Report from the Office of the State Treasurer on Short-Term Bond Financing

Legislative Background

By December 1, 2015, the Office of the State Treasurer must prepare a report to the Legislature on all various purpose general obligation bond issuance for capital projects from 2005 through 2015. The report must:

1. ***Categorize the bond issuances in terms of final maturities***
2. ***Explain the current practice of repaying debt in equal installments over a twenty-five year period, regardless of the useful life of the specific projects or properties being financed; and***
3. ***Recommend a pilot approach to short-term bond financing that matches final maturities with the useful life of specific projects or properties being financed.***

Overview of State Finance Committee Issuance Practices

The State Finance Committee (Treasurer, Governor and Lt. Governor) oversees bond sales that have been authorized by the Legislature. The vast majority of bond sales are done by competitive bid in which underwriters compete in an electronic auction to buy the bonds. Bonds are sold to the underwriter that offers the lowest cost of funds for the State, after which the underwriter is required to make a bona fide public offering of the bonds to investors. This is a public financial market that is regulated by federal agencies.

Bonds are typically not sold to pay for specific projects. Instead, they are sold only when funds are needed. Proceeds are deposited into the State's building construction accounts to pay for various projects in multiple agencies pursuant to appropriations made by the Legislature in its capital budgets.

Bonds are sold in a way that assures that the *approximately 15 year average life* of each bond issue (with level debt service and a final maturity of 25 years) *is kept far shorter than the 20-40 year weighted average expected life* of the projects funded with the bonds.

Using this type of consolidated cash-flow financing for capital projects achieves the lowest possible cost of funds while also ensuring funds are borrowed only when needed. It also results in very low Internal Revenue Service compliance costs.

<u>*Consolidated Financing Reduces the Cost of Funds*</u>

The State has achieved a low cost of funds through competitive sales – an approach that offers the greatest amount of transparency to the public and to market participants. Most issuances total from \$100 to \$500 million – spread across maturities from 1 to 25 years – with \$5-\$30 million in each maturity ($282 million in various purpose general obligation (VPGO) bonds were sold in this way in September 2015).

Most investors in the State's bonds are institutions that require minimum purchases of $1-$5 million *per maturity* so they can be assured of marketability and liquidity in the secondary market. By consolidating financings for all agencies, the State receives strong levels of interest from bond buyers and a high demand for the State's bonds, which reduces borrowing costs.

Consolidated Financing Significantly Reduces Compliance Costs and Risks

The Washington State Constitution restricts the final maturity of general obligation bonds to 30 years but nearly all VPGO bonds are issued with a final maturity of 25 years. Because the bonds are issued in a series of maturities from 1 year up to 25 years, the *average life* of a bond issue with level debt service and a final maturity of 25 years *is approximately 15 years* – far shorter than the *20-40 year weighted average expected life* of projects funded with the bonds.

Washington carefully keeps the *average life of each issuance* well below the *average expected life of the assets* being financed to ensure compliance with Internal Revenue Code requirements. The State's administrative costs are low because Washington uses a special U.S. Treasury provision [Treas. Reg. Sec. 1.141-2(d)(5), (the "d5 Rule")] that lets the State forego costly monitoring practices. Currently, the state employs one person with only a portion of their time spent on tax exempt bond compliance.

Using this rule to keep compliance costs and risks low means the State does not finance individual projects with proceeds from individual bonds. Instead, with every tax exempt bond issue the State certifies to the IRS that certain conditions are expected to be met, specifically the State expects:

- To spend proceeds within 6 months;
- To finance at least 25 separate purposes (as defined in the regulations) and no fewer than four separate purposes;
- To expend all of the proceeds of the issue before expending proceeds of a subsequent issue of similar general obligation bonds;
- Proceeds will not be loaned to the private sector or non-profit corporations; and
- Capital expenditures will not meet private activity business tests.

If the State chooses not to use the "d5 rule" and links specific projects to specific bond maturities the State would need to:

- Identify and allocate bond proceeds to expenditures on specific capital projects and monitor expenditures over time to ensure that IRS spend-down requirements have been met; and

- Monitor the use of each facility over the life of the financing and maintain records regarding any use of the facility or equipment financed with tax-exempt bonds by the private sector, non-profit organizations, or by the federal government ("private use") – which includes monitoring any management contracts in which the State authorizes a third party to operate a facility.

