DEBT CAPACITY ADVISORY COMMITTEE
COMMONWEALTH OF VIRGINIA
December 18, 2015

12:30 P.M.
TREASURY BOARD CONFERENCE ROOM
James Monroe Building
101 North 14th Street, 3rd Floor
Richmond, Virginia 23219

Members Present:	Richard D. Brown, Chairman Elizabeth B. Daley Manju S. Ganeriwala Harold E. Greer Martha S. Mavredes Ronald L. Tillett Daniel S. Timberlake Robert P. Vaughn David A. Von Moll Jody M. Wagner
Members Absent:	None
Others Present:	Janet A. Aylor, Department of the Treasury Bradley L. Jones, Department of the Treasury Sherwanda Cawthorn, Department of the Treasury Gina Burgin, Deputy Secretary of Finance Neil Miller, Deputy Secretary of Finance April Kees, Senate Finance Committee Staff Jason Powell, Senate Finance Committee Staff Tony Maggio, House Appropriations Committee Staff Leah Schubel, Davenport & Company Mary DiMartino, JP Morgan Vasyl Zuk, JP Morgan Chris Whyte, Vectre Corporation John Lawson, VDOT Jay Mahone, Department of the Treasury Michael D. Walsh, Department of the Treasury

Call to Order and Opening Remarks

Chairman Brown called the meeting to order at 12:40 p.m. and welcomed everyone to the Debt Capacity Advisory Committee ("DCAC" or the "Committee") meeting. Jody M. Wagner, newly appointed citizen member, was introduced and welcomed to the Committee.

Public Comment Period

During the public comment period, Chairman Brown asked that the Committee members, DCAC staff and the audience introduce themselves and make any public comments if they wanted to do so.

There were no public comments.

Approval of Minutes

Chairman Brown asked the Committee for a motion to approve the minutes of the October 2015 meeting. Mr. Vaughn made a motion to approve the minutes. The motion was seconded by Mr. Tillett and it was approved unanimously.

Review of the 2015 DCAC Report

Chairman Brown asked Mr. Jones to review the 2015 DCAC Report. (Exhibit 1) Mr. Jones began his overview of the 2015 report by reviewing the background of the Committee. He commented that while the debt capacity model has evolved over DCAC's nearly 25 year history, the management of debt capacity has remained a critical component of prudent financial management. Additionally, he said that by having a DCAC model and adhering to the recommendations is viewed by the rating agencies as a strength and is one reason Virginia has been able to maintain "AAA" bond ratings by all three ratings agencies.

Mr. Jones then reviewed the model inputs, parameters and model calculation. He reminded the Committee of the various revenues comprising Blended Revenues and reviewed the types of debt considered as tax-supported for the calculation. He stated that a calculation is made to determine the amount of additional debt that could be authorized and issued without causing total tax-supported debt service to exceed 5% of the forecasted Blended Revenues. He reminded the Committee that based on changes adopted in 2010, the average capacity across the 10-year model horizon is viewed as the capacity recommendation.

Mr. Jones then proceeded to review the Potential Challenges to Fiscal Stability section of the report. He stated that the challenges in Washington D.C. have made Virginia's recovery difficult; however, through new private sector investment, continued growth and enhancement of global export relationships, and increased tourism, Virginia has expanded its economy. He then stated that, despite the recent trends, Virginia will continue to face several significant risks.

Mr. Jones said that for a third year in a row, the challenge of Federal Fiscal Policy remains Virginia's top concern. He added that the Commonwealth's location makes it more vulnerable to certain spending decisions including Sequestration and Congress' inactions. He stated that while Virginia leaders have worked diligently to encourage business expansion and to increase export trade relationships, all of which has helped the economy expand, there has been a shift from high wage federal government and government contracting jobs to lower wage employment opportunities that has made the Commonwealth's recovery slow and difficult. Also, while Virginia has much to show for its business expansion efforts and a diversified employment base should be viewed as a financial strength, deeper federal cuts or inactions in Washington DC on budget and debt items could cause the Commonwealth to unexpectedly experience difficulty in the coming biennium. This vulnerability highlights the need for future budget flexibility and tools such as available balances in the Revenue Stabilization Fund. He stated that Secretary Brown could likely confirm that the Governor's introduced Budget contains significant deposits over the next couple of years to restore the Revenue Stabilization Fund. Chairman Brown confirmed there will be a large deposit that will restore the fund to a significant balance by fiscal year 2017.

