

The Commonwealth of Massachusetts



Debt Affordability Committee

9/12/16

[For policy development and discussion purposes only.]



Debt Affordability Committee



- The Debt Affordability Committee (DAC) is charged with submitting to the Governor and the General Court the Committee's recommendation for the fiscally prudent amount of new Commonwealth General Obligation debt that can be issued in the following fiscal year.
- The DAC is codified in MGL Ch. 29 §60B. The DAC was created in the FY13 budget and has released its debt affordability recommendations for FY15-FY17.
- The DAC recommendation is due by **December 15**.
- This estimate is advisory and does not bind the administration to any level of debt issuance.

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Debt Affordability Committee: Composition



| Member | Position Name |
|--|--|
| Howard Merkowitz, Deputy Comptroller | Designee of Comptroller |
| Jennifer Sullivan, Assistant Secretary of EOAF | Designee of Administration and Finance Secretary |
| Sue Perez, Assistant Treasurer for Debt Management | Designee of State Treasurer |
| Michael Butler | Treasury appointee #1 |
| TBD | Treasury Appointee #2 |
| Catherine Walsh, Governor's Appointee | Expert in Public Finance and Who Shall Be a Resident of The Commonwealth and Employed by a Public or Private Institution of Higher Education |
| Michelle Ho, Assistant CFO for Capital Programs | Designee of Transportation Secretary |

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Importance of Debt Affordability Reviews



- An annual debt affordability review acts as a primary tool for maintenance of a set of strong financial management practices
- Specifically, a periodic analysis of the affordability of debt levels provides key internal benefits to the Commonwealth
 - Ensures that the financing costs as a percentage of the operating budget are kept at manageable levels
 - Forces the setting of priorities due to the limited nature of available funds
- The reviews are also viewed as a responsible practice and credit positive by rating agencies and internal credit analysts
 - **“Strong financial, debt, and budget management policies, including annualized formal debt affordability statements, and multiyear capital investment and financial planning;”**
S&P Report, August 2016
 - **“The commonwealth also conducts a debt affordability analysis and reports its audited financial results on a timely basis.”**
Moody’s Report, August 2016
 - **“Conservative budgeting, ongoing economic and revenue monitoring, and mechanisms to protect the general fund from economically sensitive PIT and judgment and settlement receipts support the Commonwealth's fiscal flexibility**
Fitch Report, August 2016

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Importance of Debt Affordability Reviews



- For FY17, the debt service line items represent a significant portion of the overall budget
 - \$2.46 billion for general and special obligation debt
 - 6.0% of the Commonwealth's operating budget
- The debt service line items are a non-discretionary long term obligation, but the future cost of debt service is more under Commonwealth control than other long-term obligations
 - Close management aids in the prevention of structural imbalances within the budget
 - Annual planning provides a roadmap that allows for funding of necessary projects through the use of efficient and strategic amortization of the debt profile
- While the budgeting of future financing costs provides up-front flexibility, once debt is issued, it becomes the Commonwealth's most binding financial obligation
- The use of forecasting and a reasoned imposition of policy/statutory limits on additional debt are the most effective means of controlling what eventually becomes one of the Commonwealth's fixed set of costs



Bond Cap and other Capital Funding Sources



- DAC only makes a formal recommendation as to the affordable level of *bond cap* spending.
- Bond cap is set by the administration, and refers to the total amount of General Obligation bonds subject to the debt limit issued in a fiscal year to support capital spending.
- Bond cap is the principal, but not only, source of funding for the Commonwealth's capital plan. Other sources include:
 - Self-supporting/Project Financed Debt: projects where savings or revenue are anticipated to cover debt service, including the Clean Energy Incentive Program and selected IT projects
 - Federal grants and reimbursements
 - Funds from other state component units such as University of Massachusetts Building Authority or private sources
 - Operating pay-as-you-go capital, including toll revenue
 - Accelerated Bridge Program (ABP) debt covered by the Commonwealth Transportation Fund (CTF) revenues and federal grants, excluded from the statutory debt limit
 - Special Obligation Transit Bonds covered by the CTF, excluded from the statutory debt limit