To meet these additional compliance requirements, the State would need to expand its compliance program by about $350,000 per year to add a staff person at the Treasurer's Office and several staff in line agencies to track projects and expenditures. There would also be additional legal fees of approximately $125,000 *per issuance* to assure projects meet tax-exempt financing requirements.

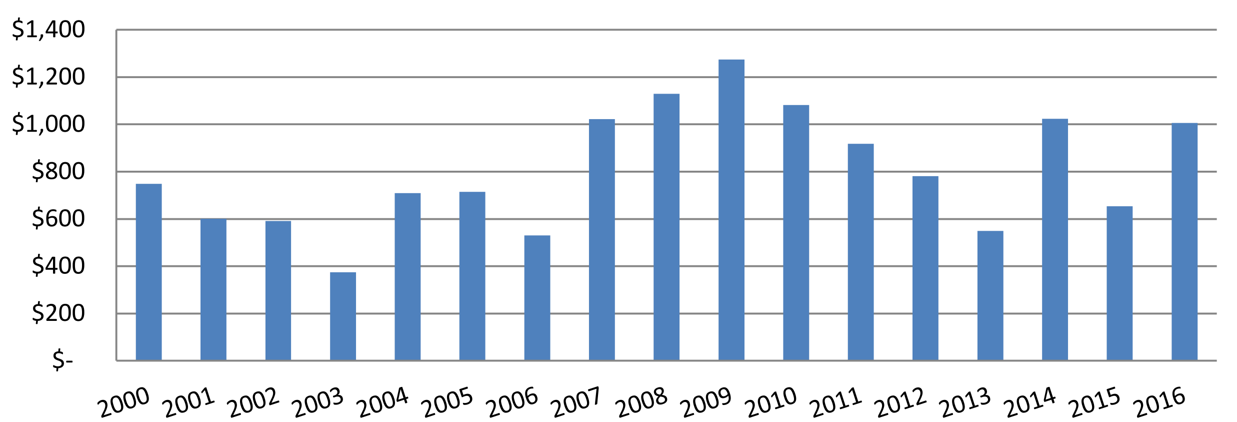
Consolidated Financing Minimizes Issuance Costs

The State must pay certain costs of issuance each time it accesses the capital markets to sell bonds such as fees for bond counsel, financial advisors and underwriter discounts – some of which are hourly rates, some fixed costs, and others are a percentage of the size of the issuance. By conducting fewer larger bond sales the State realizes significant economies of scale. For example, issuance costs for a $500 million issuance covering legal fees, credit ratings, printing and financial advisory fees total only $210,000 or less than $0.42 for every $1,000 of bonds issued. Similar costs for a $5 million issuance would total $130,000 – or more than $26.00 per $1,000 of bonds issued.

1. *Categorize the bond issuances in terms of final maturities*

Capital budget appropriations that rely on bond financing typically receive funds from semi-annual bond sales. OST determines the size of each bond sale based on agency and OFM estimates of amounts needed to pay for the next six months of capital projects, current and projected fund balances, and historical and seasonal spending patterns. Over this period, annual issuances of VPGO bonds ranged from $390 million to $1.3 billion, depending on the amount of proceeds needed at that time to pay for capital expenditures for projects

Issuance of Various Purpose General Obligation Bonds, FY 2000-2016* ($ millions)



*Excludes refundings. FY 2016 estimate. Source: Office of the State Treasurer appropriated in capital budgets. Each annual amount displayed in the chart has a 25 year final maturity with average maturities of approximately 15 years.

Capital Budget FY 2003-05 to 2015-17 ($ millions)

Bond Appropriations	2003-05	2005-07	2007-09	2009-11*	2011-13	2013-15	2015-17
Governmental Operations	245	293	540	633	387	845	803
Human Services	350	462	465	180	124	120	164
Natural Resources	333	377	694	836	587	920	861
Higher Education	819	1,064	1,138	861	505	611	774
K-12 Education	140	263	370	627	615	578	886
Total Bond Appropriations	1,886	2,460	3,207	3,138	2,218	3,074	3,489
Total Funds Appropriated	4,392	5,214	6,649	5,407	4,980	6,427	6,564
Percent Funded by Bonds	42.9%	47.2%	48.2%	58.0%	44.6%	47.8%	53.2%

Includes appropriations and reappropriations. *2009-11 total appropriations do not include Federal ARRA funds.
Source: Office of Financial Management, Legislative Evaluation & Accountability Program Committee

From 2005 to 2015, the State of Washington issued approximately $8.9 billion VPGO bonds to fund capital projects for K-12 education, higher education, natural resources, and other government agencies. Proceeds of these bonds have provided from 40 to nearly 60 percent of the funding for each biennial capital budget.

