SENATE GOVERNANCE & FINANCE COMMITTEE

SENATE NATURAL RESOURCES & WATER COMMITTEE

Overview of California's Debt Condition: Priming the Pump for a Water Bond

Committee Background

This paper provides background information for members of the Senate Committees on Governance and Finance and Natural Resources and Water for its joint hearing on February 26, 2013, "Overview of California's Debt Condition: Priming the Pump for a Water Bond." The hearing is intended to inform members about the state's debt condition, its capacity to incur additional debt for water and other competing infrastructure needs, and issues regarding using debt finance to improve the state's water quality, supply, and infrastructure.

Debt overview

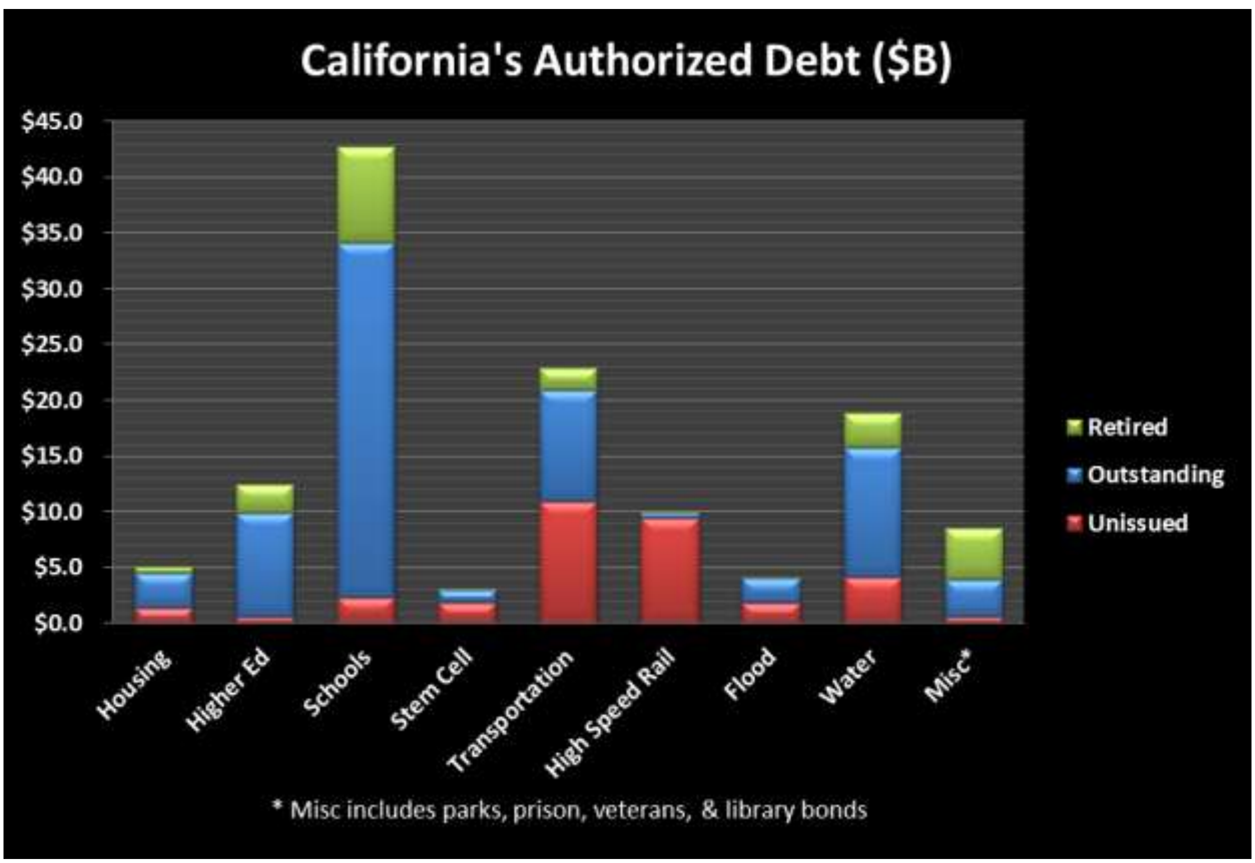
When public agencies issue bonds, they essentially borrow money from investors, who provide cash in exchange for the agencies' commitment to repay the principal amount of the bond plus interest in the future according to schedule. Bonds are usually either revenue bonds, which repay investors out of revenue generated from the project the agency buys with bond proceeds, like a parking garage, or general-obligation bonds, which the state pays out of general revenues and is guaranteed by its full faith and credit.

