UPDATE ON STATE DEBT

EXECUTIVE APPROPRIATIONS COMMITTEE
STAFF: RICHARD AMON

ISSUE BRIEF

SUMMARY

Utah recently issued $600 million in previously authorized bonds at a favorable 2.78 percent true interest cost. All three rating agencies affirmed the state's triple-A bond rating because of good financial management. The agencies did note the State's increasing debt levels. Per-capita general obligation debt is at a historical high. Utah is currently at 87 percent of the constitutional debt limit as a result of increased bonding for highway projects and a decrease in property value. While transportation revenues will be sufficient to pay debt service on existing and anticipated bonds, current revenue estimates do not support additional bond- or cash-funded highway projects until FY 2015. A recent calculation of the constitutional debt limit raised questions on how to make the calculation. The Analyst recommends clarifying in statute how to calculate the constitutional debt limit and codifying the priority of debt service payments.

DISCUSSION AND ANALYSIS

Currently Low Interest Rates

The last several years have been optimal for the State of Utah to bond for infrastructure projects. Interest rates are currently at an all-time low. Figure 1 at right shows a history of the interest rates on ten-year Treasury bonds, which are a good measure of the relative interest rates Utah receives on general obligation bonds. The most recent general obligation bond issuance of $600 million had a true interest cost of 2.78 percent.

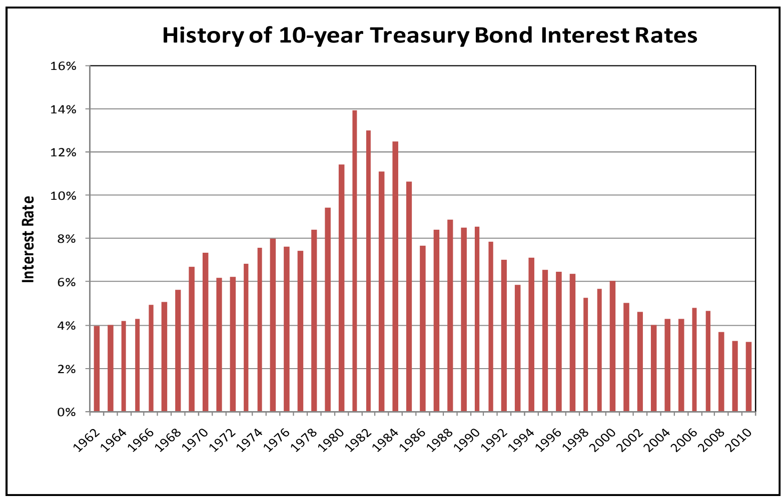

Figure 1

Rating Agency Reviews

Three national rating agencies (Moody's, Fitch, and Standard and Poor's) provide ratings of credit worthiness for bond issuers. At this time only eight states merit a "Triple A" rating from all three agencies: Delaware, Georgia, Iowa, Maryland, Missouri, North Carolina, Utah, and Virginia. The three rating agencies reaffirmed Utah's 'AAA' credit worthiness on the 2011A series of general obligation bonds. Standard and Poor's rating letter contained several interesting points on why and how Utah received an 'AAA' rating:

- Good financial management and proactive budget adjusting make Utah a best-managed state.
  - During good years Utah built up reserve funds.
  - During the recession Utah used reserve funds sparingly.
  - Utah reduced budgets to achieve structural balance by FY 2013.
  - Utah accommodated the loss of federal stimulus through budget reductions.
- Utah's debt burden, that while increasing, has historically been restrained.
  - 73 percent of debt retires in 10 years.
  - General obligations bond amortization schedules are no longer than 15 years.
- Pension and OPEB reform reduced the state's future liability significantly.

While not explicit nor necessarily recommendations, the Standard and Poor's letter also made several observations that could indicate areas for improvement:

- The state does not have a priority of payment to debt service in statute.
- The state does not have a debt management policy.
- The state has a high age dependency that is unlikely to moderate in the near future.
- General obligation debt is increasing and has doubled in recent years.

