DRAFT

THE DEBT CAPACITY ADVISORY COMMITTEE
COMMONWEALTH OF VIRGINIA
December 18, 2009

3:00 P.M.
TREASURY BOARD CONFERENCE ROOM
James Monroe Building
101 North 14th Street, 3rd Floor
Richmond, Virginia 23219

Members Present: Richard D. Brown, Chairman
William K. Butler, II
Walter W. Craigie
Manju S. Ganeriwala
Walter J. Kucharski
Philip A. Leone
Daniel S. Timberlake

Others Present: Evelyn R. Whitley, Department of the Treasury
Tracy L. Clemons, Sr., Department of the Treasury
Sherwanda Cawthorn, Department of the Treasury
David Von Moll, State Comptroller
W. E. Echelberger, Jr., Senate Finance Committee
Tony Maggio, House Appropriations Committee
Toni Walker, Department of Planning and Budget
Janet A. Aylor, Department of the Treasury
Leslie English, Department of the Treasury
Jeanine Black, Department of the Treasury
Debora Greene, Department of the Treasury
Bernice Craigie

Call To Order and Opening Remarks

Chairman Brown called the meeting to order at 3:15 p.m. and informed the members that Mr. Butler was delayed in traffic. Chairman Brown began with comments regarding Governor Kaine's speech from earlier in the day when the Budget was introduced. Chairman Brown indicated that, in the current economic environment, the revenue shortfalls should have not been surprising. He added that the debt capacity policy and model had not changed significantly since inception and suggested that the Committee could possibly look at revisiting the way analysis is prepared so that the committee can consider and recommend changes. Chairman Brown expressed a desire to get thoughts outside of the current committee by including staff of Senate Finance Committee and House Appropriations Committee in the study-group to. He suggested that the study-group could possibly meet over the course of the coming year, with their efforts culminating in December 2010.

He noted that though the introduced budget bill includes authorization for about $1 billion in additional tax-supported debt, the bill also requires that prior to the 2011 General Assembly Session, the Secretary of Finance must submit a plan consistent the recommendations of this Committee allowing for the issuance of that debt to stay within our debt capacity limits.

Public Comment Period and Approval of Minutes

The Chairman asked for public comments. Hearing none, the Chairman proceeded to the minutes. Chairman Brown asked if there were any questions or corrections relating to the minutes from the Committee's meeting of December 17, 2008. Hearing none, he requested a motion of approval. Mr. Craigie moved the approval of the minutes. Ms. Ganeriwala seconded, and the motion was unanimously approved.

Staff Report on Updated Debt Capacity Model and Draft Report

Ms. Whitley briefly summarized how debt capacity had been impacted by those economic events mentioned by the Chairman. She reiterated that 2009 had not been a good year for revenues. She noted that thirty-six states faced budget shortfalls totaling over $28 billion for fiscal year 2010, according to Stateline.org. An additional $56 billion in shortfalls was expected in 2011.

However, this negative environment has also provided opportunities for construction and debt. New bond programs were created under the American Recovery and Investment Act to issue debt. Commonwealth issuers have utilized "Build America Bonds (BABs), Qualified School Construction Bonds (QSCBs), and expects to move forward on energy conservation bonds (QECBs). Ms. Whitley added that rates were very favorable on recent debt issues. She sighted an example of the $445 million Virginia College Building Authority issue sold within the last two weeks at a true interest cost of 3.23%; compared to an issue sold last spring at 4.29% or a Public Building Authority issue sold at a 4.89% TIC. Ms. Whitley also reported that construction costs were down and currently authorized projects were realizing the benefit of lower construction costs, with projects moving forward below original price estimates.

Ms. Whitley directed the committee's attention to a handout of a report from Standard and Poor's. She went over the highlights of the report that included:

- State revenues will continue to decline well after the economy begins to rebound.
- S&P expects the difficult budget environment to translate into more borrowing for some states.
- States face challenges related to their debt affordability guidelines that could constrain debt issuance
- S&P sees pressure on states to fund infrastructure improvements as a high priority.

Ms. Whitley concluded her remarks with a brief overview of major occurrences that have reduced capacity since the December 2008 report. Since December 2008's model solution and recommendation of $370 million of capacity, staff has prepared several informal model solutions to assess impact on capacity. The Mid-Session Revenue Reforecast caused a drop in capacity to $365 million. During the 2009 session, an additional $807 million in bond projects were authorized, which further reduced capacity to $124 million from the 2008 base. In August of 2009, revenues were again re-forecasted downward.

Debt Capacity Report

Mr. Clemons presented the updated report on the model, based on the December 18, 2009 official revenue forecast. He noted that despite dramatic interest rate fluctuations that had occurred over the course of the year, the model's updated rate of 4.56%, based on the average of the last eight quarters of the Bond Buyer 11-Bond Index, resulted in a change of only 2 basis pointes since 2008. (4.56% vs 4.54%.). He noted that this was a good illustration of how the use of the 8-quarter average mitigates the impact drastic changes market rates might have on the model at a given point in time. (Mr. Butler joined the meeting at this point).