Mr. Jones continued with his overview of Federal Fiscal Policy and mentioned that future changes to the Federal Tax Code are potential challenges for Virginia. He stated that current federal policymakers, along with 2016 U.S. Presidential Candidates, continue to discuss a major overhaul of potential changes to the U.S. tax code. One challenge is the possibility of eliminating the tax-exempt status of municipal bonds, which would potentially result in a decline in the demand for municipal bonds as the benefit for these bonds diminishes. This could cause interest rates to go up which would cause more debt capacity to be used and would cause additional strains on the state budget.

Mr. Jones then discussed a second potential challenge to Virginia, Federal Monitory Policy. He stated on December 16th, the Federal Open Market Committee ("FMOC") increased the target federal funds rate by 25 basis points. Interest rates initially remained unchanged in the bond markets after the announcement supporting the notion that investors have built in interest rate risk premium in their recent investment decisions. He added that it will be important to monitor the FOMC's plans for future rate increases and of equal importance, the FOMC and the financial markets will need to monitor how the overall economy is able to absorb increased borrowing costs. Mr. Jones stated, with market sentiment and FOMC signaling that interest rates will continue to rise in the coming year, it is important to note that based on current DCAC model conditions, a 1% rise in the DCAC model interest rate would cause a decline in capacity of $60.2 million annually.

Mr. Jones then reviewed the third and final challenge included in the report, Financing Significant Infrastructure. He cited a *2013 Report Card for America's Infrastructure* by the American Society of Civil Engineers and stated that an estimated $3.6 trillion of infrastructure investments are needed through 2020 for America's infrastructure to maintain a state of good repair. The largest investment category was surface transportation at a price tag of $1.7 trillion. He said that while these quantified needs are based on a nationwide assessment, Virginia is not excluded from America's growing infrastructure problems with aging infrastructure and the need for maintenance and investment. He then referenced a Standard & Poor's Capital IQ report dated October 19, 2015 and stated that the report mentioned that states don't have the ability to solve the infrastructure gap through debt financing alone. If states were to attempt to finance their entire portion of this need, it is estimated that aggregate tax-supported debt ratios would be high and the related debt service would likely result in negative credit pressures for numerous states. Mr. Jones then stated, given the increasing need for infrastructure repairs and escalating ongoing operation and maintenance expenses, the anticipated continued reduction and delays in federal infrastructure funding, and limited debt capacity, Virginia is faced with difficult decisions as it considers the next biennium budget and potential debt authorizations. Virginia, along with other states and localities, will have to determine its most critical infrastructure projects as it determines how best to use and manage its limited debt capacity.

Mr. Jones then reviewed the draft 2015 Debt Capacity Recommendations. He stated that the 2015 Base Model Solution shows an additional $603 million in debt could be authorized and issued in each fiscal year 2016 and 2017. This amount will cause projections of debt service as a percent of Blended Revenues to exceed five percent in five of the ten years modeled. Mr. Jones stated that in addition to the Capacity Recommendation, the draft report contains two additional recommendations. Mr. Jones continued his review by telling the Committee, also included as a recommendation, as in previous reports, is the support for seeking approval of 9 (b) general obligation bonds which much be approved by voter referendum. He explained that not all projects would be a good fit for these bonds. However, if there was a project that would be a good candidate to be funded through 9 (b) bonds, it would be supported because 9 (b) GO bonds are “AAA” rated as opposed to “AA+” rated 9 (d) appropriation-backed debt and the 9 (b) debt would carry less interest costs. Chairman Brown then said that before the Governor’s announcement of the bond package, staff looked at the spread between “AA+” appropriation-backed debt and “AAA” GO debt. He continued his comments by stating, at current interest rate spreads, there was not a huge difference in costs between the two types of debt. Ms. Aylor added the current spread is approximately $95,000 per $100 million of debt. Chairman Brown continued that we are in a period where there is not as large a spread between the two types of debt as might be experienced in a higher interest rate environment. The Committee concluded the 9 (d) issuance approach is supported, but that the 9 (b) recommendation should be kept in the final report as a consideration for future debt issuances as economic conditions begin to shift and interest rates rise.

