Office of the
Legislative Fiscal Analyst

FY 2004 Budget Recommendations

Joint Appropriations Subcommittee for
Capital Facilities and Administrative Services

Utah Department of Administrative Services
Debt Service

Contents:

1.0 Summary: Debt Service

Debt Service is made up of interest and principal due on the State's bonded indebtedness. The State uses long term debt to finance large capital expenditures including new construction, major remodeling and highway projects. Dedicated revenue streams such as enterprise fund revenue or dedicated lease payments secure some bonds. Debt Service on Revenue Bonds and General Obligation Bonds are included in this appropriation.

Financing	**Analyst FY 2004 Base**	**Analyst FY 2004 Changes**	**Analyst FY 2004 Total**
General Fund	56,833,700		56,833,700
Uniform School Fund	11,466,700		11,466,700
Centennial Highway Fund	84,618,200	15,067,400	99,685,600
Dedicated Credits Revenue	31,555,400	(47,200)	31,508,200
Beginning Nonlapsing	11,092,400		11,092,400
Closing Nonlapsing	(8,809,000)		(8,809,000)
Total	$186,757,400	$15,020,200	$201,777,600
Programs			
Debt Service	186,757,400	15,020,200	201,777,600
Total	$186,757,400	$15,020,200	$201,777,600
FTE/Other			

2.0 Issues: Debt Service

2.1 General Obligation Bonds (Facilities)

Bonds issued for facility construction traditionally have been amortized over a six year period. The state pays interest for five years, then a lump sum principal payment in the final year. For a variety of reasons (i.e., structural delays from the legislative process, construction delays, procurement extensions) bonds issued by the state are actually amortized for less than six years – it is more realistic to assume that bonds will actually be issued and amortized over a period of 54 to 60 months.

During 2002 the Legislature met five times to address budget issues – first in the General Session, then again in four of the six special sessions. Over the course of these special sessions, the Legislature redirected cash appropriations for buildings to other state needs and replaced the funding with bond authorizations. As a result of these actions debt service for FY 2004 will increase by nearly $5.7 million. Section 3.4 provides an analysis of the impact of the issuing more than $230 million in general obligation bonds.

Uniform School Fund $5,697,600

2.2 Revenue Bonds

Revenue Bonds are issued through the state Building Ownership Authority. Agencies pledge a stream of revenue (either revenue from sales or dedicated lease payments) to amortize bonds. The Department of Alcoholic Beverage Control applies revenue from liquor sales to debt service on new stores, store remodeling and expansion of warehouse capacity. Other agencies, such as the Department of Corrections, pledge ongoing lease funding to debt service so that the state may own facilities rather than continue in long term leases. Funds expended on Revenue Bonds are considered Dedicated Credits paid to the Building Ownership Authority. Even though the cost of revenue bonds are slightly higher than general obligation bonds, they provide an extra measure of flexibility in dealing with statewide budget needs.

2.3 Highway Bonds

The Centennial Highway Fund provides for construction of roads and debt service on bonds. The program uses longer term bonds, but the Legislature chooses to pay those bonds on an accelerated schedule. Highway Bond debt service jumped in FY 2002 as a result of the first installment of principal payments. Debt Service in FY 2004 will require an increase of Centennial Highway Fund to pay the $97 million due in the coming year.