Property Values and the Constitutional Debt Limit

The state's constitutional debt limit caps total general obligation debt at 1.5 percent of the value of the state's taxable property. The most current numbers indicate that the fair market value of Utah property is $280 billion (a 4 percent decline from last year), which limits general obligation debt to $4.2 billion. After the July, 2011 issuance the state has approximately $3.7 billion of bonds outstanding or 87 percent of the limit. Figure 2 below shows projections of outstanding debt and the constitutional debt limit.

By practice Legislative debt policy keeps outstanding principal below 85 percent of the Constitutional debt limit. This policy provides the state flexibility to respond to unforeseen circumstances such as natural disaster and prevents the state from going over the limit should property values decline. Had the state authorized debt up to the constitutional debt limit rather than 85 percent of the limit, the recent decline in property values would have pushed the state over the limit.

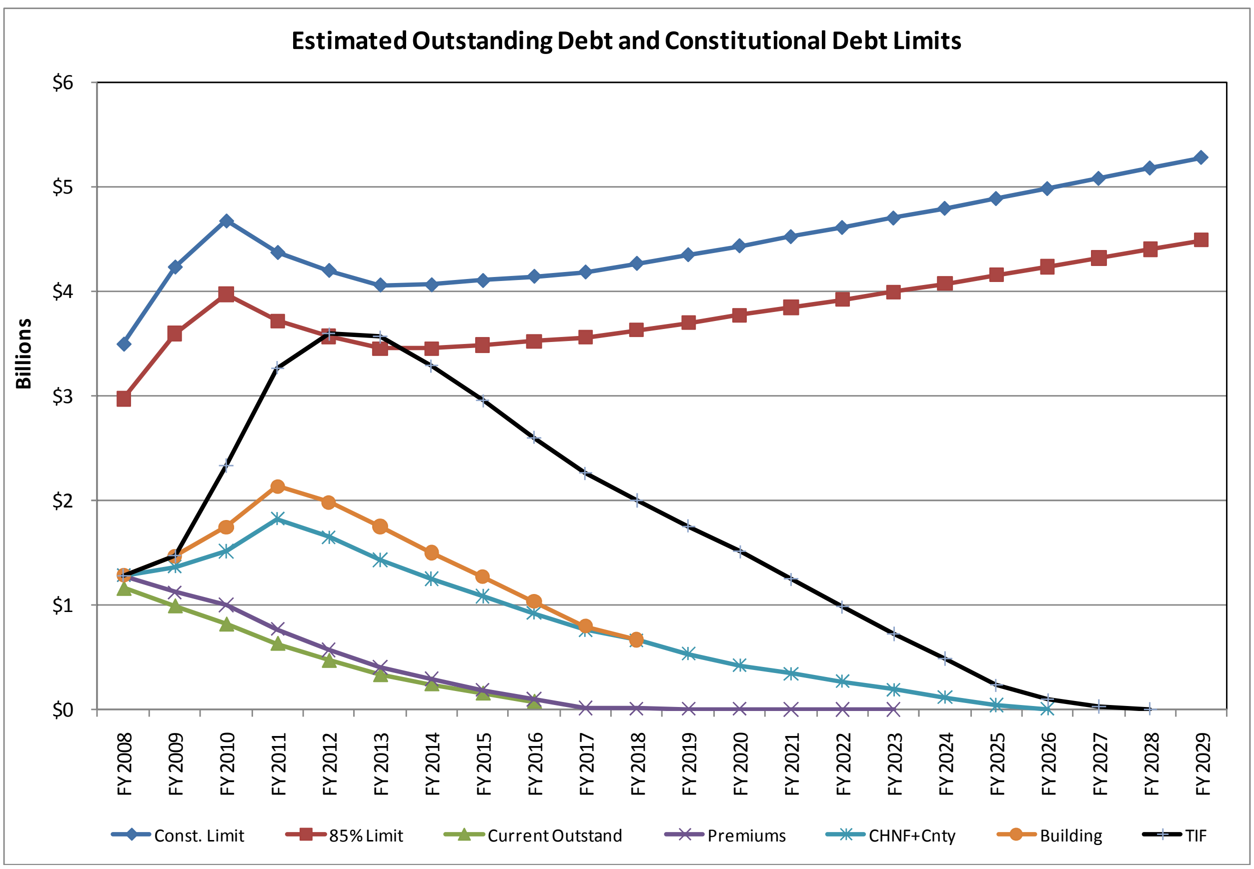

Figure 2

The figure above includes bond issuances of $300 million in FY 2013 and $80 million in FY 2014 to finish road and building projects. Assuming an additional 3.5 percent decline in FY 2013 property values and slight growth in property values thereafter, the figure estimates the state will be at 89 percent of the constitutional debt limit in FY 2013 and 82 percent in FY 2014. The line graphs in Figure 2 are cumulative. While bonding for buildings (orange line) has increased outstanding debt in the last few years, the main influence has been transportation. Critical Highway Needs Fund (light blue line) and Transportation Investment Fund (black line) highway projects (including the reconstruction of I-15 in Utah County and a portion of the Mountain View Corridor) comprise $2.7 billion of outstanding debt in FY 2012.

