Executive Office for Administration & Finance
COMMONWEALTH OF MASSACHUSETTS
STATE HOUSE ▪ BOSTON, MA 02133
(617) 727-2040

MAURA T. HEALEY
GOVERNOR

MATTHEW J. GORZKOWICZ
SECRETARY

KIMBERLEY DRISCOLL
LIEUTENANT GOVERNOR

December 13, 2024

Her Excellency Maura T. Healey, Governor
State House, Room 360
Boston, MA 02133

Michael D. Hurley, Clerk of the Senate
State House, Room 335
Boston, MA 02133

Steven T. James, Clerk of the House
State House, Room 145
Boston, MA 02133

Dear Governor and Sirs:

Pursuant to Section 60B(f) of Chapter 29 of the General Laws, as amended, the Capital Debt Affordability Committee (the "Committee"), shall by December 15 of each year submit to the Governor and the General Court the Committee's estimate of the total amount of new Commonwealth debt that prudently may be utilized for capital spending for the next fiscal year.

The Committee has determined that $3.227 billion of general obligation (GO) debt, commonly referred to as "bond cap", may prudently be utilized by the Commonwealth in fiscal year 2026. The attached presentation (the "Committee Report") includes an overview of the Committee's recommendation and the data and analysis that was performed to help inform its recommendation. From this analysis, the Committee concluded that the Commonwealth could afford to increase the bond cap in fiscal year 2026 by $110 million or 3.53% over the fiscal year 2025 amount.

<u>Committee Approach</u>

This year, the Committee, working with financial advisors from PFM, undertook a significant refresh of its affordability model tool, which it uses to forecast future debt metrics under various market scenarios. The result is a more refined and sophisticated model that enhances the Committee's ability to forecast future debt impacts under a range of economic and debt structuring assumptions. Using this newly enhanced tool, the Committee was able to take a more nuanced approach in determining its recommendation. Major new features of the model include, but are not limited to, direct debt forecasting, flexibility to structure future debt more granularly, and the ability to calculate the maximum amount of new debt that could be issued while maintaining debt levels within set targeted amounts under various economic conditions.

While the committee's recommendation is for the upcoming fiscal year (fiscal year 2026), in considering that recommendation the committee models future debt issuances over a 30-year time horizon using assumptions that generally align with moderate, conservative, and stress test scenarios. While the Committee looks at the projected impact of its recommendation for 30 years, due to the uncertainty of long-term assumptions regarding tax revenues and interest rates in the municipal market the Committee's focus is largely on the next 10 years.

To assess the affordability of this year's recommendation the Committee was guided by a series of targets for annual debt service and outstanding direct debt. First, over the next ten years the maximum annual projected debt service, including projected additional debt, as a percentage of projected budgetary revenue should be targeted at 7 percent as a benchmark debt ratio. In addition to that benchmark, debt service as a percentage of budgetary revenue should not exceed 8 percent over thirty years. Second, new debt issuance subject to the debt limit imposed by Section 60A of Chapter 29 of the General Laws must be within that limit, which is equal to $33.797 billion for fiscal year 2026; further, direct debt should remain within the limit over the next ten years assuming reasonable future bond cap growth. Per statute, the direct debt limit grows by five percent annually.

Affordability Modeling & Analysis

The Committee's recommendation considers results from a series of modeling runs that incorporate many assumptions related to future economic and financial market conditions. Key inputs considered by the Committee include tax revenue projections, interest rate trends, municipal (muni) bond market performance, current and future bond cap growth, and bond issuance timing, among others. The Committee also considers future debt structuring and strives to align related assumptions with actual Commonwealth practices.

All input assumptions are based on the best available data the Committee had at the time of modeling and are subject to change. Notably, current modeling does not consider any future federal policy shifts that may impact market conditions and overall debt affordability. Additionally, the Committee recognizes that future geopolitical events and related uncertainty could also impact future affordability.

The Committee was mindful of these potential risks and generally maintained a conservative modeling approach. Below is an overview of key input assumptions that the Committee used in this year's analysis.

