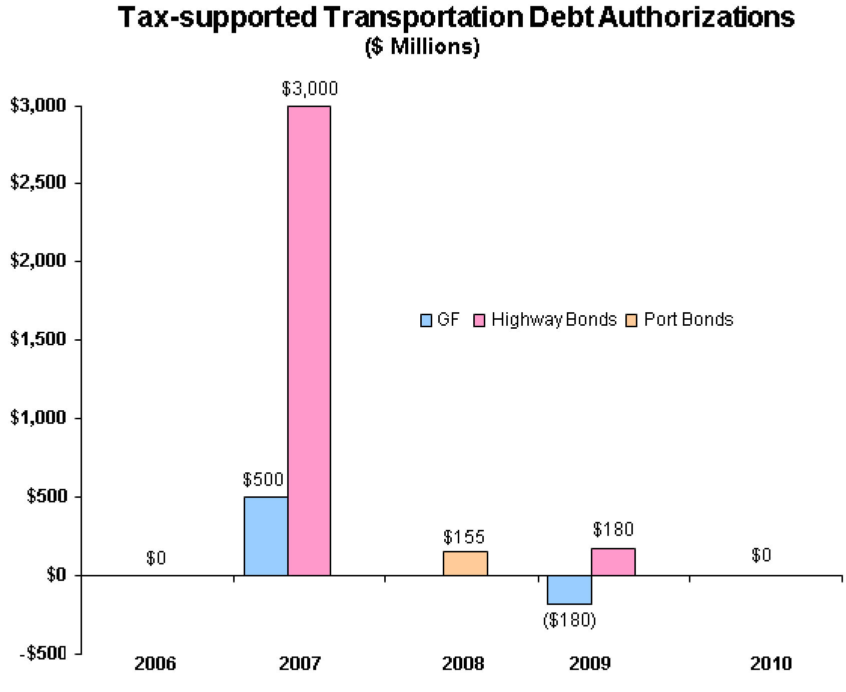
The Move to Debt for Capital Projects

- 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 and 2009 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 could not be issued until 2011 due to 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) authorized the issuance of up to $3.18 billion of Capital Projects Revenue (CPR) bonds.
  - SB 1446 (2011) and HB 2527 (2011) authorized the issuance of up to $1.2 billion of Direct Grant Anticipated Revenue (Direct GARVEE) bonds. **(Not tax-supported debt)**



What is Virginia's Debt Capacity Model?

- The **Debt Capacity Model**, administered by the **Debt Capacity Advisory Committee (DCAC),** is an estimate of Virginia's capacity to authorize and issue new tax-supported debt.
  - The Model is used to advise 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.

- In recent years, issuance of authorized debt was constrained to keep projected debt service payments under the 5 percent limit each year.

Why Restrict Tax-Supported Debt?

- **The self-imposed restriction on tax-supported debt is valuable to retaining Virginia's AAA bond rating.**
- The AAA bond rating is important for two reasons:
  - AAA rated bonds yield a lower interest rate – saving the Commonwealth money.
    - In FY 2011 about 21 percent of Virginia's outstanding tax-supported debt was rated AAA. The remainder was rated one notch lower – AA.
    - At present there is approximately a 20 to 30 basis point (0.2 to 0.3 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.**

DCAC Changes to the Debt Capacity Model

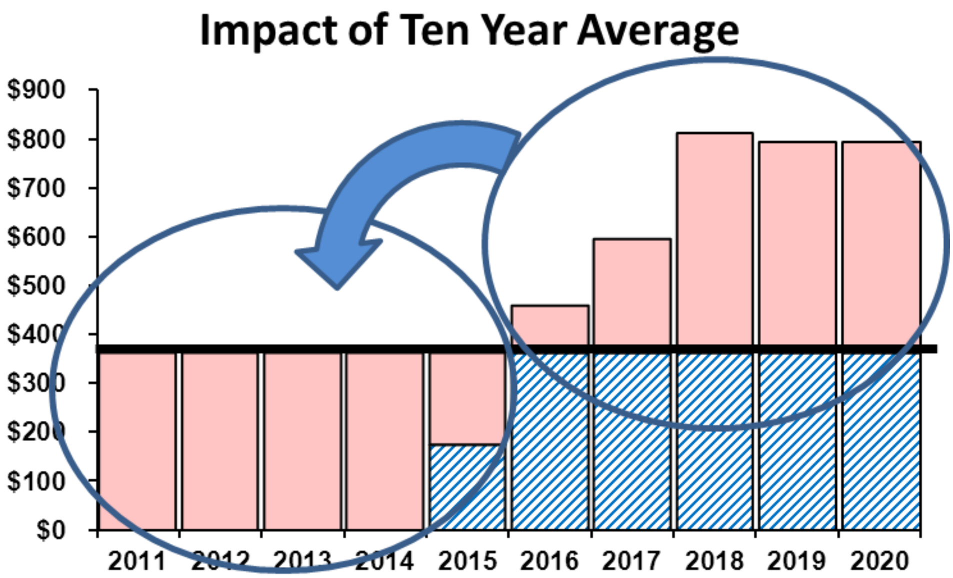
- The inability to authorize new debt obligations beyond those approved through 2010, and wide fluctuation in annual capacity limits, prompted DCAC to initiate a complete review of the Model.