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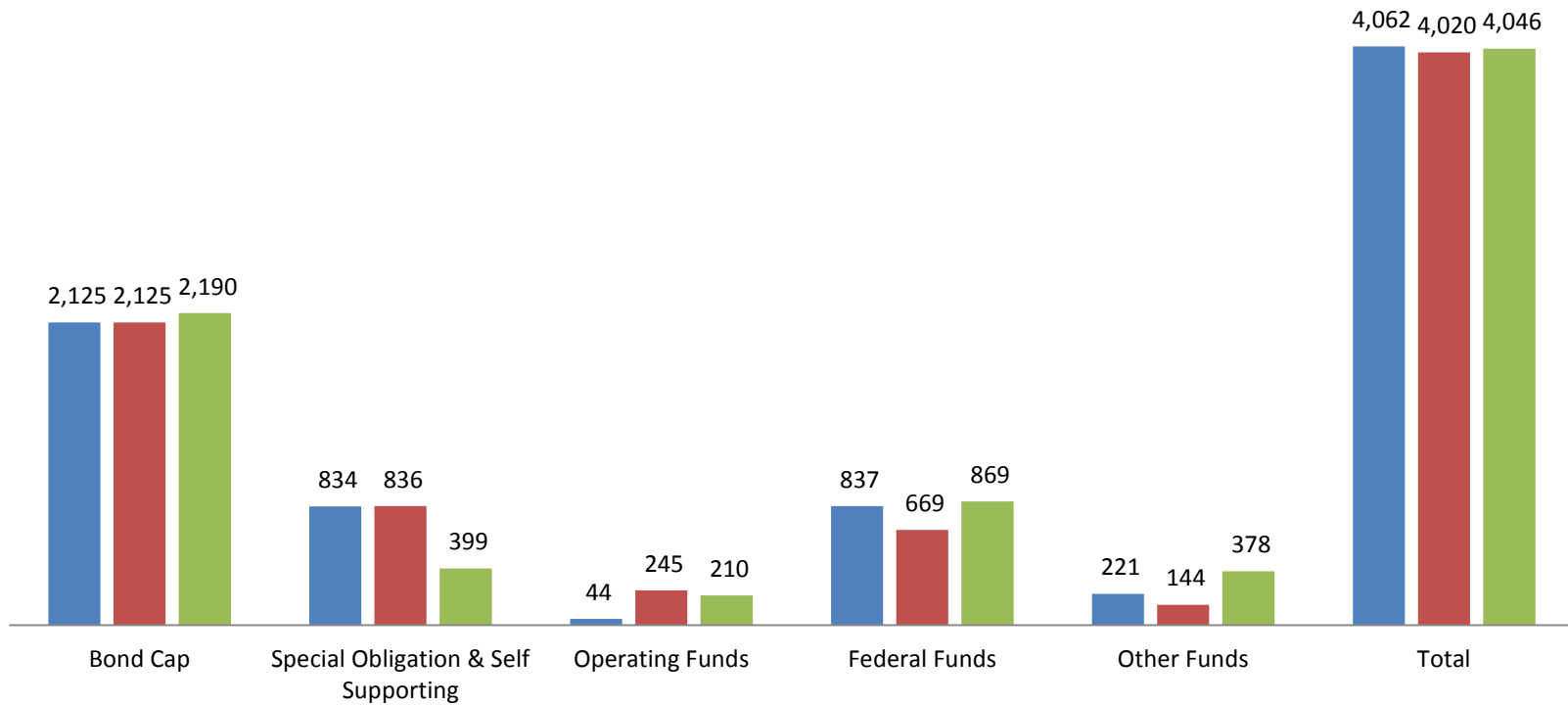


FY17 Capital Plan: Sources of Funds



FY15-FY17 Capital Plan Funding Sources (\$)

FY15 FY16 FY17



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Debt Affordability Committee: Charge