Centennial Highway Fund $15,067,400

3.0 Programs: Debt Service

3.1 FY 04 Debt Service Needs

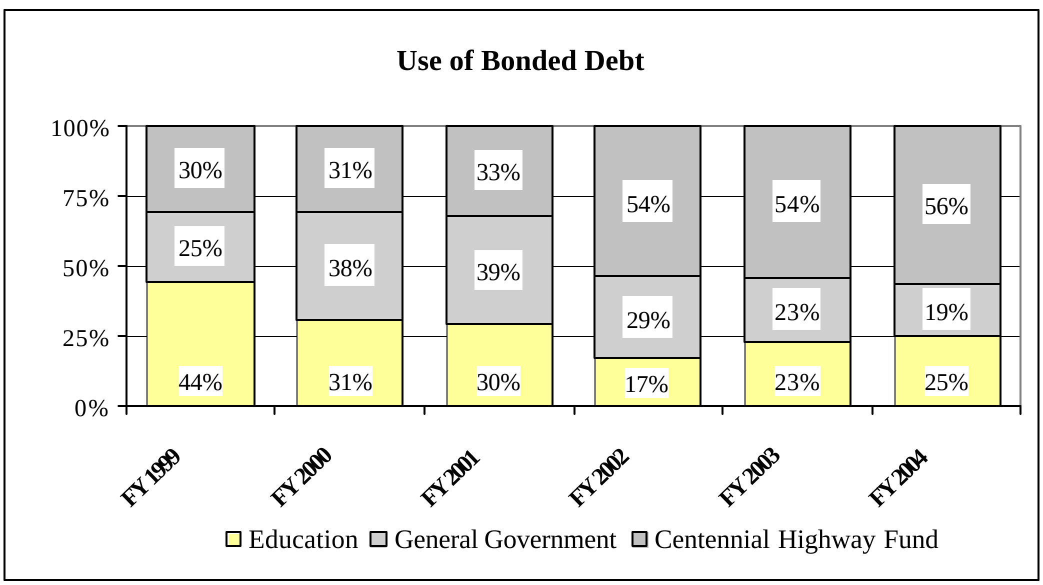
The Table shown below does not include an additional $5,697,600 in State Funds needed to fund debt service in FY 2004. The increase will fund interest payments on bonds authorized during the Fourth, Fifth and Sixth special sessions of 2002.

Financing	2002 Actual	2003 Estimated	2004 Analyst	Est/Analyst Difference
General Fund	38,084,800	56,833,700	56,833,700	
General Fund, One-time		(2,000,000)		2,000,000
Uniform School Fund	24,670,600	11,466,700	11,466,700	
Centennial Highway Fund	82,657,500	84,618,200	99,685,600	15,067,400
Dedicated Credits Revenue	33,909,700	31,555,400	31,508,200	(47,200)
Transfers	6,638,700			
Beginning Nonlapsing	12,109,400	22,882,100	11,092,400	(11,789,700)
Closing Nonlapsing	(22,882,100)	(11,092,400)	(8,809,000)	2,283,400
Total	$175,188,600	$194,263,700	$201,777,600	$7,513,900
Expenditures				
Current Expense	175,188,600	194,263,700	201,777,600	7,513,900
Total	$175,188,600	$194,263,700	$201,777,600	$7,513,900
FTE/Other				

*General and school funds as revised by Supplemental Bills I-V, 2002 General and Special Sessions. Other funds as estimated by agency

3.2 G. O. Debt Distribution

Facility debt accounts for approximately forty-four percent of debt service.



3.3 Board of Bonding Commissioners

General obligation debt is issued and managed under the authority of the Board of Bonding Commissioners, which consists of the Governor, the Treasurer, and a member of a political party different from that of the Governor (UCA 63B-1-201).

Constitutional debt limit

The State's constitutional debt limit caps total general obligation debt at 1.5 percent of total fair market value of taxable property. For FY 2003, the Division of Finance estimates additional capacity of $1.08 billion after deducting outstanding debt totaling $1.36 billion.

Constitutional Debt Limits

Constitutional Limitations (1)	**FY 2001**	**FY 2002**	**FY 2003 (2)**
Fair Market Value	$ 152,352,902,000	$ 163,185,740,000	$ 163,185,740,000
Constitutional Bonding Limit	2,285,294,000	2,447,786,000	2,447,786,000
Beginning G.O. Debt	1,212,325,000	1,146,000,000	1,474,400,000
Principal Payment	(81,325,000)	(92,800,000)	(97,550,000)
Bonds Sold	15,000,000	421,200,000	-
Bond Principal Refunded	-	(208,000,000)	(263,675,000)
Refunding Bonds Sold	-	208,000,000	253,100,000
Outstanding Principal	1,146,000,000	1,474,400,000	1,366,275,000
Additional Bonding Capacity	*$ 1,139,294,000*	*$ 973,386,000*	*$ 1,081,511,000*

(1) For fiscal years 2001 and 2002, bonding capacity is as of June 30 of the respective fiscal year. Bonding capacity for fiscal year 2003 is as of December 31, 2002.