Revenue Growth Rate Assumptions: Revenue growth assumptions were derived using Compound Annual Growth Rate (CAGR) methodology – the same methodology utilized by the Department of Revenue (DOR) and which is generally considered a standard industry approach. Fair Share surtax revenue is excluded from the base calculation. The Committee also considers market updates and outlooks provided by DOR, as well as other economic vendors when determining revenue growth assumptions. Revenue year-over-year (YoY) growth scenarios used this year include:

- Moderate: 4.3% average annual YoY growth

- Conservative: 3.2% annual growth rate (20-year CAGR low)
- Stress Test: 1.6% annual growth rate (10-year CAGR low)

Interest Rate Assumptions: To forecast interest rates the Committee utilizes Moody's Analytics projections, which the Committee has found to be relatively conservative in recent years. The Committee also considers the inclusion of a premium. Scenarios used this year include:

- Non-premium interest rate scenarios: based on Moody's Aa yield curve projections:
  - <u>Base Case</u>: 3.7 – 4.7%
  - <u>Conservative</u>: 4.2% - 5.2%
- Premium interest rate scenario: 5% interest rate which aligns with the bond coupon typically used by the Commonwealth.

Premium Assumptions: Commonwealth tax-exempt bond transactions typically include a bond premium which refers to the excess price paid for a bond over and above its face value. Premium is an especially important for modeling direct debt scenarios because bond premium proceeds do not count towards the direct debt limit. One of the new features of the model is the incorporation of a premium input. The amount of bond premium received is determined by the difference between the coupon rate on the bonds offered (the Committee assumes 5%) and the AAA Municipal Market Data (MMD) yield curve that serves as a key reference in the muni bond market. The MMD curve is based on muni AAA valuations and market activity and is used as a benchmark for pricing and evaluating newly issued muni bonds. Because premium can be volatile, the Committee used the following four premium scenarios based on Commonwealth actuals dating back to 2022:

- Average: 11.0% - average premium received excluding high and low premiums
- Moderate: 10.0% - slightly below the average; current assumption used for budgeting
- Conservative: 7.8% - 2023 average (year of lowest premium)
- Premium Low: 3.1% - recent lowest premium received

Debt Structuring Assumptions: The Committee used debt structuring assumptions that align with typical Commonwealth bond issuances. Key assumptions include a three-year interest period and level debt service, among others.

Future Bond Cap Growth: Future Bond cap growth refers to the rate at which the bond cap will grow. For modeling purposes, the Committee assumes the bond cap will continue to grow by the recommended fiscal 2026 amount over the next thirty years.

In addition to robust modeling, the Committee examines other factors as part of its analysis, such as the Commonwealth's existing overall debt portfolio, including special obligation debt, which is debt that is secured by a specific pledged revenue stream, unlike GO bonds which are secured by the Commonwealth's full faith and credit and whose debt service is paid with general fund revenues. Additionally, the Committee considers contingent requirements, which relate to debt of certain independent authorities that the Commonwealth acts as a back stop for. The Committee also considers the Commonwealth's capital investment plan (CIP), other fixed long-term liabilities, credit ratings, pertinent debt ratios, Gross Domestic Product (GDP) and income levels, and comparisons to other states. Recognizing the importance of the Commonwealth's ability to keep pace with its capital needs, the Committee also considers inflation and construction cost escalation trends.

Committee Analysis Highlights

Below is an overview of highlights from this year's analysis. More details on the Committee's analysis can be found in the attached slide deck report.

- The Commonwealth's general obligation (GO) credit rating is strong (Aa1/AA+/AA+), supported by a robust and diverse economy, high income levels and a history of strong financial management. Relatively high debt levels compared to other states is the biggest credit offset, however state investment in local communities is a driver of these relatively elevated levels. Unlike many other state GO credits, the Commonwealth issues debt for both state and local level purposes. As a result, the Commonwealth is estimated to be one of the lowest in the nation for local debt as a percentage of personal income. When factoring in other long-term liabilities such as pension and OPEB contributions, MA's fixed costs as a percentage of revenues is somewhat moderated relative to peers.

- Debt service as a percentage of revenues is approximately 4% - well below the Committee's targeted affordability limits. The Committee found that debt service as a percentage of revenues remain within policy limits in all modeling scenarios except the revenue "stress test" scenario, which shows debt service exceeding the revenue limit sometime within in 2047–2049. However, this is well outside the ten-year time horizon that the DAC tends to focus on.

- The Committee views the statutory direct debt limit as the most constraining factor in its affordability analysis. At the end of fiscal year 2024 current outstanding direct debt was 89% of the direct debt limit, however this buffer is expected to decrease in the coming years as the bond cap continues to grow. The Committee's analysis, which focuses on anticipated impacts over the next ten years, suggests a $110 million year-over-year annual bond cap increase would result in Commonwealth outstanding direct debt reaching 99% of the direct debt ceiling around 2031, where it will stay until 2037, after which point the buffer between projected actual outstanding direct debt and the limit begins to increase.