Calculation of Constitutional Debt Limit

Utah code clarifies that the constitutional limit should be calculated using 100 percent of the fair market value of taxable property from the last assessment. While outstanding debt remains under the limit, the calculation of the constitutional debt limit for the recent bond issuance revealed that neither the constitution nor statute precisely defines how to make the calculation. Specifically neither is clear as to:

1. *What constitutes "last" assessment of property?* – Is the annual Tax Commission report sufficient or should up-to-date property estimates be used?
2. *What is included in assessed property?* – Should land assessed under the Farmland Assessment Act be included at fair market value and/or are there other properties not currently being assessed that should be?

We propose a working group consisting of our office, the Governor's Office, the Treasurer, the Division of Finance, and the Tax Commission to explore and answer these question. By the 2012 General Session this working group will have a recommendation on specific changes the Legislature can make in statute to clarify how to calculate the constitutional debt limit.

Transportation Projects and Funding

Transportation projects have had the most influence on the constitutional debt limit in recent years. Figure 3, produced by an updated capital model, shows a four year actual history and a ten year projection of transportation capital outlays. Lines and bars in Figure 4 are cumulative. Debt funding transportation projects from FY 2009 through FY 2014 enabled the state to double and even triple capital expenditures during the recession, which bolstered Utah's fragile economy. Significant increases in debt service result from these bonds beginning in FY 2011. In fact, a majority of the revenue going into the transportation fund (blue line in Figure 3) is dedicated to paying off debt service (green bars) for the next several years.