- DCAC voted on December 17, 2010 to update the Model in two ways:
  1. ***Technical Changes:*** A series of technical changes were unanimously supported by the committee.
  2. ***Policy Change:*** Available capacity is based on the **average** of the available capacity over the ten year period. The Model now in use (2011):

     $$\frac{\textbf{Debt Service/Average Blended Revenues}}{\textbf{10}} \leq \textbf{5.0 \%}$$

  - No change in overall 10-year debt capacity.
  - Increases capacity available for immediate authorization by shifting capacity from future years that is generated by the revenue growth assumptions.

DCAC Changes to the Debt Capacity Model



- The **policy** change allowed an additional $363 million of **<u>average</u>** annual tax-supported debt capacity for the 2011 session (up to $3.6 billion total), after allowing for the issuance of all currently authorized tax-supported debt.
- Although the **policy** change allowed all transportation debt authorized under HB 3202 to be accelerated and issued by 2020, <u>insurance premium tax revenues and approximately $50 million in one-time TTF revenues will be required to make debt service payments.</u>

2011 Uses of the Additional Debt Capacity

- The Governor proposed two primary uses for the additional debt capacity:
  - Acceleration of $480 million of transportation debt authorized in HB 3202, and
  - $114 million for traditional capital projects.
  - Additional capital projects were expected to be added by the General Assembly.
- The Senate proposed to use $652.4 million of this additional debt capacity for capital projects:

SB 800 Capital Proposals Funded with General Fund Supported Bonds by Project Type	
Major Category	**Bonds $ Millions**
New Construction	$ 585.3
Equipment for Previously Authorized Projects	51.5
Maintenance Reserve	8.6
Project Supplements	7.3
Total: GF Supported Bonds for Capital Projects	**$ 652.7**

2011 Uses of the Additional Debt Capacity

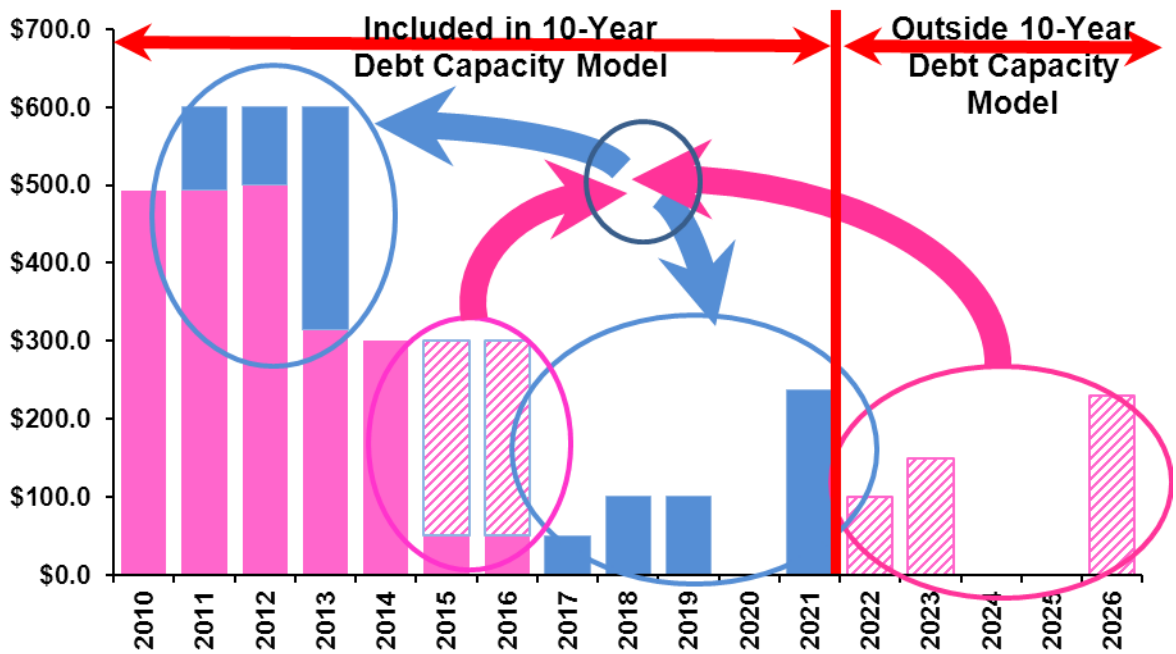
- No capital amendments were adopted at the 2011 regular session to make use of the additional debt capacity.
- The Governor proposed $72.5 million of limited capital amendments funded with tax-supported debt that were approved at the 2011 reconvened session:

Chapter 890 Capital Projects Funded with General Fund Supported Bonds by Project Type

Major Category	Bonds $ Millions
Equipment for Previously Authorized Projects	$ 51.1
New Construction and Renovations	5.0
Maintenance Reserve	9.0
Project Supplements	7.3
Total: GF Supported Bonds for Capital Projects	**$ 72.5**