California relies on the California Constitution and the state's General Obligation Bond Law to issue general obligation debt. The Constitution allows the Legislature to place general obligation bonds on the ballot for specific purposes with a two-thirds vote of the Assembly and Senate, as it did with the Safe, Clean, and Reliable Drinking Water Supply Act (SBx7 2, Cogdill, 2010). Voters can also place bonds on the ballot by initiative, as they have for parks, water projects, high-speed rail, and stem cell research, among others in recent years. Either way, general obligation bonds must be ratified by majority vote of the state's electorate.

Unlike local general obligation bonds, enacting a state general obligation bond doesn't trigger an increased tax or other revenue stream to repay the bonds. Once sold, Article XVI of the California Constitution commits the state to repay investors from general revenues above all other claims except payments to public education.

Where are we?

California has authorized $135.4 billion in general obligation and revenue bond debt, of which almost $35 billion has been redeemed, nearly $80 billion to be repaid in the future, and approximately $33 billion that the Treasurer has not yet sold as detailed below. The Governor's proposed 2013-14 Budget points out that voters have authorized $100 billion in new, general obligation bonds since 2000, and the state has issued more than $28 billion since 2009. According to the Treasurer's *Debt Affordability Report* and the Budget, the State plans to sell between $5.2 and $5.7 billion in 2012-13, and $7.5 and $7.8 billion in 2013-14.



In the *Debt Affordability Report*, the Treasurer measures the state's debt burden relative to is general fund revenue, personal income, and per capita. In the Report, the Treasurer projects that the state will spend 8.9% of general fund revenue on debt service in 2012-13 ($8.6 billion of debt service versus $95.9 billion in revenue). Figure 11 of that Report measures the other ratios against similar States, and includes each state's debt rating.

FIGURE 11

DEBT RATIOS OF 10 MOST POPULOUS STATES, RANKED BY RATIO OF DEBT TO PERSONAL INCOME

STATE	MOODY'S/ S&P/ FITCH(a)	DEBT TO PERSONAL INCOME(b)	DEBT PER CAPITA(b)	DEBT AS A % OF STATE GDP(b)(c)
Texas	Aaa/AA+/AAA	1.5%	$588	1.25%
Michigan	Aa2/AA-/AA-	2.2%	$785	2.02%
North Carolina	Aaa/AAA/AAA	2.3%	$815	1.85%
Pennsylvania	Aa2/AA/AA+	2.8%	$1,134	2.54%
Ohio	Aa1/AA+/AA+	2.8%	$1,012	2.45%
Florida	Aa1/AAA/AAA	3.0%	$1,167	2.97%
Georgia	Aaa/AAA/AAA	3.1%	$1,099	2.68%
Illinois	A2/A/A	6.0%	$2,564	5.06%
California	A1/A-/A-	6.0%	$2,559	5.07%
New York	Aa2/AA/AA	6.6%	$3,208	5.38%
MOODY'S MEDIAN ALL STATES		2.8%	$1,117	2.40%
MEDIAN FOR THE 10 MOST POPULOUS STATES		2.9%	$1,117	2.61%

(a) Moody's, Standard & Poor's, and Fitch Ratings as of September 2012.

(b) Figures as reported by Moody's in its 2012 State Debt Medians Report released May 2012. As of calendar year end 2011.

(c) State GDP numbers have a one-year lag.