- Statute charges DAC with examining multiple factors affecting the prudent level of bond-cap issuance, including:
 1. Outstanding debt
 2. State's capital program
 3. Debt service projections for next 10 years
 4. Bond ratings and credit rating agency criteria
 5. The marketability of state bonds
 6. Pertinent debt ratios and their comparison with other states
 7. Composition of Commonwealth Debt: fixed rate vs. variable rate
 8. Debt of Commonwealth component units
- The 2014 DAC also recommended that the committee take other long term obligations including pension and OBEB liabilities into account

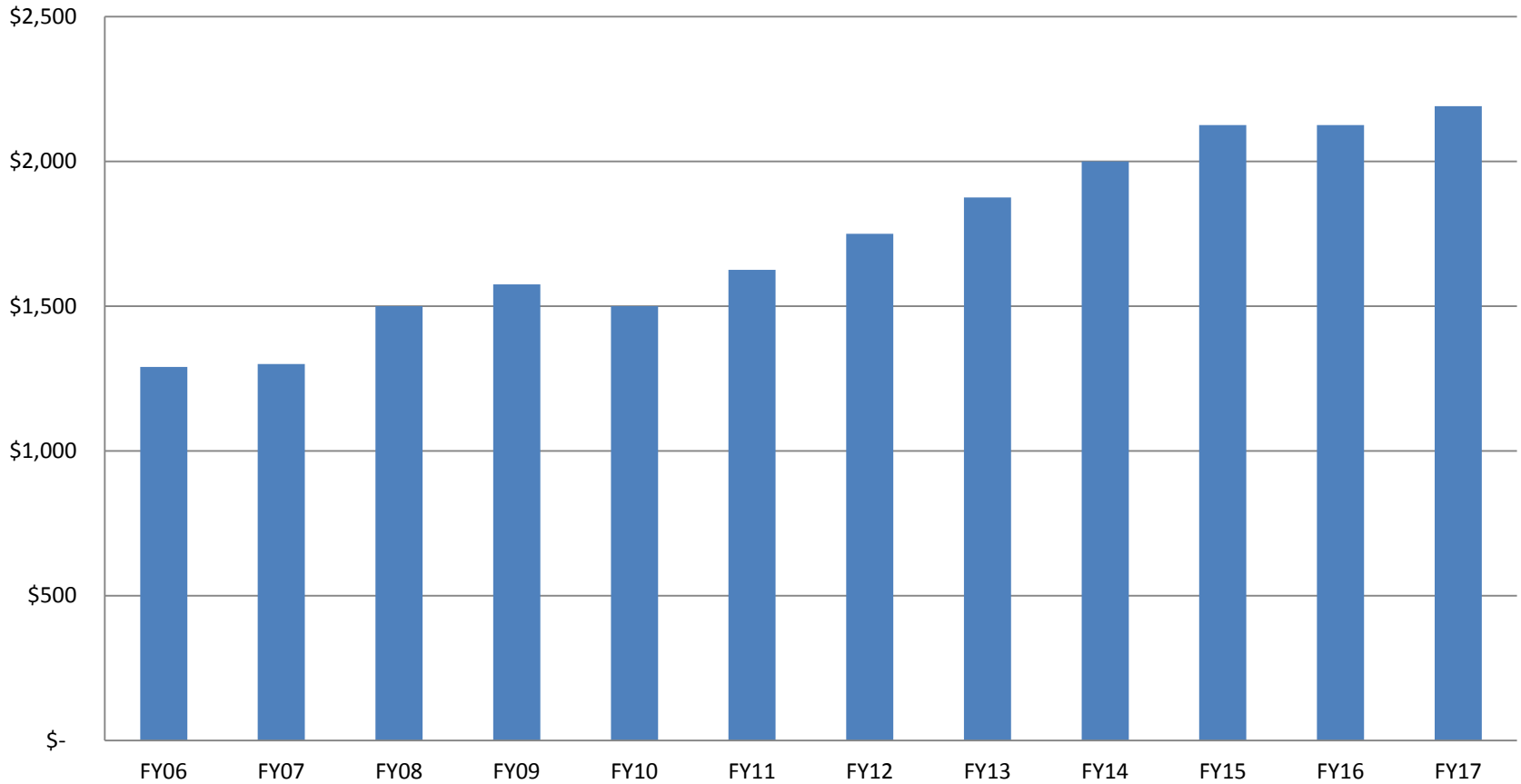
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Published Bond Cap FY06-FY17



