



BUILD AMERICA BONDS FEDERAL SUBSIDY

INFRASTRUCTURE AND GENERAL GOVERNMENT APPROPRIATIONS COMMITTEE
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ISSUE BRIEF

SUMMARY

The Treasurer and the State Bonding Commission issued five bond series using the federal Build America Bonds (BAB) program. The BAB program requires issuers to sell bonds at higher taxable interest rates and provides a subsidy back to the issuer in the form of an IRS refund. The BAB program saved the State \$21 million over the life of the \$982 million 2009CD issuance and \$34 million on the \$1,035 million 2010AB issuance. Recently, bond rating agencies provided direction to issuers using the BAB program to budget debt service gross of federal subsidies. This direction indicates a certain level of risk with the BAB program. In order to meet this “best practice” the State will need to change the way it appropriates debt service funds. Rating agencies may negatively view the current practice of appropriating the subsidy as a dedicated credit net of transportation fund appropriations.

BACKGROUND

As part of the American Recovery and Reinvestment Act the federal government created the Build America Bond (BAB) program to help states and local governments access capital markets in a time of market instability. The federal government gives state and local bond issuers a subsidy of 35 percent of the interest cost when they issue taxable bonds under this program. The subsidy helps offset higher interest costs associated with taxable bonds (governments typically issue tax-exempt bonds). The IRS administers the subsidy and issuers must make a formal request through a new IRS form for each semi-annual subsidy.

As of October 2010 the State of Utah has issued five bond series using Build America Bonds. Two of the issuances are State Building Ownership Authority (SBOA) lease revenue bonds, two issuances are General Obligation (GO) highway bonds, and the other issuance is a revenue bond (Rev) issued by the State Bonding Commission to recapitalize a loan fund. Table 1 below lists the bond series and provides additional detail.

<u>Series</u>	<u>Type</u>	<u>Use</u>	<u>Issuance</u>				<u>True</u>
			<u>Date</u>	<u>Principal</u>	<u>Interest</u>	<u>Subsidy</u>	<u>Interest Cost</u>
2009C	SBOA	DABC Warehouse	09/09/2009	\$ 16,715,000	\$ 14,625,279	\$ (5,118,848)	3.70%
2009E	SBOA	Huntsman Cancer Hospital	09/09/2009	\$ 89,470,000	\$ 82,113,173	\$ (28,739,611)	3.72%
2009D	GO	State Highway Projects	09/29/2009	\$ 491,760,000	\$ 271,636,254	\$ (95,072,689)	2.99%
2010C	Rev	Water Loan Recapitalization	02/23/2010	\$ 31,225,000	\$ 14,782,247	\$ (5,173,787)	3.01%
2010B	GO	State Highway Projects	09/30/2010	\$ 621,980,000	\$ 258,674,586	\$ (90,536,105)	2.08%

Table 1

ISSUES

Savings from Build America Bonds

The U.S. Treasury Department released a report in April 2010 estimating that the Build America Bond program saves issuers 112 basis points (1.12 percent) on the yield for a 30 year bond. Utah’s savings is lower than the national average because the State holds an “AAA” bond rating and issues a maximum of 15 year bonds. The BAB program saved the State 22 basis points and \$21.2 million on the 2009 issuance and 35 basis points and \$33.8 million on the 2010 issuance. Tables 2 and 3 below show more detail on the savings.

2009CD Highway and Building Projects					
	Principal	Interest	Subsidy	Total Payment	True Interest Cost
All tax-exempt bonds	\$ 982,170,000	\$ 328,912,701	\$ -	\$ 1,311,082,701	2.94%
BABs subsidy	\$ 982,170,000	\$ 402,819,795	\$(95,072,689)	\$ 1,289,917,106	2.72%
BABs savings	0	\$ (73,907,094)	\$ 95,072,689	\$ 21,165,595	0.22%

Table 2

Taxable BABs sell at higher interest rates than tax-exempt bonds which result in higher total interest payments. The BAB subsidy covers the additional interest costs associated with the taxable bonds and produce a savings in total payments. The True Interest Cost reflects the BAB subsidy savings.