As the *Debt Affordability Report* notes, California is one of the largest issuers in the market. The interest rates California pays are affected by the state's economic and fiscal health, general market interest rates, amount of supply from other issuers, investor perception of the state's credit, investor demand, and the performance of alternative investments. The report notes that the state continues to face financial challenges caused by the 2007-09 recession and slow recovery, but a second straight on-time State Budget helps its credit. Additionally, voter enactment of Proposition 30 in November, 2012 will result in additional revenues that reduce the difference between state revenues and expenditures, thereby decreasing risk and enhancing the state's credit quality.

The market for municipal bonds, including state General Obligation bonds, has regained strength after several setbacks in the years following the financial crisis, including concerns over issuer credit quality, including potential and actual municipal bankruptcies, the collapse of the auction rate security and variable rate debt obligation markets, and difficulties obtaining bond insurance and credit enhancement at reasonable prices. However, interest rates fell last year due to reduced issuance, and a “flight to quality” resulting from continued economic weakness and concerns over the quality of European sovereign debt. One of the world’s largest asset management firms, BlackRock, recently wrote that the municipal bond market was off to a strong start in 2013 due to larger than anticipated demand and improved fiscal conditions in states.

How do investors view California bonds?

Investors ultimately determine a state’s creditworthiness and the interest rate paid on a bond when they bid to purchase a state bond. However, ratings issued from the three major ratings agencies often inform investors regarding the investment risk they take when purchasing a California general obligation bond. These ratings change over time in response to a state’s fiscal situation and economy, among other factors.

California’s bond rating has lagged behind other states’ ratings in recent years, and was until recently at or near the bottom. On January 31, 2013, Standard and Poor’s Ratings Services raised California’s rating from A- to A its long-term ratings and underlying ratings on California’s $73.1 billion in general obligation bonds and $1.9 billion in Proposition 1A bonds, with a stable outlook. The upgrade was the first from any of the three major ratings agencies since 2006. In its report, Standard and Poor’s stated:

> “The upgrades reflect our view of California's improved fiscal condition and cash position, and the state's projections of a structurally balanced budget through at least the next several years. As part of Governor Jerry Brown's recent budget proposal and multiple-year plan, the state would also largely retire its backlog of payment deferrals and internal loans. We view the alignment between revenues and expenditures as much improved and largely a result of policymakers' heightened emphasis on fixing the state's fiscal structure in the past two budgets. This has primarily consisted of programmatic reductions and reforms designed to generate budget savings because, until recently, strongly rebounding tax collections have not accompanied the economic recovery. Now the economic expansion is gaining positive momentum, however. In addition, the voters' approval in November of temporarily higher statewide sales and personal income tax (PIT) rates positions the state to capitalize on burgeoning economic activity and income gains. We believe these factors have worked in concert to help the state reverse fiscal course. As recently as 2011, the state's four year general fund forecast anticipated annual deficits ranging from $17.4 billion to almost $27 billion. Now the Department of Finance (DOF) projects small surpluses through at least fiscal 2017. The projected surpluses would be larger except that, under the governor's proposal, much of the new revenue is dedicated to debt retirement.”

Despite Standard and Poor’s upgrade, the state’s rating is still below most other comparable states as the Treasurer’s Figure 11 shows. On February 4, 2013, Moody’s Investor Service declined to upgrade its rating of California debt, according to news reports, citing the state's improvement but offset by its "boom and bust revenue and economic cycles."

Bond ratings are one way of measuring the quality of a state's debt, but another is the market price of a bond, measured by its yield. A "yield spread" is a relative measurement equal to the difference in the quoted rates of return of two different bonds: a "tighter" spread indicates that the market's assessment of the risk associated with each is similar, whereas a "wider" spread means that the market believes that more risk is associated with one bond than the other. Yield spreads are usually expressed in basis points (one basis point is one one-hundredth of one percent), and often use a benchmark such as U.S. Treasury notes for comparison.

California bonds have traded better since the S&P upgrade. According to Reuters, prior to the S&P upgrade, California had the third widest 1-year yield spread relative to top-rated debt after Puerto Rico and Illinois, monitored by Municipal Market Data. After the upgrade, California had the ninth-highest spread.