(2) The fair market value for FY2003, which is the 2002 calendar year end fair market value is unavailable at this time, so the calendar year 2001 fair market value has been used.

Source: Utah Division of Finance

Statutory debt limit

The State Appropriations and Tax Limitation Act (UCA 63-38c-402) further limits general obligation debt to 20 percent of the allowable spending limit from the General Fund, Uniform School Fund, and Transportation Fund, less debt service. The limitation is established using a formula that includes population growth, inflation, and 1985 appropriations as a baseline.

For FY 2003, the statutory general obligation debt limit is $834.6 million. Transportation bonds are exempted from the statutory limitation, leaving outstanding general obligation debt of $411.9 million to apply against the limit. The State has approximately $422 million in additional FY 2003 general obligation bonding capacity.

Statutory Debt Limits

Statutory Limitations (1)	**FY 2001**	**FY 2002**	**FY 2003 (2)**
Appropriations Limitation	$ 3,798,512,000	$ 4,176,703,000	$ 4,173,189,000
Statutory Bonding Limit	759,702,000	835,341,000	834,638,000
Outstanding Principal	1,146,000,000	1,474,400,000	1,366,275,000
Exempt Transportation Bonds	(908,000,000)	(1,000,450,000)	(954,325,000)
Non-Exempt Bonds	238,000,000	473,950,000	411,950,000
Additional Bonding Capacity	*$ 521,702,000*	*$ 361,391,000*	*$ 422,688,000*

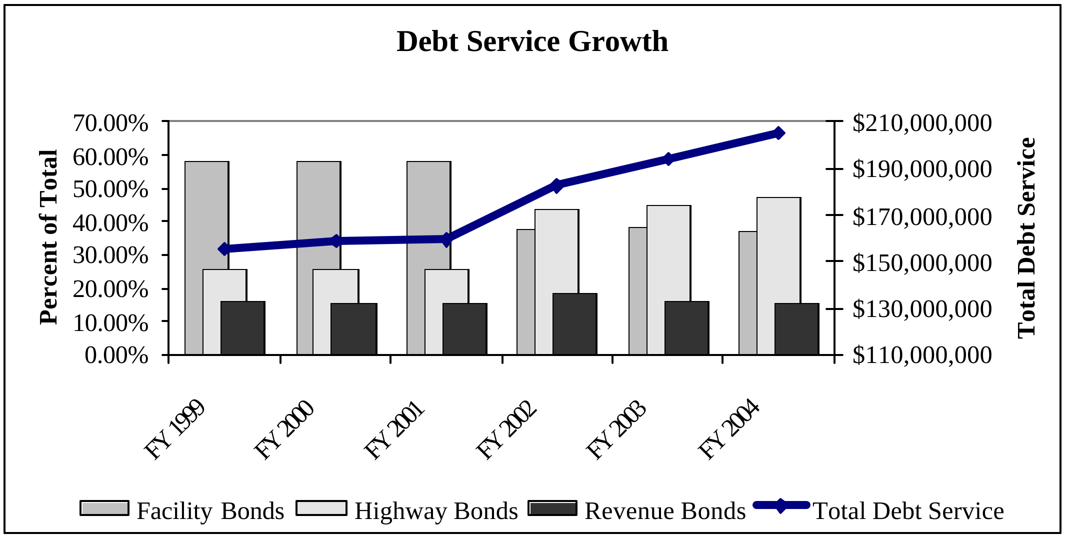
(1) For fiscal years 2001 and 2002, bonding capacity is as of June 30 of the respective fiscal year. Bonding capacity for fiscal year 2003 is as of December 31, 2002.