- Construction cost escalation, which has been historically high, is something the Committee continues to monitor. The Committee notes that construction escalation has outpaced CIP growth in recent years, and while construction escalation has somewhat cooled, it still remains a capital challenge and will likely continue to erode the CIP's purchasing power. We note that this erosion is likely to be further compounded given bond cap growth will be constrained by the direct debt limit.

Committee Recommendation Summary

While the Committee's formal bond cap recommendation is for fiscal year 2026, the Committee's recommendation is based on prudent economic assumptions, as well as future bond cap growth. Overall, the Committee's analysis suggests an annual year-over-year bond cap growth of $110 million in fiscal years 2026 through 2056 is affordable and sustainable assuming modeling input assumptions remain relatively in line with actuals. The below table provides the resultant ten-year forecast.

DAC Modeling Projections	FY26 Rec	Projected								
	FY26	***FY27***	***FY28***	***FY29***	***FY30***	***FY31***	***FY32***	***FY33***	***FY34***	***FY35***
Bond Cap Amount*	$3.227	*$ 3.337*	*$ 3.447*	*$ 3.557*	*$ 3.667*	*$ 3.777*	*$ 3.887*	*$ 3.997*	*$ 4.107*	*$ 4.217*
Bond Cap Annual $ Growth* *(steady annual growth)*	$0.110	*$ 0.110*	*$ 0.110*	*$ 0.110*	*$ 0.110*	*$ 0.110*	*$ 0.110*	*$ 0.110*	*$ 0.110*	*$ 0.110*
Annual Bond Cap Growth (%)	3.5%	*3.5%*	*3.4%*	*3.3%*	*3.2%*	*3.1%*	*3.0%*	*2.9%*	*2.8%*	*2.8%*
Debt service as % of Revenue *(3.2% rev growth)*	4.74%	*4.72%*	*4.53%*	*4.71%*	*4.67%*	*4.64%*	*4.80%*	*4.64%*	*4.73%*	*4.68%*
Direct Debt as % of Direct Debt Limit *(11% premium)*	95%	*96%*	*97%*	*98%*	*98%*	*99%*	*99%*	*99%*	*99%*	*99%*
** $ in billions*										

To arrive at its conclusion, the Committee performed wide range modeling that considered a variety of assumptions and scenarios ranging from moderate to stress test levels. While the Committee looks at debt affordability impacts over a thirty-year horizon, it recognizes that modeling uncertainty increases the further out in time it spans. Therefore, the Committee is particularly focused on the upcoming ten-year horizon where there is more certainty, especially in the early years.

Overall, the fiscal year 2026 recommendation supports CIP growth while keeping debt service and outstanding principal within long-term targets. The Committee's analysis is based on the best available data at the time of analysis and reasonable assumptions around future bond cap growth. Changing conditions or events during the fiscal year, such as increases or decreases in budgetary revenue, changing interest rates and other market conditions, or specific emerging capital needs, may warrant borrowing more or less during the year than is initially recommended by the Committee. Any such potential change would be subject to the direct debt limit.

Sincerely,

Kaitlyn Connors
Assistant Secretary
Executive Office for Administration and Finance
Designee of Secretary Matthew J. Gorzkowicz, Chair

Voting Committee Members

Kaitlyn Connors	Designee of the Secretary of Administration & Finance, Matthew J. Gorzkowicz
Sue Perez	Designee of the Treasurer and Receiver-General, Deborah Goldberg
Pauline Lieu	Designee of the Comptroller, William McNamara
Michelle Scott	Designee of the Secretary of Transportation, Monica Tibbits-Nutt
Catherine Walsh	Appointee of Former Governor Charles D. Baker
Marty Benison	Appointee of Treasurer and Receiver-General, Deborah Goldberg

Non-voting Committee Members

Michael J. Rodrigues	Chair, Senate Committee on Ways and Means
Patrick M. O'Connor	Ranking Member, Senate Committee on Ways and Means
Aaron Michlewitz	Chair, House Committee on Ways and Means
Todd M. Smola	Ranking Member, House Committee on Ways and Means
Edward J. Kennedy	Chair, Senate Committee on Bonding, Capital Expenditures and State Assets
Ryan C. Fattman	Ranking Member, Senate Committee on Bonding, Capital Expenditures and State Assets
Michael J. Finn	Chair, House Committee on Bonding, Capital Expenditures and State Assets
David T. Vieira	Ranking Member, House Committee on Bonding, Capital Expenditures and State Assets