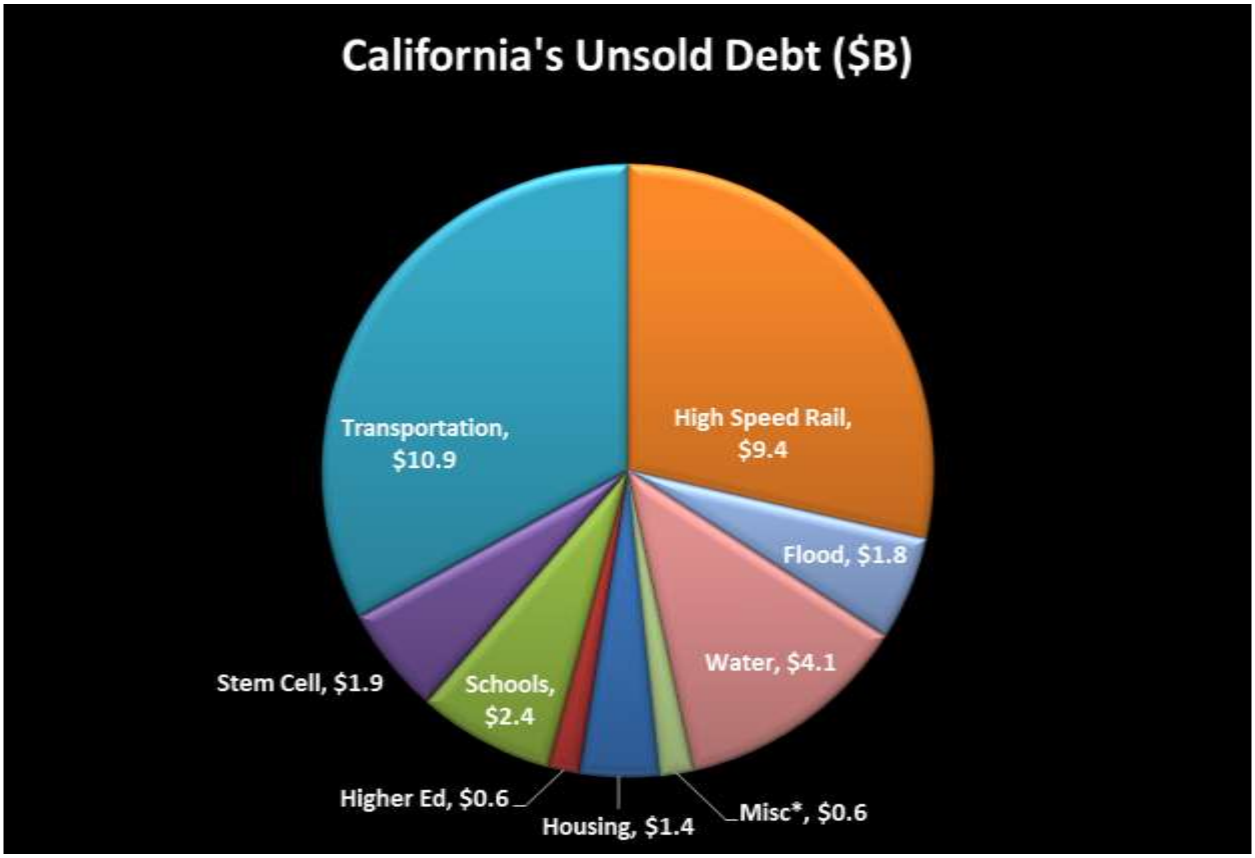
Key Questions:

- How does California's debt condition affect its creditworthiness and its interest rates?
- How would additional debt affect California's credit worthiness?
- Is there a prudent upper limit to the amount of debt? If so, what is it?
- If the state doesn't authorize additional debt, when would California's debt burden reach the current national average?

What does it mean for a bond to be authorized, but unsold?