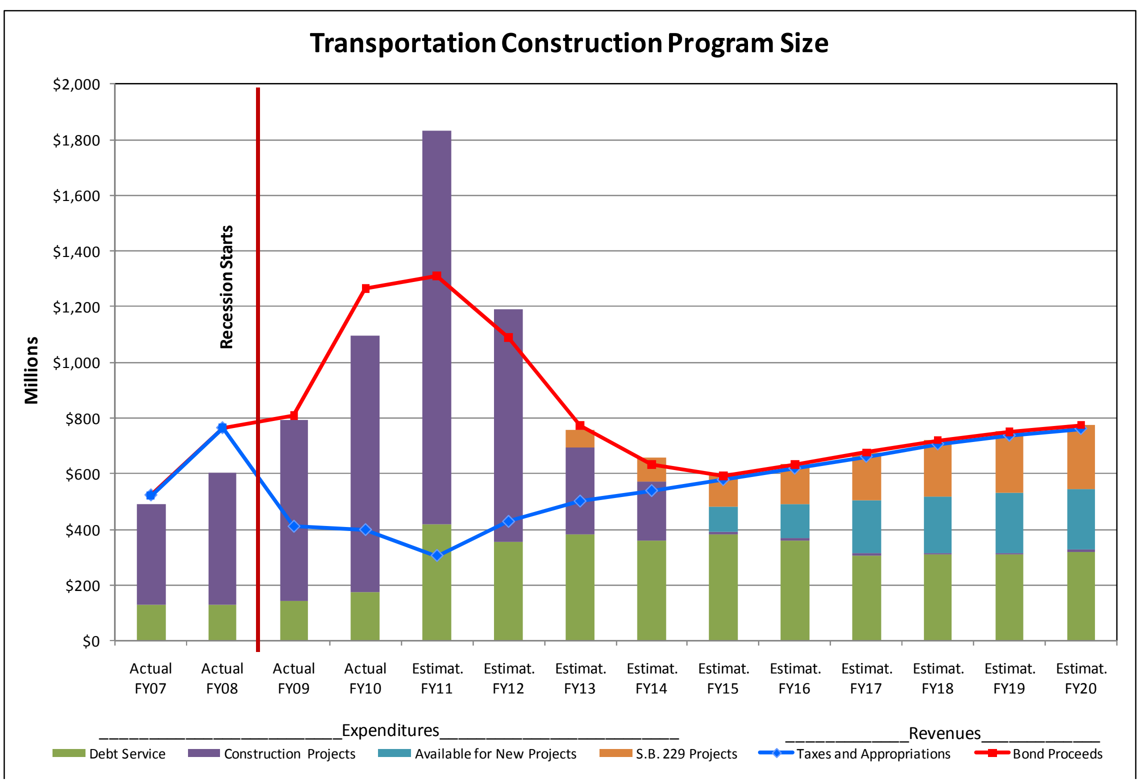

Figure 3

Transportation revenues are needed to finish currently authorized projects until fiscal year 2015 when some funding becomes available (teal bars in Figure 3) for cash funding new projects or debt service on new bonds. Funds from S.B. 229 *Transportation Funding Revisions* (2011 G.S.) will begin accruing to transportation in FY 2013 (orange bars) that could be used for projects or debt service.

The dip in transportation revenue in FY 2011 results from House Bill 438, *Transportation Modifications* (2010 G.S.) that reduced the sales tax revenue into the Centennial Highway Fund by approximately $113 million to fund building projects. Bonding replaced the $113 million of sales tax revenue.

Utah's General Obligation Bond Debt

General obligation bonds pledge the "full faith, credit and resources of the state" including a property tax levy to pay debt service on the bonds if annual appropriations do not cover the obligation. Utah has always appropriated sufficient funds to cover all obligations and has never defaulted on a bond issuance nor resorted to a property tax levy to pay debt service.

Debt per capita represents the amount of outstanding principal each Utah citizen would owe at a moment in time (see Figure 4 below). The current estimate of Utah's general obligation debt per capita is $1,185 per person. Debt per capita peaked in FY 2003 as a result of the I-15 reconstruction project in Salt Lake County and then ebbed over the next five years as Utah paid off the debt and cash-funded infrastructure. The current spike in debt per capita is a result of increased bonding for highway projects including the reconstruction of I-15 in Utah County and the Critical Highway Needs program.