Published Bond Cap (\$M)



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Debt Affordability Committee: past recommendations



■ 2013

- Recommended \$2.125 B of bond cap issuance
- Recommended 3 part test:
 - Debt service targeted to 7% of budgeted revenues and not to exceed 7.5% of budgeted revenues
 - Outstanding debt to stay within statutory debt limit
 - Bond cap not to increase >\$125 M/year

■ 2014

- Recommended \$2.25 B of bond cap issuance
- Certified that \$2.25 B met the 3 part test, applying 8.0% of budgeted revenue policy
- In June 2015, Administration announced FY16 bond cap of \$2.125 B, based on fiscal pressures and affordability analysis

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Debt Affordability Committee: past recommendations



■ 2015

- Recommended \$2.19 B of bond cap issuance
- Recommendation based on fiscal affordability and linked 3% increase in bond cap to long term revenue growth rates
- Certified that \$2.19 B met the 3 part test, applying the 8% of budgeted revenue policy and 7% of budgeted revenue target
- In June 2015, Administration announced FY17 bond cap of \$2.190 B



Debt Affordability Committee: 2016 Workplan



- Meeting #1: Introduction (September 12)
 - DAC roles and responsibilities
 - Presentation of model
 - Debt portfolio
- Meeting #2: Model in Practice (October 17)
 - Model presented in more detail
 - Presentations on assumptions
 - Massachusetts debt in context of other states
 - Discussion on assumptions and improvements to model
- Meeting #3: Debt Affordability Recommendation (approx. December 1)
 - Revised Debt Affordability Model
 - Discuss/adopt model and report
 - Formally recommend debt affordability level for fiscal year 2017
 - Formal Recommendation may require potential 4th meeting



Debt Affordability Model: 8% Test



- A&F followed on the work of the DAC to internally model debt service and debt load.
- Model starts with existing debt schedule and layers on projected issuance based on the FY17-21 capital plan.
- A&Fs “first cut” metric is the 8% of budgeted revenues test:
 - Debt Service on direct Commonwealth debt cannot exceed 8% of budgeted revenues in a fiscal year.
 - Budgeted Revenues excludes the sales tax transfer to the MBTA and MSBA, but includes pension payments.
 - Direct debt includes all debt issued by the Commonwealth and backed by budgeted tax revenue. It includes debt such as ABP that is excluded from the debt limit but does not include debt of component units such as the MBTA.