State law allows the Treasurer to set the times and the amounts of general obligation bond sales. While the state has authorized $33 billion of bonds that have not yet been sold, the Treasurer must make tradeoffs whenever executing a bond sale. Selling too much debt at one sale would lead to investors demanding higher than desirable interest rates as supply would likely exceed demand, requiring debt service payments exceeding those that would have resulted from spreading bond sales over time. However, projects authorized in bond acts to receive proceeds must wait for the Treasurer to sell bonds.

California's $33 billion of unsold bonds are dedicated to a variety of purposes, authorized by several past Bond Acts.

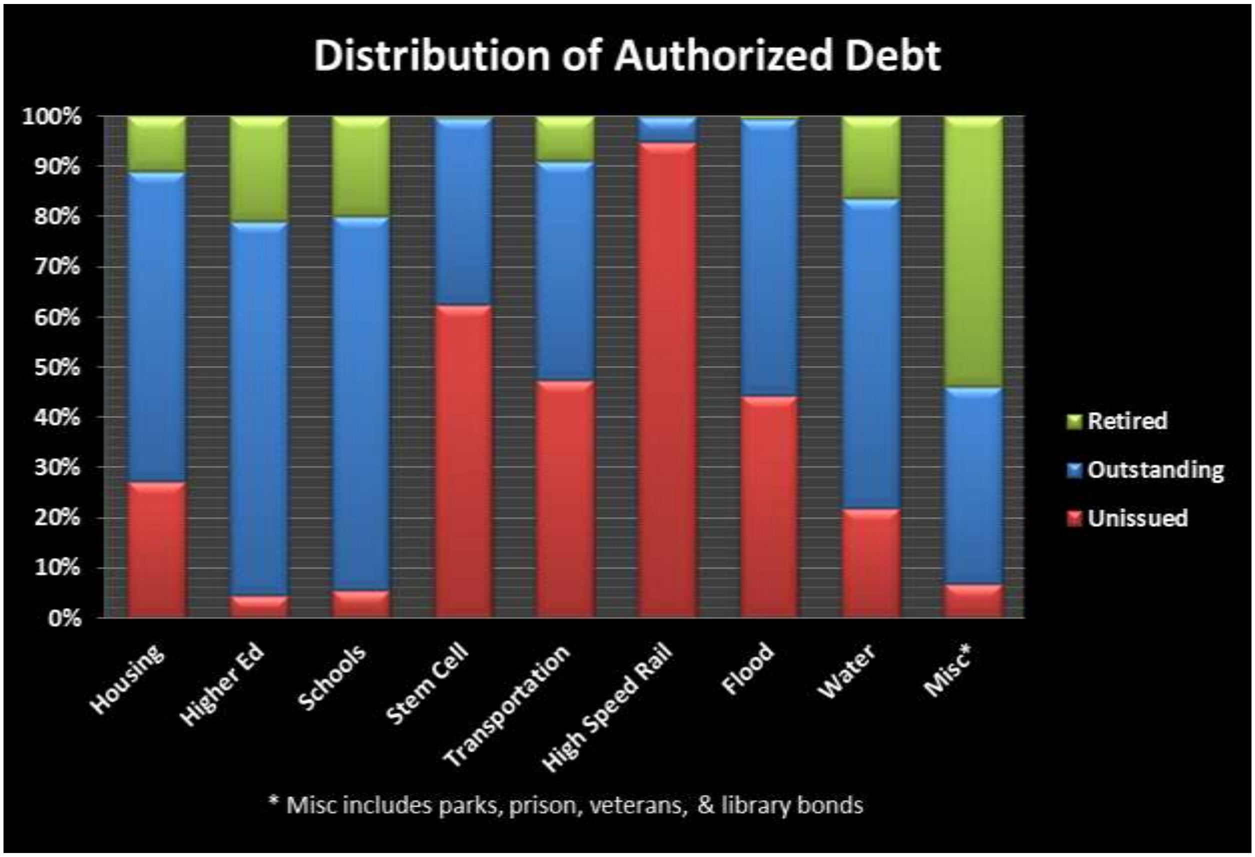


<u>Key Questions</u>:

- Is the 26% ($33 B) in unsold bonds considered large relative to historical patterns and other states?
- Does this amount affect California's credit worthiness? How?
- How would additional authorized, unsold bonds, on top of the $33 M, affect California's credit worthiness?
- Is there a prudent upper limit to the amount of authorized, unsold bonds? If so, how large is it?