2010AB Highway and Building Projects					
	Principal	Interest	Subsidy	Total Payment	True Interest Cost
All tax-exempt bonds	\$ 1,034,970,000	\$ 278,467,801	\$ -	\$ 1,313,437,801	2.43%
BABs subsidy	\$ 1,034,970,000	\$ 335,219,943	\$(90,536,105)	\$ 1,279,653,838	2.08%
BABs savings	0	\$ (56,752,142)	\$ 90,536,105	\$ 33,783,963	0.35%

Table 3

Debt Service Budget

Table 4 below shows the BAB subsidies by fiscal year and compares them to the annual debt service budget. BAB subsidies represent about 4.5% percent of the total debt service. Future bond issuances will likely lower these percentages, especially in FY 2017 through FY 2020 (where previous highway bonds left gaps for future principal payments to be “filled in”).

Fiscal Year	GO 2010B Hwy	GO 2009D Hwy	2010ABC Water	SBOA 2009C DABC	SBOA 2009E Hosp.	Total BAB Subsidy	GO Debt Service	SBOA Debt Service	Total Debt Service	BAB % of Total Debt Service
FY 2010	-	(5,843,738)	(174,996)	(222,372)	(1,194,132)	(7,435,238)	271,693,814	25,833,513	297,527,327	2.5%
FY 2011	(5,659,403)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(15,958,871)	336,228,156	33,795,579	370,023,735	4.3%
FY 2012	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	376,834,794	33,292,180	410,126,974	4.3%
FY 2013	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	380,679,213	30,966,112	411,645,325	4.3%
FY 2014	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	387,425,113	31,120,582	418,545,695	4.3%
FY 2015	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	352,399,913	32,297,928	384,697,841	4.6%
FY 2016	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	364,590,163	32,195,226	396,785,389	4.5%
FY 2017	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	300,881,588	31,645,466	332,527,054	5.4%
FY 2018	(7,518,026)	(7,734,360)	(492,176)	(325,423)	(1,747,510)	(17,817,494)	193,495,513	29,603,929	223,099,442	8.0%
FY 2019	(7,518,026)	(7,734,360)	(408,512)	(325,423)	(1,682,612)	(17,668,933)	153,344,913	24,134,887	177,479,800	10.0%
FY 2020	(7,189,096)	(6,656,365)	(318,056)	(325,423)	(1,682,612)	(16,171,553)	180,837,531	21,678,593	202,516,124	8.0%
FY 2021	(6,017,513)	(5,258,276)	(220,309)	(301,243)	(1,588,949)	(13,386,289)	257,514,110	21,441,331	278,955,442	4.8%
FY 2022	(4,809,121)	(3,875,727)	(114,505)	(275,858)	(1,486,992)	(10,562,203)	248,344,920	21,023,346	269,368,266	3.9%
FY 2023	(3,530,214)	(2,428,068)		(249,083)	(1,377,948)	(7,585,313)	243,913,232	13,120,944	257,034,175	3.0%
FY 2024	(2,240,037)	(1,401,277)		(220,919)	(1,275,152)	(5,137,385)	239,575,488	13,129,715	252,705,203	2.0%
FY 2025	(946,514)			(191,180)	(1,164,646)	(2,302,340)	195,049,327	11,821,422	206,870,749	1.1%
FY 2026				(157,164)	(1,043,215)	(1,200,378)	76,415,000	12,958,714	89,373,714	1.3%
FY 2027				(121,128)	(868,892)	(990,020)		12,371,272	12,371,272	8.0%
FY 2028				(82,973)	(684,272)	(767,245)		12,620,064	12,620,064	6.1%
FY 2029				(42,698)	(468,967)	(511,665)		98,589,891	98,589,891	0.5%
FY 2030					(241,146)	(241,146)		12,633,988	12,633,988	1.9%
	(90,536,105)	(95,072,689)	(5,173,787)	(5,118,848)	(28,739,611)	(224,641,038)				

Table 4

Risks of Build America Bonds

While Build America Bonds save issuers money over the life of the bonds, they come with some additional risk and compliance issues.