(2) Capacity does not include approximately $175 million of debt authorized but not issued.

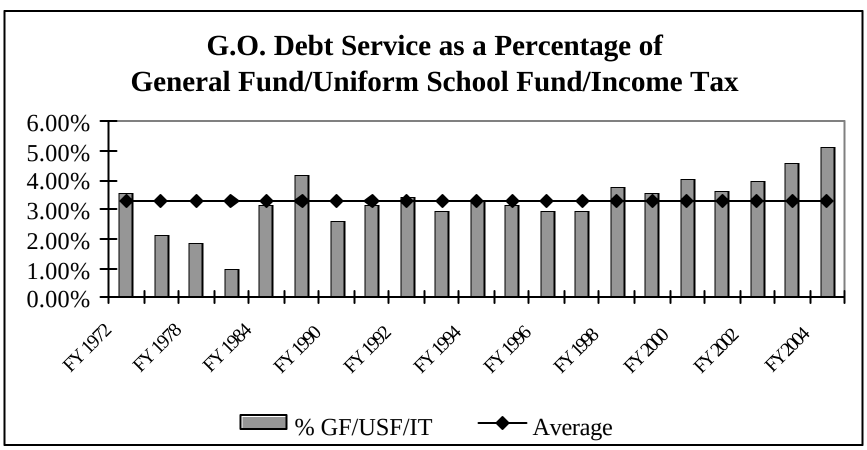
Source: Utah Division of Finance

3.4 Growth in Debt Service

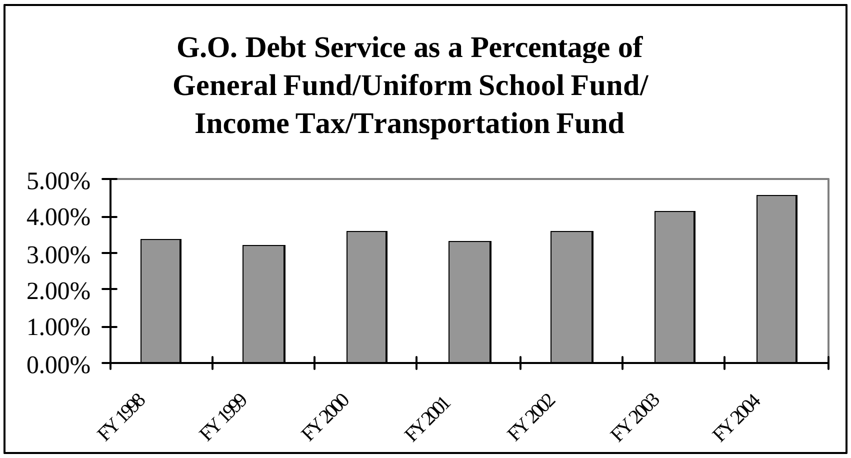
The Legislature uses several tools to finance new facilities. Bonds issued for facility construction are amortized over a six year period. The state pays interest for five years, then a lump sum principal payment in the final year. For a variety of reasons (i.e., structural delays from the legislative process, construction delays, procurement extensions) bonds issued by the state are actually amortized for less than six years – it is more realistic to assume that bonds will actually be issued and amortized over a period of 54 to 60 months.