Which programs have been bond funded?

The *Debt Affordability Report* lists 63 separate bonds that have been authorized over the past 40 years. These bonds have, and in many cases continue to fund a wide variety of programs. Some programs, such as earthquake, libraries, and veterans bonds, have received sporadic bond authorizations at best. However, programs like schools, higher educations, natural resources, and water programs have all benefited from fairly frequent infusions of bond funds.



Some bond programs, such as high speed rail and stem cell research, have a significant portion of their bond authorization as unissued. In contrast, higher education and school bond funded programs have only about five percent of their authorized bonds still unissued.

<u>Key Questions</u>:

- Presuming most programs require periodic authorization of bonds, is it reasonable to conclude that the lower the level of unsold bonds, the greater the urgency to authorize additional bonds, and vice versa?
- What conclusion, if any, can be drawn by the level of unsold bonds for water and flood management?

What water projects have bonds funded?

Over the years, the types of programs and projects funded by water bonds have changed significantly. In the 1970s and 80s, resources bond authorizations tended to be relatively small and narrowly focused. Bond authorizations ranged from $60M to $375M and averaged just under $200 M. The authorizations also tended to be for a specific purpose; e.g., just drinking water quality improvement projects, just capital improvement projects to achieve federal Clean Water Act objectives; or just state and local parks acquisitions and development. Furthermore, the bonds generally left specific project funding decisions to the discretion of the funding agency.

The 1990s saw only one authorized resources bond, the Safe, Clean, Reliable Water Supply Act, also known as Proposition 204. This bond was a distinct departure from previous bonds. It was comparatively large, just under $1B. Instead of being narrowly focused, it funded various programs and projects in three major areas: Restore and improve the Bay-Delta; wastewater treatment and water supply and conservation; and local flood control and prevention. Moreover, instead of having one or two broad categories of funding within each program area, Proposition 204 included numerous discrete funding categories and explicit project authorizations. Perhaps most important, Proposition 204 marked the beginning of the trend towards bond funding for not just capitol project, but program expenditures as well.

Resources bonds authorized by the voters in the 2000s continued the trend towards larger authorizations and broader bond programs; e.g., watershed restoration programs, levee construction and maintenance, water conservation programs, groundwater cleanup projects, integrated regional water management projects, Delta restoration and planning, etc. Two of the three bonds authorized in the 2000s were put on the ballot via the initiative process, Propositions 50 and 84. These bonds largely discontinued the practice of naming specific projects. Instead, they designated regional funding pots, with projects and programs selected on a competitive basis with funding criteria established in the bond.

In 2009, as a part of a larger package of water related bills, the legislature passed and the governor signed SBx7 2(Cogdill). That bill authorized the placement of an $11.14B general obligation bond for water related programs and projects on the November 2010 ballot. The original authorization has been amended three times, correcting drafting errors and ultimately delaying the bond to the November 2014 general election. As the bond currently stands, it would authorize funding for seven categories of funding:

- Drought Relief – including drinking water programs for disadvantaged communities.
- Water Supply Reliability – including integrated regional water management projects.
- Delta Sustainability – including projects to protect and enhance a sustainable ecosystem.
- Statewide Water System Operational Improvements – including surface storage projects.
- Conservation and Watershed Protection – including ecosystem and watershed restoration.

- Groundwater Protection and Water Quality – including groundwater cleanup projects
- Water Recycling Program – including pilot projects for new technology.

<u>Key Questions</u>:

- Are some uses of bonds more appropriate than others? Such as?

- What other options besides General Obligation bonds should the Legislature consider for financing important water programs and projects?

What are "good" bond financing principles?