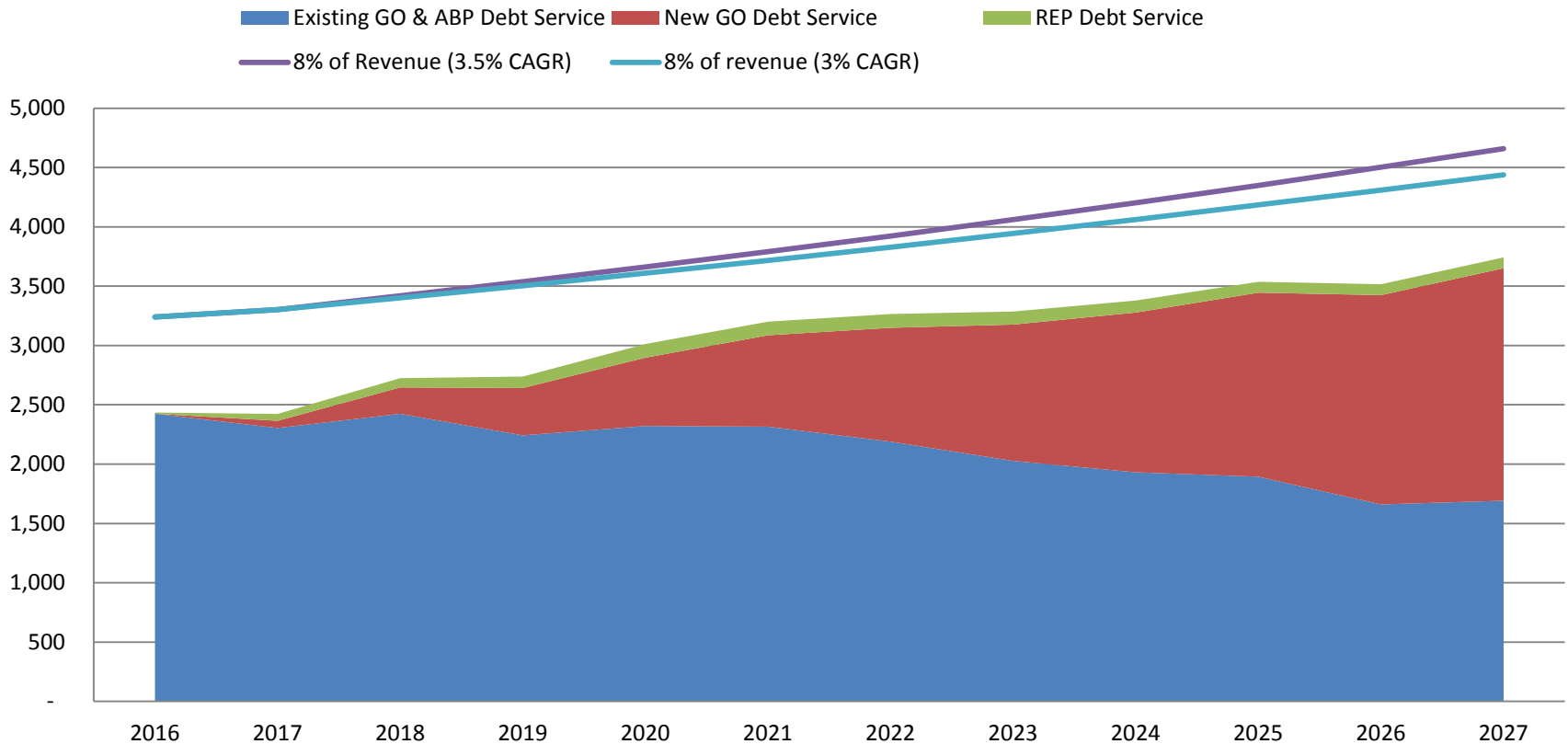
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8% Test: One View