As staff to the House Appropriations Committee, Mr. Maggio asked if the Committee could further discuss the capacity calculation of $603 million mentioned in the recommendation. Mr. Maggio asked Mr. Jones what factors changed to result in an increase in capacity from $543 million at the interim DCAC meeting in October 2015 to the current recommended capacity of $603 million in December 2015. Mr. Jones commented that while a slight decline in the model interest rate increased the capacity amount slightly, the increase was attributable to the changes to the December revenue forecast. Specifically, Mr. Jones credited the increase in capacity to the General Fund forecast which anticipates greater than $1 billion of additional revenues in outer years of the forecast compared to information available in October.

The Committee then briefly discussed new proposed debt projects and a question was raised about the impact of a decision to exclude a project from proposed debt financing. Mr. Jones explained that the model doesn’t take into consideration the proposed debt when the capacity is calculated. He stated that only debt that has been authorized is included in the calculation.

Mr. Jones then continued his review of the report by discussing the second of the Other Recommendations. He stated this recommendation is the continued support of the use of traditional financing methods such as those offered through the issuance of general obligation bonds, or the use of appropriation-supported programs through the VCBA or the VPBA since bonded capital lease and other conduit borrowings typically result in higher financing costs and are ultimately still viewed as tax-supported debt.

Mr. Jones then stated that since the Committee had already reviewed what constitutes General Fund and Transportation Trust Fund tax-supported debt, he only wanted to mention one item under the Review of Tax-Supported Debt section of the report. Mr. Jones mentioned that currently debt service paid by the Transportation Trust Fund ("TTF") exceeds 5% of TTF revenues. This means that to the extent that the 5% of TTF revenues is exceeded, capacity generated from the General Fund is being utilized. He explained that this does not mean that the General Fund is paying for the TTF's debt service, but it means that capacity derived from the General Fund is being used to keep overall capacity for all tax-supported debt under the 5% target. He stated that most recently the TTF related debt service was approximately 8% of the TTF revenues.

Mr. Jones reviewed the Trends in Tax-Supported Debt section of the report and explained the report data includes pension liabilities and beginning in 2008, it also includes OPEB liabilities. He said there has been steady growth in outstanding tax-supported debt from $6.4 billion in 2006 to $15.5 billion in 2014. He states there was a large spike in 2015 mostly due to a reporting change regarding GASB 68 that impacted the reporting of net pension liabilities. He then proceeded to review the detail of outstanding tax-supported debt's three major categories: GO Bonds; Section 9 (d) debt; and Other Long-Term Obligations, which include pension and OPEB liabilities. The GO debt was said to have had a balance as of June 30, 2015 of $1.61 billion, an increase of $570 million over the ten-year period. This is due in part to a $1 billion 9(b) general obligation bond referendum approved by voters in 2002. Those bonds were issued as needed with the last of the issuances in 2010. Since 2012, the outstanding GO balance was said to have declined 9% or about $170 million.

Mr. Jones then reviewed Section 9 (d) Debt and reminded the Committee that this type of debt includes VPBA, VCBA, CTB, certain obligations of the VPA, bonded capital leases, other long-term capital leases, and installment purchases. He said that the total 9 (d) Debt as of June 30, 2015 was $9.38 billion compared to $3.81 billion at fiscal-year end 2006, which was equivalent to a 146% increase over the ten-year period. He explained the significant increase can be attributed to significant authorizations for transportation bonds in 2007, as well as significant authorizations for VPBA and VCBA bonds in 2008, 2009, 2010, 2013, and 2014. He explained that in 2015 an additional $139 million of VPBA and VCBA bonds were authorized, but that the outstanding balance of Section 9 (d) Debt increased 8% or $687 million between fiscal year 2014 and fiscal year 2015 due to the issuance of bonds authorized in recent years.