1. The federal government could discontinue or not fund the Build America Bond program.
2. The IRS requires a form for each semi-annual BAB subsidy at least 45 days before interest payments are due. Delays or neglect in submitting the semi-annual form could prevent timely receipt of the BAB subsidy.
3. By law BAB issuances cannot have more than a “de minimis” amount of premium or the IRS could disqualify the bonds for receipt of the subsidy.
4. By IRS regulation issuers must spend 100% of investment earnings from BAB issuances on capital projects or could face potential IRS penalties.
5. Recent IRS attention focuses on the secondary market for BABs and requires issuers to monitor sales from initial sale to closing. Early BAB issuances in 2009 sold for large premiums in the secondary market by “flippers” who bought the bonds at low prices and immediately sold them for a profit. The IRS wants to limit bond “flipping” and could punish issuers for not ensuring that their bonds initially sale at market rates.
6. The IRS treats the BAB subsidy as an overpayment of tax and therefore can reduce the amount of the subsidy to collect any outstanding taxes or obligations owed to the federal government (through the Treasury Offset Program).

Mitigation of BAB Risk

The following solutions help mitigate the risks of Build America Bonds discussed above. The number of each solution below corresponds to the risk numbered above.

1. The State includes an extraordinary call feature to allow the State to call (pay off) the bonds in the event the federal government abandons the BAB program.
2. The State’s paying agent and registrar is responsible to submit the proper paperwork to the IRS as early as possible. This reduces the risk associated with personnel change in the Treasurer’s office.
3. The State issues bonds at par without any premium to avoid the “de minimis” requirement.
4. Typically the interest earned on bond proceeds goes into the debt service fund to pay debt service. The Division of Finance will ensure that interest earnings on BAB proceeds stay in the construction funds.
5. The Treasurer’s Office and the State’s financial advisor monitor the trading of Utah bond issuances on the secondary market. They also required the underwriters of the most recent 2010A BAB issuance to sign an agreement increasing the underwriters’ responsibility to reasonably price our bonds. The underwriters monitor who will buy the bonds exclude known “flippers” from the bond allocation process.
6. In order to avoid the risk associated with the Treasury Offset Program the State must stay on top of potential liabilities to the federal government. The State will need to manage the liabilities proactively. This risk is similar to that of other federal revenues.

Rating Agency Requirements

Three credit agencies rate state government issued bonds – Standard and Poor’s, Moody’s, and Fitch. The rating agencies recently provided direction to issuers of Build America Bonds that a best practice is to budget debt service gross of the federal subsidy. This practice protects debt service payments to bond holders should the federal government stop, defer, or reduce the payment of the BAB subsidy. The Analyst views this preference by the rating agencies as an indication of the risk associated with the BAB subsidy.

Typically the State budgets bonds net of a revenue source (like the BAB subsidy). This practice allows the State to reduce state fund appropriations to debt service by the amount of the revenue. Budgeting debt service gross of the subsidy will require a change in budgeting practice for debt service.

Budgeting Options

The State has several options to budget debt service and the BAB subsidies:

1. Increase the Transportation Fund appropriation to debt service by \$15.3 million one-time in FY 2012 (the amount of the subsidy) and keep the BAB subsidy in debt service.
2. Modify revenue collections to the General Fund to include the BAB subsidy and then increase General Fund appropriations to debt service.
3. Create a restricted fund to receive the BAB subsidy and appropriate the restricted revenue to debt service.
4. Deposit the BAB subsidy in debt service, increase appropriations from the General Fund or Transportation Fund to debt service by the amount of the subsidy, and appropriate the amount of the subsidy from debt service back to the General Fund or Transportation Fund.
5. Maintain the current practice of recording the BAB subsidy as a dedicated credit in the debt service line item.

RECOMMENDATION

The Analyst recommends the Legislature consider budgeting option 4 as mentioned above to meet the bond rating agencies’ recommendation to budget debt service net of Build America Bond subsidies. This would involve a FY 2012 increase of \$15,252,400 and a FY 2011 increase of \$13,393,800 from the General Fund and a corresponding transfer from debt service nonlapsing balances back to the General Fund to hold the General Fund harmless.