Debt Service Affordability: 8% test



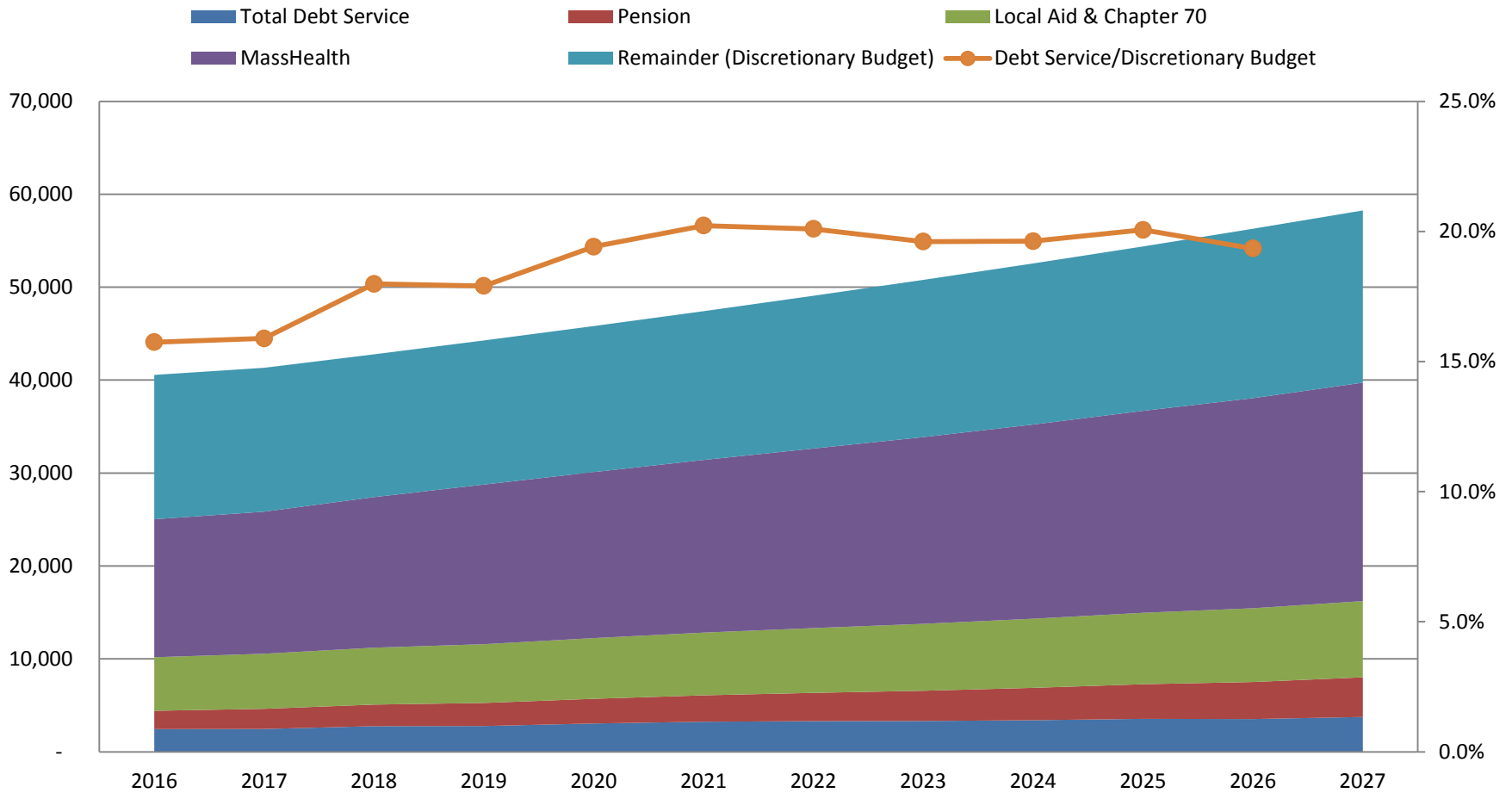
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Debt Service and Discretionary Revenue



Debt Service and the Discretionary Budget



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Assumptions



- The model makes assumptions on interest rates, issuance, revenue growth, and drivers of non-discretionary spending
- All assumptions can be changed to “stress-test” the affordability of different levels of issuance under different economic and spending scenarios
- The two charts show represent the assumptions used in developing the capital budget

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Assumptions: Issuance



| Measure | Working Assumption | Rationale |
|-----------------------------|--|--|
| 10 year interest rate | 3.5% +10 bps /year | Conservative, slightly higher than today's rates. Interest rate increases programmed for 15 years (ending in 2032) |
| 20 year interest rate | 4% +10 bps/year | " |
| 30 year interest rate | 4.5% + 10 bps/year | " |
| Debt Service | Level debt service (equal payments until maturity)+Contract Assistance | Abstracts past serial issuance, proceeds vs. par, doesn't push off estimated impact |
| Bond cap issuance | \$2.190 B/year through 2021, 3% thereafter | Current capital plan |
| ABP issuance | \$400 M over 3 years | Remainder of authorization. Split between GANS/CTF |
| Special Obligation Issuance | \$1.90 B over 5 years | Current capital plan, including \$450 M issued FY16 |
| Self-Supporting Issuance | \$100M/year | Based on recent spending levels |