Mr. Jones then reviewed Other Long-Term Obligations which have experienced the most growth, increasing $7.24 billion or 478% from $1.52 billion at fiscal year-end 2006 to $8.76 billion at fiscal year-end 2015. He again emphasized that the increase in 2015 was mostly attributed to the reporting change caused by the GASB 68 Rule. The increase over the last fiscal year was specifically related to growth in pension liabilities which increased 108% or $3.45 billion.

Mr. Jones then reviewed the tax-supported debt authorized and issued from years 2006 to 2015. He said, in 2015 the amount of net tax-supported debt authorized was $206 million which was a result of $149 million of collective VPBA and VCBA authorizations, $68 million of 9 (c) authorizations, and a $10 million rescinded authorization of VPBA bonds for a Department of Game and Inland Fisheries project. He continued by stating that between fiscal year 2006 and fiscal year 2015, $13.3 billion of tax-supported debt was collectively authorized. He then reviewed the tax-supported debt issued and mentioned the total amount of tax-supported debt issued in fiscal year 2015 was $1.16 billion. He explained that while a large amount of VCBA bonds were issued in 2015, there were also two large issuances of VPBA bonds, and there were transportation and port related issuances. He stated between fiscal year 2006 and fiscal year 2015 there was $10.4 billion in tax-supported debt that was issued. With the June 30, 2015 authorized and unissued debt amounting to $4.39 billion, of which $3.72 billion is for 9 (d) projects, he explained it is likely that significant issuances will continue over the next several years even if no additional debt is authorized.

Mr. Jones reviewed the uses of outstanding tax-supported debt. He explained that of the total $10.4 billion issued between fiscal year 2006 to fiscal year 2015, 51% was for higher education related projects and equipment. The next highest category was stated to be transportation projects at 21%.

Mr. Jones then reviewed the actual tax-supported debt service over the last 10 years and the projected debt service that includes debt service on the recently authorized but unissued debt. He commented that the analysis assumes the authorized and unissued bonds will be issued at the model interest rate of 4.03%. Mr. Jones continued his review saying that tax-supported debt service is expected to cross the $1 billion mark by fiscal year 2017.

Mr. Jones then proceeded with the Review of State Credit Ratings section of the report. He said the Commonwealth continues to be rated "AAA" with a stable outlook by all three rating agencies. He added that the Commonwealth's appropriation-supported programs are one notch below the general obligation rating and also carry a stable outlook from the three rating agencies. Mr. Jones said that all three rating agencies continue to note Virginia's credit strengths: long-standing history of pro-active and conservative financial management, a manageable debt burden controlled through a debt affordability model, strong financial policies and practices, pension reform and a diverse economy that has fared better than the nation. He then mentioned what the rating agencies site as challenges: spending pressures from education and transportation needs, managing the effects of a sluggish economy, and the state economy's direct linkage to the U.S. Government. He said the ratings agencies have applauded the Commonwealth's prompt actions to address the recent revenue shortfall and have attributed this to Virginia's positive factor of pro-active and conservative financial management. He continued his review by stating that while the rating agencies have viewed the fiscal year 2015 revenue surplus as positive, Standard & Poor's ("S&P"), in its November 2015 VCBA Pooled Program ratings report, still viewed the "Commonwealth's gap-closing measures as predominately one time in nature and therefore a weakness".

Mr. Jones commented that the FY2015 revenue surplus will result in a mandatory replenishment to the Rainy Day Fund in FY2017 and the rating agencies view the replenishment mechanism as a strong feature of the Commonwealth's credit. He stated that while the rating agencies have noted the constitutionally mandated deposit in fiscal year 2017 will significantly increase the Rainy Day Fund balance, they note the depletion in fiscal year 2015 and fiscal year 2016 has weakened the Commonwealth's reserve funds. He concluded his remarks on this section of the report with a quote from a recent S&P ratings report. Chairman Brown commented that the Governor's Introduced Budget should address the structure and reserve level concerns mentioned by S&P.