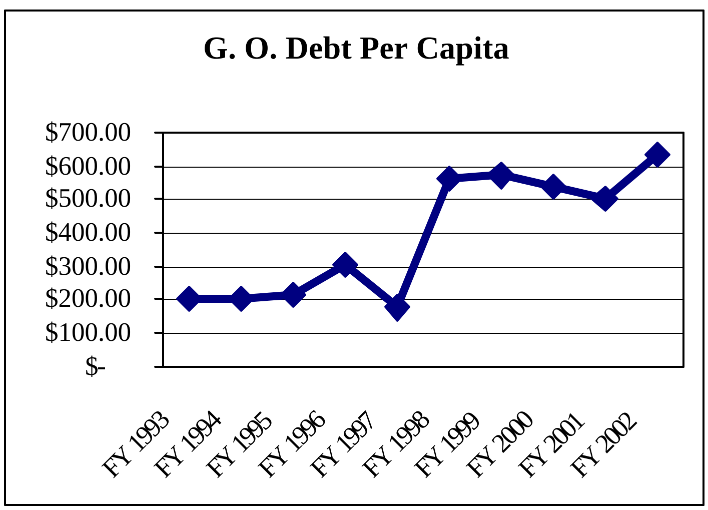
One advantage of bonding is that the borrower pays back present value with future dollars. Long term bonds may offer value in excess of present value, but if a state issues long term bonds every year it may ultimately find that debt service will become a driving force for all budget decisions. Utah has long been known as a very conservative state when it comes to bonding – but debt service is projected to exceed five percent of General Fund/Uniform School Fund/Income Tax collections in FY 2004. This is due in large part to shrinking revenue and expanded debt for highway projects.



The traditional calculation of debt service as a percentage of general revenue began prior to unprecedented issuance of significant highway bonds. If Transportation Fund is figured into the calculation for FY 1998 through 2003 the average percentage rises to 3.7 percent and the anticipated percentage for FY 2004 climbs to 4.6 percent.



Growth creates a huge impact on state governments, so any analysis of budget increases should be matched against population growth. Utah's growth is primarily internal, meaning that the state must contend not only with the problems of a growing population, but also the problems brought by a young population that can not contribute to the tax base. Even when growth is considered, Utah now finds itself in unprecedented territory in relation to outstanding debt. Due to the I-15 project, debt is now three times higher per capita now than it was ten years ago. With another $121 million in facility debt to be added in FY 2003 or 2004, it seems likely that this number will continue to exceed $600 per person for the next several years.



Construction, not bonding creates economic stimulus

Prior to the 2002 General Session, the Bureau of Economic and Business Research (BEBR) presented a report to the Legislature on the fiscal impact of bonding. The BEBR found that for

> every $100 million dollars spent for the construction of highways and roads in Utah supports 2,312 jobs in the local economy over the life of the project and generates $79.0 million in earnings for Utah workers and their families. In addition to the employment and earnings impacts, these projects will indirectly generate $9.0 million in state and local tax revenue.[1]

Even though the report focused on generating earnings and economic impact through construction, the inference throughout the report was that bonding created an economic stimulus:

> Bonding for capital facilities is an appropriate policy for projects that are needed to maintain the efficiency and quality of public services. Bonding has additional benefits during a period of economic downturn. The benefits from bonding have several advantages. If projects can be put in place and a substantial amount of the work completed during the downturn, the positive impacts on employment, earnings and tax revenues can help alleviate the downturn and provide a stimulus to recovery in economic activity.[2]

Construction spending can provide significant impact on state and local economies. The impact comes from the creation of jobs and the purchase of material, not from the financing structure. Bonding increases costs for projects and increases in debt service reduce budget flexibility. In the long term, bonding spreads the cost of construction over more users and allows for future inflated dollars to pay for current costs but it does not provide an economic stimulus on its own merit. Used wisely, bonding can allow governments to fund large scale infrastructure projects to meet critical needs. Utah's tradition of conservative borrowing and short term debt minimizes the cost of borrowing and maintains budget flexibility. As the Legislature considers capital facility and highway projects in 2003, it should be mindful of the fact that an additional $257 million of new debt was authorized in 2002, less than half of which went to new construction projects. More than $160 million in bonds were issued to replace cash in the construction budget in order to provide one-time sources of revenue for other statewide needs.

2002 Bond Authorizations

Bill Number	Amount	New Construction
HB 2	$108,470,000	$90,500,000
SB 4001	70,054,500	0
SB 5006	19,485,700	0
SB 6001	35,361,700	0
	$233,371,900	$90,500,000

[1] Robson, R. Thayne, et al. (January 2002). *The Economic Impact of Bonding for Capital Facilities in Utah*, pg. 7. Salt Lake City, Utah: University of Utah – Bureau of Economic and Business Research.
[2] Ibid.