Assumptions: Budget



| Measure | Assumption | Rationale |
|------------------------|--|---|
| Revenue Growth | 3.5% increase a year | FY06-FY16 CAGR of 3.17% |
| Pension | 10% increase to FY17 and 7% a year thereafter ; fully amortized FY37 | Current funding schedule. New funding schedule based on most recent valuation will be implemented in FY18 |
| MassHealth | 6% growth through FY20, 4% thereafter | Conservative growth rate assumptions – 8.2% annual growth rate FY09-FY16 |
| Local Aid & Chapter 70 | 3.3% | Historical growth rate |
| Existing Debt Service | Paid down at current schedule | Best working assumption, though refinancing will likely smooth repayment (September 1, 2016 DBC run) |

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Debt Load: Direct Debt Overview



| | Balance as of 6/30/2016 (\$M) |
|---|----------------------------------|
| Net Proceeds: Outstanding Principal | \$24,402 |
| <i>Special Obligation Debt (to date, legacy gas tax, Convention Center)</i> | (808) |
| <i>Accelerated Bridge Program - Federal Grant Anticipation Notes</i> | (688) |
| <i>Accelerated Bridge Program - CTF</i> | (1,545) |
| <i>Transportation Infrastructure Fund</i> | (1,150) |
| <i>School Building Assistance (pre-spin off assistance)</i> | (652) |
| <u><i>State debt subject to Statutory Debt Limit</i></u> | <u>19,558</u> |
| Statutory Debt Limit | \$20,749 |

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Statutory Debt Limit



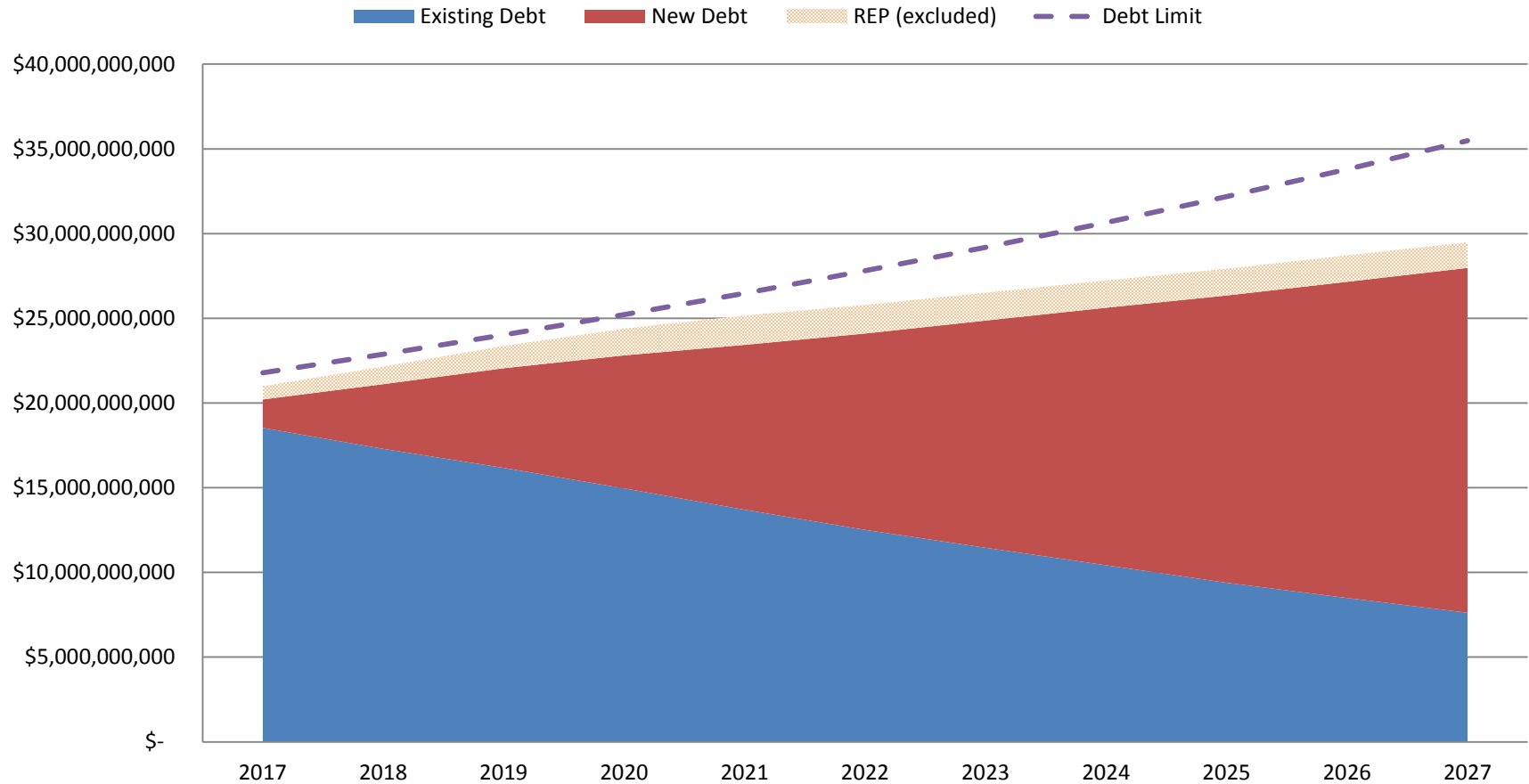
- The commonwealth may not issue debt exceeding the statutory debt limit.
- Statutory debt limit is \$21.8 B and increases 5% annually
- Certain types of debt backed by specific revenues, including ABP and Rail Enhancement Program debt, are excluded by statute from the debt limit calculation
- Exclusion of Rail Enhancement Program debt relieves pressure on statutory debt limit, allowing for flexibility in refunding and issuance