Mr. Clemons proceeded in reviewing highlights of the report on the model, noting that there were no changes to any of the models general parameters or assumptions. He provided a brief overview of the model's assumptions for the issuance of currently authorized debt; and an over view of the updated model solution. He informed the Committee that due primarily to the continued declines in forecasted revenues, debt service as a percentage of revenues would exceed 5%; therefore there was no capacity to authorize new debt for issuance over the next two-year period of 2012 and 2013.

Mr. Clemons informed the Committee that, because of this unprecedented solution, a new column (column 6) had been added to the model to reflect actual outstanding debt service as of % of revenues. He explained that since the model created a solution that does not allow for additional capacity, this column was added to emphasize that the 5% threshold had not been breached on currently outstanding debt, but would be breached based on assumed issuance of authorized and unissued debt, or any potential additional debt in the near-term. Ms. Whitely added that the precipitous declines in forecasted revenues had virtually converged to meet debt service and the 5% threshold. Mr. Clemons noted that the model's forecasted revenue had declined by $18 billion since the December 2008 Report. He added that in total, over $34 billion of forecasted revenue had been removed from the model since the Committee's February 2008 special report.

Chairman Brown emphasized that the issuance of authorized debt in the pipeline could be managed, in a manner that remains below the 5% threshold. As an example, he noted that column 6 reflected 4.28% in outstanding debt as a % of revenues in 2011. Based on the planned assumed issuance of currently authorized debt for that year, the percentage goes up to 4.98%. Chairman Brown reiterated that ability to manage the issuance of current authorizations already in the pipeline, coupled with the model's current solution allowing for no more new debt for the next two years, should allow the Commonwealth to remain below that threshold.

Mr. Clemons continued with his review of the updated model and explained that while there was zero capacity for issuance of new debt authorization in the first several years, based on the current revenue forecast, capacity slowly returns in 2014-2019 as debt service as a percent of revenue remains below 5%. Mr. Clemons concluded his report on the model with a brief overview of how the model would be impacted by the various standard sensitivity scenarios.

Mr. Craigie asked whether the $3 Billion of authorized transportation projects would have to go back to the General Assembly for approval. Ms. Whitley responded that the none of the transportation authorization had yet been issued because transportation revenues were still not sufficient to support the debt service. She explained that the authorization was not tied to specific projects, but instead for projects under the CTB capital plan, and did not have to go back to the legislature. Chairman Brown acknowledged that to be the case and noted that model included transportation debt along with a portion of Transportation Trust Fund revenues. Mr. Maggio, of the House Appropriations Committee Staff, asked if inclusion of the debt and revenues in the single model resulted in the use of capacity that would otherwise be available for general fund supported debt, such as that of VCBA or VPBA. He also asked if transportation debt should be neutralized in the model, similar to 9(c), since issuance of transportation bonds was limited by the availability of transportation revenues sufficient to pay the debt service. Ms. Whitley explained that the legislation authorizing this debt included a hierarchy of multiple funding sources to support the debt service, if a given revenue stream failed. She added that the projects also were not originally authorized as 9(c), which by definition, must be supported by project revenues, for example toll facility bonds, some of which have previously been authorized and issued as 9(c). Chairman Brown noted that whether to continue to include transportation debt in our single analysis or model, versus evaluating it under a separate measure, could very well be included with the study-group's analysis.

Mr. Clemons briefly reviewed the debt burden section of the report. He noted that a comparison of AAA state debt burdens showed that even though Virginia is at it's self-imposed debt capacity limit, the Commonwealth remains low in more universal debt burden measures, such as debt per capita and debt as a percentage of income, relative to the other AAA states.

Chairman Brown added that this was consistent with some of his opening remarks. Although there was no current capacity for issuance of new debt authorization based on our current debt affordability measure, the Commonwealth compares favorably to other AAA states using the more universal measures of debt burden.

Discussion of Moral and Contingent Liability Updated

Mr. Clemons proceeded to the Moral Obligation and Contingent Liability overview, reminding the Committee that moral obligation bonds were those that carried a debt service reserve fund make-up provision. The only current issuer of moral obligation bonds was the Virginia Resources Authority (VRA). He informed the Committee that the VRA's cap was increased to $1.5 billion by the 2009 General Assembly from $900 million.

Mr. Leone asked why the VHDA balance had gone to zero Mr. Clemons stated that the Virginia Housing Development Authority (VHDA) had stopped issuing moral obligation bonds several years ago, and during 2009, all of the outstanding moral obligation debt was refinanced and defeased.

Mr. Clemons concluded with an overview of the sum sufficient appropriation bonds, noting that the Virginia Public School Authority (VPSA) remained the only sum sufficient appropriation issuer. He provided and update on that programs current ratings and outstanding balances.