2011 Uses of the Additional Debt Capacity

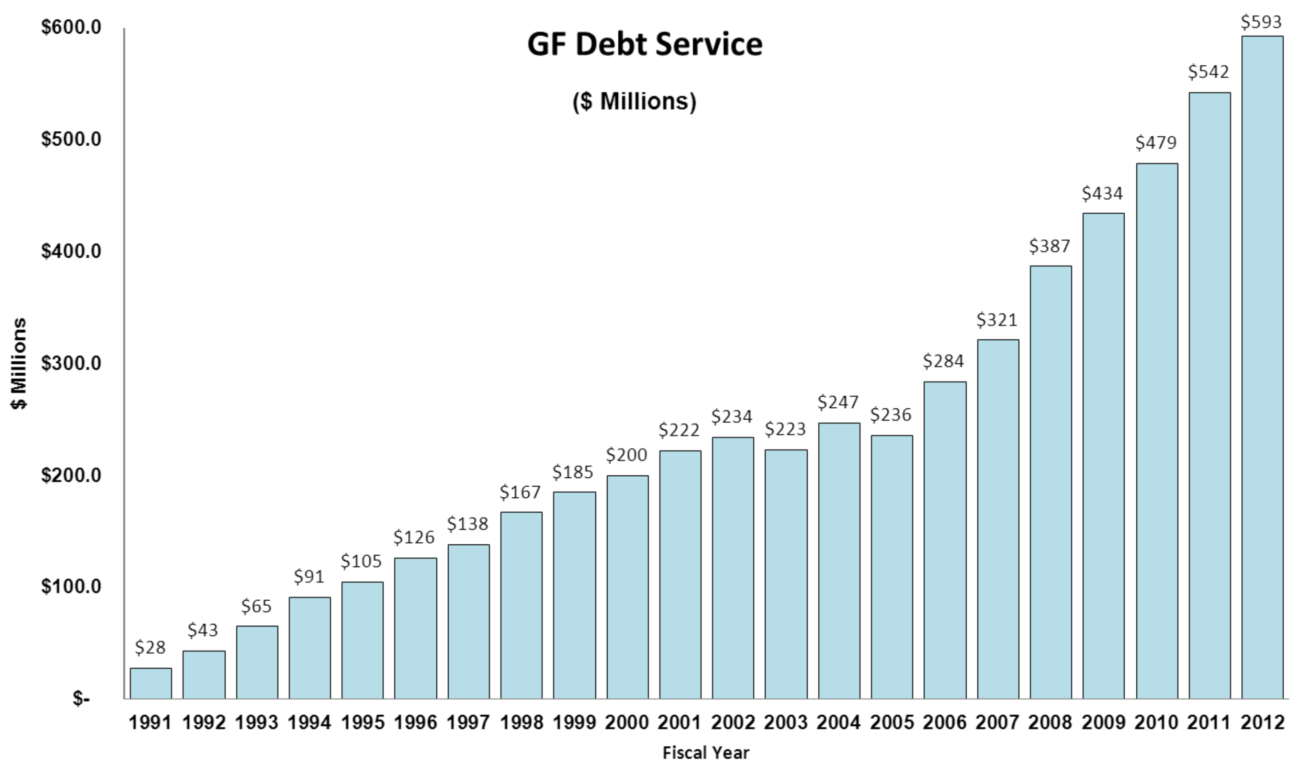
- The 2011 transportation program relies heavily on debt.
- Accelerates the transportation debt authorized in HB 3202 (2007).



- The $1.2 billion in direct GARVEE bonds for transportation authorized in 2011 **do not** count against the Commonwealth's debt capacity.
- Adjusted for 2011 session actions, estimated debt capacity was $367 million annually ($3.7 billion total) in March 2011.
  - December revisions will provide an estimate of the debt capacity available to the 2012 General Assembly.

What Factors Constrain Debt Capacity?

- GF debt service has increased by 70 percent since FY 2007.
  - Driven by increased reliance on debt for capital projects.



What Factors Constrain Debt Capacity?

- 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.
  - At current budgeted interest rates (4.2 percent) debt capacity increases $5.5 million annually ($55 million total) for each additional $100 million of annual revenue.
- In the absence of substantial revenue growth, the need to fund additional GF debt service payments will require budget reductions in other areas.

Future Debt Outlook

- Virginia continues to have adequate debt capacity to meet its essential capital needs.
- Several factors make this a good time to utilize the Commonwealth's capacity for additional tax-supported debt:
  - GF capital requests for the 2012-2014 biennium totaled more than $6 billion.
  - Interest rates are at historic lows.
  - Bids on state capital projects continue to come in under budget.
- Several factors may inhibit the use of this available debt capacity:
  - Potential federal budget reductions may adversely affect Virginia's budget and overall economy.
  - Moody's has assigned a "negative outlook" to Virginia's AAA credit rating.
  - The political environment surrounding the national debt may adversely affect the willingness of some to make use of Virginia's capacity.