On March 1, 2006, the Senate Committee on Natural Resources and Water, in its *Report to the Conference Committee on Infrastructure Bonds: Recommendations For The Proposed Infrastructure Bonds*, described a set of bond financing principles to guide its recommendation to the Conference Committee:

*Bond Financing Principles**

In order to determine how to use bond financing to meet statewide goals, it is important to set forth some fundamental principles. The Committee based its recommendations for the flood, water, and natural resources infrastructure bonds on the following principles:

1. <u>State Funds For State Responsibilities</u>. The State has specific responsibilities regarding floods, water, and natural resources, which include:

   - *Enhancement of Public Trust Resources*. Enhancement denotes actions beyond those required under existing regulatory requirements. This responsibility almost always requires the use of bond funds.

   - *Public Health & Safety*. The Legislature has delegated this responsibility to cities, counties, and special districts. However, if a local government fails to meet this responsibility, it is the duty of the state to step in and correct the problem. Sometimes, but not always, this requires the use of bond funds.

   - *Establish State Resources Goals & Remove Impediments To Achieving Those Goals*. The Legislature sets resources goals and policies by enacting statutes and creating new programs. There may, however, be impediments to achieving the goals, such as lack of experience in working towards that goal, institutional conflicts, or fear of liability. Sometimes, but not always, bond funds may be used to aid in planning or first steps to help remove those impediments.

- *Establish & Enforce Rules of Behavior*. While actually establishing and enforcing the rules of behavior rarely requires the use of bond funds, occasionally bond funds are necessary to fund research or the completion of products necessary to support the establishment or enforcement of rules of behavior.

2. Subsidies Should Be Avoided. Providing state funds for things that are not a state responsibility should be characterized as a subsidy, and should be avoided. Two key reasons for avoiding subsidies are:

    - *Subsidies Mask Economic Price Signals*. Economists would argue this leads to less than optimal resource allocation.

    - *Subsidies Violate The Beneficiary Pays Principle.* If the state is not the responsible financial party, then someone else will be.

3. Bonds Should Aid in the Implementation of Policy, Not Create Policy. Bond acts authorize the issuance of public debt to further public policy. There are many reasons why it is best to avoid setting public policy in the bond acts themselves.

    - *Water Resources Policy Is Constantly Evolving.* Policy set in a bond is often too static. This is evidenced by the large amount of "orphan" bond funds; i.e., bond funds that were authorized but unused 10 or more years after authorization.

    - "*Solutions" To Problems Are Changing.* There is a new awareness that traditional solutions to flood risk and local and regional water problems may no longer be appropriate. Resolving these problems will require research and extensive policy debate on the outcomes of that research. Bonds should be designed to allow flexibility to reflect new and better solutions.

    - *Bonds Should Be Flexible To Evolving Policy*. The legislative process is the appropriate way to change policies. To the extent possible, bonds should be drafted to allow policies to evolve and still provide the necessary funds.

4. Respect Separation Of Powers And The System Of Checks And Balances. Bond acts should not be used to circumvent the constitutionally established roles of the legislative and executive branches.

    - *The Legislative Branch's Power To Allocate Funds.* One of the fundamental checks on the executive branch is the budget process. In that process, the role of the Governor is to develop and propose a budget; the role of the Legislature is to review the proposed budget, amend where necessary, and to appropriate the funds to implement the budget. Bond funded programs that are funded by continuous appropriations bypass the formal budget process with its inherent checks and balances system. Consequently, continuously appropriated bond programs should be avoided.

- *Oversight and Transparency.* Another of the fundamental checks on the executive brand is the Legislature's oversight. The Legislature's ability to perform this function is greatly aided by requiring programs to be developed and implemented through open and transparent processes.

The Committee on Natural Resources and Water has endeavored to ensure that its recommendations conform to the bond financing principles set forth above.

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* Excerpt from: Senate Committee on Natural Resources and Water, Report to the Conference Committee on Infrastructure Bonds: Recommendations For The Proposed Infrastructure Bonds, March 1, 2006

Key Questions:

- Are those reasonable principles for the current or a future water bond?

- What changes, additions, or deletions should be made?