Ms. Daley asked if a surplus is ever captured in the model to create additional capacity. Mr. Jones replies that a surplus is not directly responsible for an increase in capacity; however, a surplus would likely impact future revenue forecasts and could increase future debt capacity through an increased revenue forecast.

Mr. Powell, as staff to the Senate Finance Committee, asked if the previously authorized capital lease for Virginia Port Authority is included in the model. Ms. Aylor confirmed that the lease is now being included. Ms. Daley asked if the $350 million of proposed VPBA debt for the VPA is included. Ms. Aylor responded that since the debt is proposed and is not yet authorized it is not included in the model.

Mr. Jones then presented the Review of Comparative Ratios section of the report. He stated that recent Moody's reports have noted declining annual growth in states' net tax-supported debt, but that in its *State Debt Medians 2015 Report*, Moody's noted the first decline in total net tax-supported debt since it began compiling this data 28 years ago.

He continued his comments by stating that while Moody's anticipates 2015 may result in an additional decline, their long-term outlook, "expects debt levels to rise again as states seek to address deferred infrastructure needs at a time of stagnant federal transportation aid."

Mr. Jones then reviewed ratios presented in Moody's 2015 report. He stated that the median nationwide net tax-supported debt ("NTSD") per capita declined by 4% to $1,012 compared to $1,054 the prior year, which was the third decline in a row. In the 2015 report, Virginia remained ranked as having the 19th highest debt per capita at a level of $1,356. He stated Virginia's debt per capita increased 4.1% from $1,302 the prior year. Mr. Jones then reviewed the NTSD as a percentage of personal income and stated that it declined from 2.6% the prior year to 2.5% in 2015. However Virginia experienced an increase in its NTSD as a percentage of personal income. In the 2015 report, Virginia's ranking rose to the 21st highest in NTSD as of percentage of personal income compared to a ranking of 24th in the prior year. In 2015 Virginia was calculated by Moody's to have 2.8% of net tax-supported debt as a percent of personal income compared to 2.7% the prior year. Mr. Jones noted that while these rankings are useful for comparison purposes, it is important to note that many other factors contribute to a state's overall credit rating. He also noted that not all states amortize debt the same length of time, which could increase debt ratios for certain states. He mentioned that Delaware's high ranking in the charts is partially attributed to short amortization of their debt. Mr. Tillett asked if Maryland also has a shorter amortization of debt. Ms. Aylor confirmed that Maryland has a 15 year amortization while Delaware has a 10 year amortization. Mr. Jones continued that in terms of total net tax-supported debt, California remains at the top of the list with $93.4 billion outstanding followed by New York with $61.0 billion. Virginia remained twelfth this year with $11.3 billion outstanding compared to $10.8 billion outstanding the prior year.

Mr. Jones asked if members had any questions about the aforementioned items in the report. Upon hearing no further questions on the report, Mr. Jones asked the Committee to refer to the Appendix portion of the report.

Mr. Jones briefly reminded the Committee of the assumptions used in the model. He also mentioned that moral obligation debt issued by Virginia Resources Authority and sum sufficient appropriation secured debt issued by Virginia Public School Authority are not included in the standard model. He explained that only if there was a default that triggered the state to contribute to debt service would either of these types of debt be included. He stated worst case default scenarios on these types of debt are included at the end of the Appendix.

He then directed the Committee's attention to the Currently Authorized Tax-Supported Debt Issuance Assumptions. He noted that since all of the 2002 9 (b) GO authorization has been utilized no more debt 9 (b) debt remains to be issued. He said the 9 (d) appropriation-backed programs have $3.7 billion of authorized but unissued debt. He added that this amount does not include any of the currently proposed debt in the Governor's Introduced Budget.