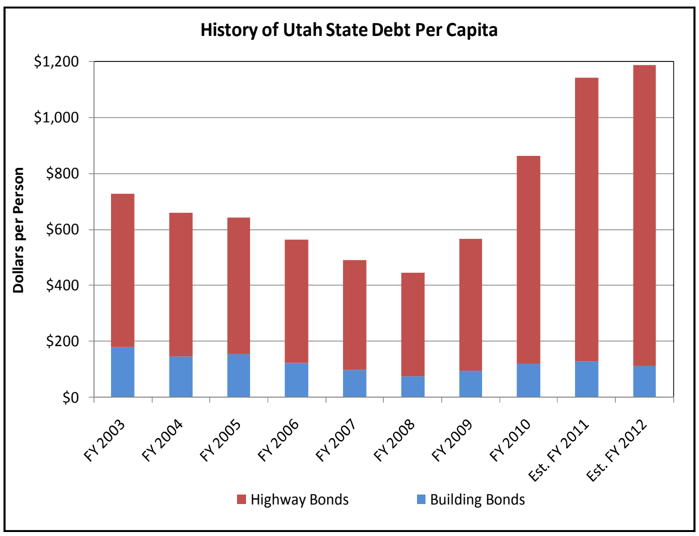

Figure 4

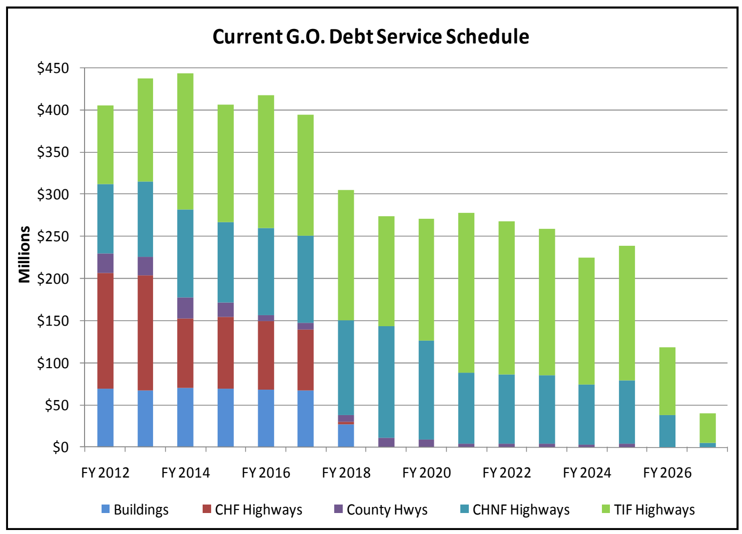

Figure 5

Historically the state issues general obligation bonds with fifteen year maturities for highways and six year maturities for buildings. These short maturities allow the state to pay off almost three-quarters of its debt in 10 years. In FY 2013 the state will pay off $295 million of bond principal and pay $152 million of interest on general obligation bond debt. Figure 5, above, displays the current debt service schedule, but does not reflect unissued bonds authorized by the Legislature, which include:

- $40 million for various buildings (S.B. 5, 2011 G.S.)
- $53 million for critical highway needs (S.B. 283, 2008 G.S.)
- $440 million for Transportation Investment Fund projects (S.B. 239, 2009 G.S.)

State Debt Obligations

While General Obligation debt ($3.7 billion) is the most important debt held by the state, there exist several other types of debt obligations that amount to an additional $7 billion of contingent liability to the state. These obligations include public school debt, higher education revenue bonds, housing authority bonds, and student loan bonds. (See *State Debt Obligations Issue Brief* from the 2011 General Session for more information.)

Effect of Possible U.S. Debt Rating Downgrade

Rating agencies placed the U.S. government on notice for a potential debt rating downgrade from the current AAA rating. Beginning this week, rating agencies will also begin evaluating the credit ratings of AAA-rated states in light of the U.S. review. Moody's Investor Services indicates it will evaluate state government ratings based on four main measures:

- Employment sensitivity to national factors and federal employment
- Federal money entering the state from procurement contracts and Medicaid
- Access to capital markets measured by variable rate debt
- Available resources and operating fund balances

A downgrade to neither the U.S. credit rating nor the Utah state credit rating is certain at this point. However, future state bond ratings may reflect not only how the state manages its debt and finances but also the fiscal stability of the United States.

CONCLUSION AND RECOMMENDATION

With outstanding debt currently at 87 percent of the constitutional limit and the state paying off $295 million of bonds in FY 2013, the state has bonding capacity to complete authorized capital projects. Additionally, transportation revenues will be sufficient to pay debt service on existing and anticipated bonds. However, significant capacity to bond or cash-fund new transportation projects, beyond SB 229 revenue, will not likely exist until FY 2015.

The Analyst recommends the Legislature consider legislation to:

1. Clarify how to calculate the constitutional debt limit including what is meant by "last assessment" of taxable property and what should be included in assessed property.
2. Codify the priority of payment to debt service obligations.