As the Legislature considers priorities for FY 2004, it should consider that of the $233 million in bonds issued for construction of new facilities, only $90.5 million will go toward projects not already considered in economic forecasts.

3.5 Capital Facility Financing

The State employs several methods of financing to meet state needs.

General Obligation Bonds - G.O. debt is secured by the full faith and credit of the State and its ability to tax its citizens. General Obligation debt is counted against the state's constitutional and statutory debt limits (highway bonds are exempt from the statutory limit). In recent years the State of Utah issued General Obligation Bonds for facilities that mature in six years. Other states and government entities typically issue General Obligation Bonds with terms of 10 to 20 years. Debt service interest begins to accrue when the bonds are issued.

Lease Revenue Bonds - The State Building Ownership Authority, the official owner of state facilities, issues Revenue Bonds. The occupying agency pays rent to the Authority which is used to pay debt service. A pledge of future rental payments (subject to legislative appropriation) and a mortgage on the financed project secure debt.

Since neither the full faith and credit of the state nor its taxing power secure lease Revenue Bonds, it is not counted against statutory debt limits. However, subsection 63-9a-6(2) states the debt issued by the Building Ownership Authority plus other debt issued by the State (less $954 million in highway debt) cannot exceed 1.5 percent of the value of the taxable property of the state. A statutory change would be required for BOA bonds if G.O. bonds were authorized up to the constitutional limit. Unlike General Obligation Bonds, Revenue Bonds are typically issued with a repayment period of 20 years. An additional amount is borrowed to cover interest payments during construction.

Revenue Bonds - This type of bond may be issued when a revenue stream can be identified and legally restricted for repayment of the bonds. The only state facilities which have been financed using Revenue Bonds have been for higher education facilities where the revenues pledged have included student fees, auxiliary services revenues, or reimbursed overhead. In order for the bonds to be marketable, the pledged revenue stream must be substantially larger than the debt service requirements. This type of debt is not secured by the full faith and credit of the state nor its taxing power and is exempted from calculations of the state's constitutional and statutory debt limits.

Certificates of Participation (COP) - COP are very similar to lease Revenue Bonds with one major difference: instead of being a bond issued directly by a governmental entity, COP's represent an undivided interest in a lease agreement. This lease agreement may be entered into by any entity that has the ability to lease space. Although either the state or a private entity may initially hold title to the facility, title must pass to the state by the end of the lease term in order for the interest on the COP to be exempt from federal income tax.

Summary - All of the above are accounted for as debt on the state's accounting records and are considered to be debt by national rating agencies. In addition, the State Auditor issued an opinion in December of 1995 that any General Fund, Uniform School Fund, or Transportation Fund used to retire lease purchase and revenue bond obligations should be counted in the spending limitation formula.

Relative Costs

The total cost associated with various options for financing projects are listed below, ranked from least expensive to most expensive. Specific projects may have circumstances that would affect this ranking. The order for Revenue Bonds and certificates of participation depends on the nature of the project and the source of funding for the debt service.

1. Cash (state funds)
2. General Obligation Bonds
3. Lease Revenue Bonds
4. Revenue Bonds
5. Certificates of Participation
6. Leasing (long-term)

The true cost of bond financing may be much less than commonly assumed because most of the state's payments to investors are made in future years using dollars that may be cheaper due to inflation. However, savings from inflated dollars are difficult to achieve with short-term bonds. The Analyst believes that the differential in interest costs and inflation savings should be considered when the state issues general obligation debt.

The relative cost of different types and terms of debt fluctuates with the financial market. As a general rule, a 20 year general obligation bond carries an interest cost which is about two thirds of one percentage point higher than a 6 year General Obligation Bond. A twenty year lease revenue bond carries an interest cost which is about one third of one percentage point higher than a 20 year general obligation bond. Interest rates for certificates of participation are generally higher than lease Revenue Bonds. By far the largest costs occurs when the state enters into a long term lease instead of purchasing a building that an agency will need for fifteen or twenty years.