Mr. Tillett asked Chairman Brown when the Commonwealth last met with the rating agencies. Chairman Brown said conversations where held with the rating agencies in the fall of 2015. He added the Governor, Chairmen of the Money Committees and he went to visit the rating agencies in January 2015. Chairman Brown said there is a tentative plan to have the rating agencies come to Virginia sometime in 2016.

Mr. Jones then directed the Committee's attention to the Base Model Solution on page A-5 of the report. Mr. Jones explained that revenue improvements and the improved future revenue outlook have caused capacity to increase to $603 million from the estimate of $543 million in October and $459 million recommended last December. He further commented that as with recent calculations, the capacity is being derived from significant capacity in the middle to later portions of the model. Mr. Maggio asked what resulted in the change to future debt service between the October and December models. It was discussed that the interest rate assumptions declined slightly, but overall future debt service is higher in the December model due to the current model's inclusion of the authorized, but not yet executed capital lease for the VPA. Chairman Brown briefly reviewed the purpose and status of the VPA lease.

Mr. Jones then reviewed the Base Model Average Solution on page A-6 of the report. He explained this solution shows the modeled impact if the average capacity is authorized and issued in each of the model years. He explained the 5% target would be exceeded in 5 of 10 years. He stated in recent past reports the target under this model solution was exceeded in 6 of the 10 years.

Mr. Jones then directed the Committee's attention to the table of revenue data used in the model. He asked if there were any questions about the revenue data on page A-9, but there were no questions.

Mr. Jones then reviewed the Sensitivity Analysis on page A-10 of the report. He said the Revenue Sensitivity and the Interest Rate Sensitivity sections would likely be of the most interest to the

Committee. He explained that if the model is altered to assume a change in revenues of $100 million in each and every year the incremental change in capacity is $5.76 million. He then explained that if a 1% changed in revenues is assumed in each and every year the incremental change in capacity would be $16.62 million. He concluded his review of the Sensitivity Analysis by explaining that if 100 basis points were added to the model interest rate then capacity would decline approximately $60 million annually to $543.27 million.

Mr. Jones then transitioned to review the moral obligation and contingent liability section of the Appendix. He began by quickly reviewing a chart showing all debt of the Commonwealth. He reminded the Committee that VRA, VHDA and VPSA are all allowed by statute to issue moral obligation bonds, but that VRA is currently the only moral obligation debt issuer. He stated that as of June 30, 2015, VRA had approximately $878 million of moral obligation debt outstanding. He explained that if the model is altered to include the conversion of all VRA moral obligation debt to tax-supported debt that the capacity would decline to $530.31 million.

Mr. Jones then explained that the VPSA is the only issuer of non-tax-supported debt that utilizes a sum sufficient appropriation as an additional credit enhancement. He stated that the sum sufficient appropriation represents a contingent liability for the Commonwealth. Mr. Jones stated that if the model is altered to assume the conversion of the VPSA's total outstanding debt secured by a sum sufficient appropriation, $3.117 billion as June 30, 2015, the resulting average debt capacity would decline to $343.71 million.

Mr. Jones asked if there were any questions on the Report of the Appendix. Hearing none, he turned the meeting back to Chairman Brown.

Motion to Adopt Final Report and Recommendation of Debt Capacity

Chairman Brown then asked for a motion to adopt the final report and cover letter that is to include a recommendation that $603 million can be prudently authorized in 2016 and 2017. Mr. Vaughn made the motion, which was seconded by Mr. Timberlake. The Committee voted unanimously to approve the motion.

Motion to Approve Resolution of Recognition and Appreciation for Mr. William K. Butler

Chairman Brown directed the Committee to the proposed Resolution (Exhibit 2) for Mr. William K. Butler to recognize his many years of service to the Committee. He asked Mr. Jones to read the Resolution. Chairman Brown then asked for a motion to pass the Resolution. Mr. Tillett made the motion, which was seconded simultaneously by Mr. Vaughn and Mr. Von Moll. The Committee voted unanimously to approve the motion.

With no further business, the meeting adjourned at 1:55 p.m.

Exhibits may be obtained by contacting the Department of Treasury at (804) 225-2142.