2. ***Explain the current practice of repaying debt in equal installments over a twenty-five year period, regardless of the useful life of the specific projects or properties being financed.***

The State's VPGO bond issues have been structured as long-term fixed rate bonds – not unlike a fixed rate mortgage. As a result, annual debt service payments (principal and interest) are approximately equal over the life of the debt so that a portion of the debt is repaid each year. Level debt service works in conjunction with consolidated financing to keep costs low and to make debt service costs paid from state operating budget appropriations more predictable. Maintaining level debt service:

Shares the cost of capital projects equally over time. Much like home owners with a standard 30-year home mortgage, the State repays a portion of the borrowing every year; and

Keeps borrowing costs down. Structuring bond issues with level debt service achieves low borrowing costs because the cost of funds is a combination of short, intermediate and long-term interest rates. The "all-in" or True Interest Cost ("TIC") on the overall borrowing incorporates the actual yields at every maturity. For example, interest rates for each maturity of the Series 2016B priced on September 30, 2015 ranged from 0.25% at the shortest maturity to 4.05% at the 25-year maturity with an overall TIC for the Series of 3.49%, right in line with the 15.4-year average life of the issue.

3. ***Recommend a pilot approach to short-term bond financing that matches final maturities with the useful life of specific projects or properties being financed.***

The Office of the State Treasurer recommends four options to consider when financing capital projects:

1) *Continue using consolidated cash flow financing*. This method achieves the lowest possible cost of funds and very low administrative, issuance and compliance costs. It is recommended that the State continue to finance capital expenditures with consolidated cash-flow financing with long-term fixed rate bonds with maturities from 1 to 25 years structured with level debt service.

   For example, issuance costs for a $500 million issuance for legal fees, credit ratings, printing and financial advisory would cost $210,000 or less than $0.42 per $1,000 of bonds issued. Competitive sales sized to attract institutional investors achieve significant pricing efficiencies. Working within the U.S. Treasury guidelines reduces administrative costs. Using these methods, the State has achieved a weighted average cost of capital on the entire VPGO portfolio of only 3.4 percent.

   Structuring fixed rate bonds with level debt service ensures that a portion of the borrowing is repaid every year, and enables the State to benefit from lower interest rates at shorter maturities. A final maturity of 25 years with an average maturity of approximately 15 years ensures the debt will be repaid well within the expected average life of the assets.

2) *Use COPs (certificates of participation*) to acquire real estate or equipment in cases where the state is not making grants to other entities. This well-established program is designed for project financing where the life of the financing is explicitly matched to the life of the asset.

   COPs require agencies to provide investors with a security interest in the assets being financed. They also have additional administrative costs related to monitoring expenditures and tracking the use of each asset over the life of the financing. COPs cannot be used to provide grants to other governmental entities. Most COPs reimburse agencies after they have made upfront expenditures.

3) *Use cash for small-sized and shorter-lived items* especially when making grants for narrowly defined purposes to other governmental entities. IRS requirements for

compliance, monitoring the use of bond proceeds by grant recipients, and recipient reporting make it problematic to use bond or COP proceeds for project-specific grants.

4) *Issue small amounts of bonds in short maturities* for project-specific purposes. This option would be very expensive because the cost of issuance, cost of funds and post-issuance administrative compliance costs would all increase.

   For example, costs of legal fees, credit ratings, printing and financial advisory services for a $5 million issuance would total $130,000 – or more than $26.00 per $1,000 of bonds issued. And, the state's compliance program costs would more than triple on an on-going basis.

   In contrast, the issuance costs for a $500 million level debt service issuance for legal fees, credit ratings, printing and financial advisory services totals only $210,000 or less than $0.42 for every $1,000 of bonds issued.

It would be most cost effective to use options 1 through 3 as appropriate depending on the specific circumstances surrounding the projects and/or budget items to be funded. Because of its very high cost of issuance and significant increases in compliance costs and risks, use of Option 4 is not recommended.