Discussion of the Final Report to the Governor and General Assembly

Chairman Brown directed the membership to the draft of the report cover letter to begin discussion of the final report and recommendations. He, reiterated that there was no current capacity to authorize and issue new debt for the next two years, based on the current debt affordability measure and revenue projections.

He stated that the Commonwealth compared well to other triple-A states on measures such as debt per capita and debt as a percentage of personal income. Since the model/policy had not been reviewed in a comprehensive manner, he suggested a study group, composed of treasury staff and money committee staff, could re-examine a number of areas, such as (i) whether the 5% remains the appropriate measure, (ii) should more than one factor or measure be considered, (iii) should the committee focus on capacity based on a point in time or averaged over a given length of time, (iv) should the model's debt composition be adjusted, or (v) should certain components, such as transportation and their corresponding revenue streams, be analyzed separately from general fund supported components. He stated that it would be his intent that during the coming year, this group could analyze these and other questions and issues related to debt capacity, and present options for this Committee's consideration and discussion prior to next December's meeting. Accordingly, next December's model would possibly include the various alternatives that the Committee agrees are appropriate, as it makes its annual recommendation.

Mr. Kucharski added that the Committee should perhaps broaden its review to not only include bonded debt and known liabilities with known obligations, but also include some assessment of some of the other major required obligations of the Commonwealth. These obligations, such as pensions and Medicaid, will also ultimately require significant resources of the General Fund and could significantly impact budget flexibility. He emphasized that the analysis of alternative measures should not lose sight of the fact that some portion of the general fund must also be used for these required obligations. The percentage of the general fund set aside for bonded debt combined with the portion that must be used to meet these other required obligations will leave less available for everything else. He added that there was also a ratings link, since there was growing attention to these obligations from each the rating agencies. Broadening the analysis would not only assist the Governor and legislature in this area, but would also signal to the investment community and the ratings agencies that attention was being given to this area.

Chairman Brown acknowledged the significance of keeping up with such required obligations. He added that the pension plan debate involved many policy issues that may or may not be within the Committee's purview. However he agreed that that these obligations could be reviewed by the study-group and, to the extent possible, addressed by the DCAC in its roll as an advisory committee. Mr. Leone agreed that there indeed were policy issues involved, and that the priorities would ultimately be determined by the Governor and Legislature. However, due to the potential general fund impact of these obligations, he stressed that it was important that the Committee consider broadening its focus to review and report in some fashion.

Mr. Craigie noted that although the DCAC was merely an advisory committee, it has had a major impact since its inception with both the legislature and the various governors. He reminded members that the threats to the ratings, due in part to the unstructured way in which debt was authorized prior to the DCAC's establishment, got the attention of both branches. This body was established in response to those concerns. The process developed by this body has had an impact on maintaining effective management of the Commonwealth's debt load and ratings. He noted that although the rating agencies and investment community had become accustomed to the 5% affordability measure, the study-group's review of the measure, as well as the concerns expressed by Mr. Kucharski, were reasonable

Ms Whitley stated that another factor with the single 5% measure and the model in general, was that it never contemplated such dramatic changes in revenues. The solution is not only materially altered by dramatic revenue declines, but also dramatic revenue increases, which may overstate capacity.

Mr. Butler questioned whether staff could look at additional sensitivities to capture this impact. He asked if there would be negative ratings impact if the debt capacity limit were raised temporarily to 5.50% or 6.50%. Ms. Whitley stated that such adjustments along with a number of others would be taken under consideration as part of the study. She further explained that the relationship of debt burden and revenues was only one of the factors considered by the rating agencies. Given that the revenue declines were hitting all states, the Commonwealth's situation relative to other states was still favorable. She reminded the Committee that each of the rating agencies had affirmed the Commonwealth's Triple-A rating with a stable outlook in October, 2009.

Mrs. Ganeriwala added that the rating agencies consider other factors such as, structural balance, long term growth potential, management flexibility, addressing of infrastructure needs, overall economic performance etc. While a breach of the 5% measure may or may not have immediate impact on the rating, the Committee and Commonwealth should remain cognizant of the revenue trends, as budget actions are considered. Mr. Craigie agreed and sited that the years in the model in which the 5% threshold is breached, should be recognized as a flag and taken into account, given the uncertainty of any turn-around in revenue trends.

Chairman Brown thanked the members for their comments, questions and recommendations. The committee then reviewed and discussed its cover letter for the report. Upon completion of this discussion changes were proposed by the membership for inclusion in the letter regarding its recommendations and the study-group. Staff was directed to finalize the changes that had been discussed and re-distribute the letter to the members for review, comment and approve by December 23, 2009. The Committee's report and recommendations were due to the Governor and Legislature by January 1, 2010.

Ms. Ganeriwala asked if there was a recommended timeline in which a working committee or study-group would be established. Mr. Brown indicated that he would work with the money committee to establish a panel for this project to begin in the summer of 2010.

With no further business, the meeting adjourned at 4:40 p.m.