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January 12, 2005

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: January 2005 Special Session Assembly Bill 1/Senate Bill 1: Authorization of Additional Refunding Bonds

January 2005 Special Session Assembly Bill 1/Senate Bill 1 are companion bills that would refinance state general obligation debt.

BACKGROUND

Generally, debt is refinanced in either an economic refunding or a structural refunding, or a combination of those methods.

Economic Refunding. In an economic refunding, the new stream of debt service payments is designed to reduce the total cost of the outstanding debt and is typically undertaken to take advantage of reduced interest rates. No increase in debt service payments occurs in any year due to an economic refunding and debt service payments are reduced in some or all years during the life of the refunding issue. The transaction can be structured so that the debt service savings are realized equally in each year during the life of the refunding bonds or concentrated in the early or late years of the transaction.

Approximately $2.8 billion in bonding has been authorized to carry out bond refunding transactions that provide true interest cost savings to the state relating to tax supported and self-amortizing programs. In July, 2004, the state issued the final $117.2 million of this bonding authority, which will generate approximately $3.4 million in interest savings to the state.

Structural Refunding. In a structural refunding, the new stream of debt service payments can be higher or lower in a given year than under the current stream of payments. For example, the debt service payments in the early years of the refunding could be reduced while debt service payments are increased in future years. A structural refunding tends to increase the average life of debt. Bonds are outstanding longer and therefore, the interest costs tend to be greater.

Under 2003 Act 129, $175 million in refunding bonding authority was authorized to carry out a structural refunding of principal payments on the state's debt, which were due in 2003-04. The $175 million in bonds were issued on May 26, 2004. As a result, the state's GPR sum sufficient debt service appropriations expended $175 million less than previously estimated in 2003-04. From the $175 million in GPR funds made available from this refunding in 2003-04, $123.5 million was transferred to the medical assistance trust fund. In addition, the private bar reimbursement appropriation under the Office of the State Public Defender was increased by $4,050,000 in 2003-04 and $5,163,500 in 2004-05 and $1,000,000 in 2003-04 was provided to the District Attorney's general program operations appropriation.

SUMMARY OF THE BILLS

The bills would increase the bonding authorization for refunding of tax supported and self-amortizing general obligation debt by $360 million, from its current level of $440 million to $800 million.

FISCAL EFFECT

The Department of Administration (DOA) Capital Finance indicates that the additional $360 million is needed to replenish the refunding authority that was used in calendar year 2004, when the state refinanced $440 million in general obligation debt to take advantage of lower interest rates.

Because future interest rates and the specific bonds that could be refinanced are unknown at this time, the final amount and timing of any savings to the state associated with this refunding bond authority is unknown. However, DOA Capital Finance officials indicate that current market conditions would allow the state to realize interest savings of up to $11 million, if $360 million in bonds were refinanced. The GPR portion of these debt service savings would be an estimated 80% of this amount, or $8.8 million. DOA Capital Finance officials also indicate that the refinancing would likely be structured to allow the state to realize all the interest savings in the next biennium, which would make the $8.8 million in GPR funds available during the 2005-07 biennial budget deliberations. Based on the potential repayment structure of the refunding bonds, most of the $8.8 million would be available in 2006-07.

Under the bills, bonds could only be issued using this refunding authority if the debt refinancing meets the current law requirement that the true interest costs to the state must be reduced. This true interest savings requirement would certainly be satisfied by an economic refunding, but could also be met even if the bonding authority provided under the bills would be used to restructure the state's debt by delaying a May, 2005, or other future, principal payment due on outstanding state debt similar to the structural refinancing carried out under Act 129. However, DOA Capital Finance officials indicate that from a debt management perspective, this refunding bonding authority would only be used to carry out an economic refunding. In addition, the Building Commission would have to approve the issuance of these proposed bonds, and would have the opportunity to determine whether any significant structural refinancing is involved.

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