Suggested Policy Issues

During the 1996 General Session, the Legislature adopted general guidelines for issuance of state debt. The Analyst recommends the adoption of those guidelines again for the 2003 General Session.

General Obligation bonding should be the preferred method for critical facilities whose costs exceed the availability of current funding. It is assumed that the need for the facility has received full analysis for justification. Short term bonds (6 to 10 years) should be used when a facility has no present funding base to service debt and when the building fulfills a critical need that can not be funded within the base budget for capital facilities. Long term bonds should be used (15 to 20 years) when there are current facility occupancy costs within the agency base budget that could be used to assist the funding of debt service.

Current market conditions should also be considered when bonding is discussed. For example, if current rates are lower than what the Treasurer is earning on the state investment pool, it may be a favorable time to bond. This is especially true with short term bonds that will not recover interest costs through inflation.

Revenue Bonds should be considered when a dedicated source of revenue is available to cover underwriting requirements. Generally, a coverage ratio is required that is in excess of actual debt service. Examples would include higher education facilities such as dormitories and parking lots where the funding source for debt service is derived from rents or fees.

Lease Revenue Bonds or *Certificates of Participation* should be used if the Legislature is otherwise willing to fund a lease for a long term facility need and it would be wiser to use those operating funds instead for debt service on a lease revenue bond. Also, this type of funding could be considered when an agency has an outside source of revenue in addition to any existing costs in the budget base. An example would be the State Library where Federal funds are available as lease costs but federal regulation may not allow the funds to be used for debt retirement. Of course, it would be wiser still to issue a long-term General Obligation bond instead and shift the operating funds to debt service. Caution should be exercised by the Legislature to avoid excessive lease purchase obligations since they are treated like debt once funds have been committed. If funds were not appropriated in a given year the state would enter into a default position. Lease Revenue Bonds should be issued with a repayment period not to exceed 20 years.

Leasing provides the least expensive option for space only for short term needs. Some programs are temporary in nature or provide a function that needs to be able to change locations frequently. The Analyst recommends that DFCM continue to provide funding alternatives for the Legislature when agency high cost leases are requested. High cost leases are defined in statute as real property leases that have an initial term of ten years or more or will require lease payments of more than $1,000,000 over the term of the lease, including any renewal options.

4.0 Tables: Board of Bonding Commissioners - Debt Service

	2000	2001	2002	2003	2004
Financing	**Actual**	**Actual**	**Actual**	**Estimated***	**Analyst**
General Fund	71,206,700	73,223,900	38,084,800	56,833,700	56,833,700
General Fund, One-time				(2,000,000)	
Uniform School Fund	20,152,500	20,152,500	24,670,600	11,466,700	11,466,700
Centennial Highway Fund	45,628,600	41,104,400	82,657,500	84,618,200	99,685,600
Centennial Highway Fund, One-time		3,079,000			
Dedicated Credits Revenue	21,919,600	20,044,000	33,909,700	31,555,400	31,508,200
Transfers		3,999,800	6,638,700		
Beginning Nonlapsing	8,123,600	8,757,200	12,109,400	22,882,100	11,092,400
Closing Nonlapsing	(8,757,200)	(11,474,700)	(22,882,100)	(11,092,400)	(8,809,000)
Total	$158,273,800	$158,886,100	$175,188,600	$194,263,700	$201,777,600
Programs					
Debt Service	158,273,800	158,886,100	175,188,600	194,263,700	201,777,600
Total	$158,273,800	$158,886,100	$175,188,600	$194,263,700	$201,777,600
Expenditures					
Current Expense	158,273,800	158,886,100	175,188,600	194,263,700	201,777,600
Total	$158,273,800	$158,886,100	$175,188,600	$194,263,700	$201,777,600
FTE/Other					

*General and school funds as revised by Supplemental Bills I-V, 2002 General and Special Sessions. Other funds as estimated by agency.