Statutory Debt Limit Projection



Statutory Debt Limit Projections





Other Debt-Like Obligations



| Gen. Obligation Contract Assistance Requirements (\$M) | 2017 |
|--|---------|
| Massachusetts Clean Water Trust | \$ 57.4 |
| Massachusetts Department of Transportation | 125.0 |
| Massachusetts Development Finance Agency | 9.0 |
| Social Innovation Financing Trust | 2.3 |
| <i>Total Contract Assistance</i> | \$193.7 |
| Leases | \$144.7 |

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Debt Load, Component Units and Authorities



- In addition to Commonwealth issued debt, some of which is excluded from statutory debt limit, the state contains multiple public authorities that also issue debt
- While not directing obligations of the Commonwealth, the rating agencies take into account these authorities' debt load when evaluating Commonwealth debt
 - Authorities draw on same economic base as Commonwealth debt
 - Some authorities viewed by rating agencies as implicitly guaranteed by Commonwealth
- Authorities listed on succeeding slides in rough order from tax-supported (closest to state obligation) to direct fee supported

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Debt of component units



| Authority | Outstanding Debt (\$M) | Revenue Source |
|--|------------------------|---|
| Mass. Bay Transit Authority | \$5,634 | 1% of state sales tax, fares, assessments |
| Mass. School Building Authority | 6,201 | 1% of state sales tax |
| MassDOT: Legacy Turnpike Debt | 2,216 | Tolls, \$125 M/year contract assistance |
| Massachusetts Clean Water Trust | 3,332 | Interest income on loans to municipalities paid out of water rate fees, contract assistance |
| UMass Building Authority | 2,924 | Campus resources (tuition and fees), fees from revenue generating buildings |
| Mass. State College Building Authority | 1,370 | Fees from revenue generating buildings |

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Debt of Component Units



| Authority | Outstanding Debt (\$M) | Revenue Source |
|---|------------------------|--------------------------------|
| MassDevelopment | \$ 7 | Property and interest income |
| MassHousing | 3,363 | Working capital and bond funds |
| Steamship Authority | 80 | Passenger fares |
| <u>Massachusetts Water Resource Authority</u> | <u>5,689</u> | <u>Rate revenues</u> |
| <i>Total, Named Authorities</i> | <i>\$30,816</i> | |
| TOTAL: Direct Debt + Authorities | \$50,374 | |

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