State Bonding Overview

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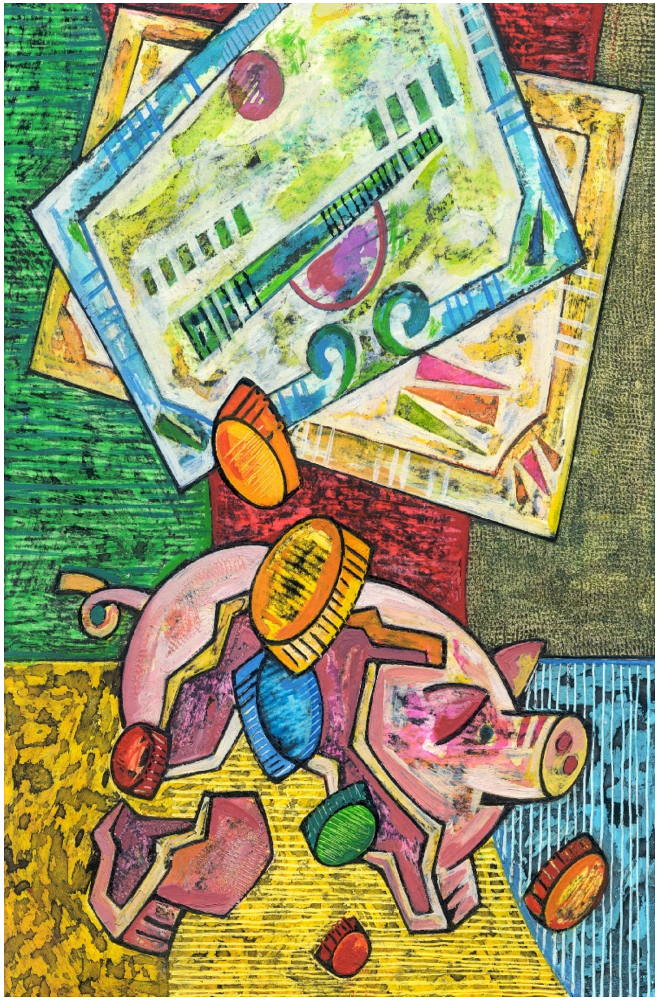
What is a bond issue?

- Bond issuance is the process of borrowing money from investors
- A bond is a financial instrument whereby the borrower has a legal obligation to repay investors who loaned money to the borrower
- Bonds have debt service schedules for payment of principal and interest, just like home mortgages and car loans



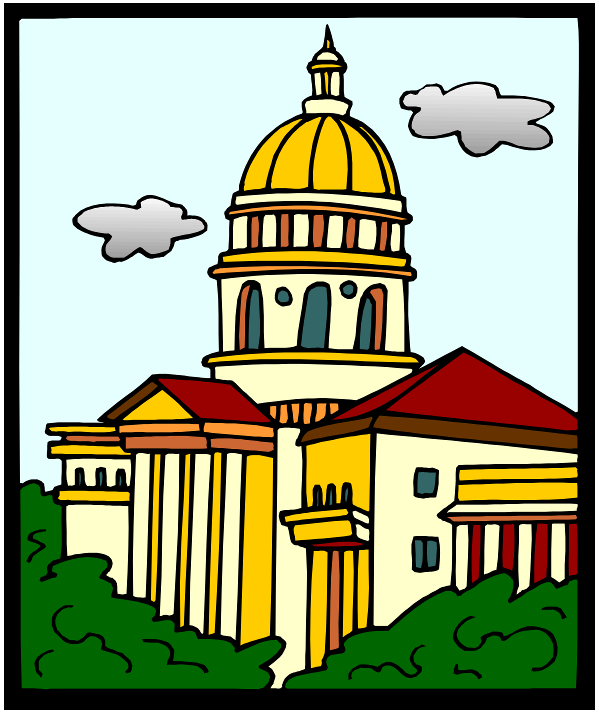
Why does the State issue bonds?

- Bonds are the main source of funding for the State's long-term infrastructure and capital needs
- Interest on Oregon's bonds that are issued for "governmental purpose" projects are exempt from both federal and state taxation
  - Investors are willing to accept a *significantly* lower interest rate due to the double tax-exemption available on our bonds
  - Pension Obligation Bonds issued by both the State and Oregon local governments are not considered "governmental purpose" under federal tax law, and therefore must be issued on a higher interest cost, federally "taxable" basis

What types of projects are financed with State bonds?

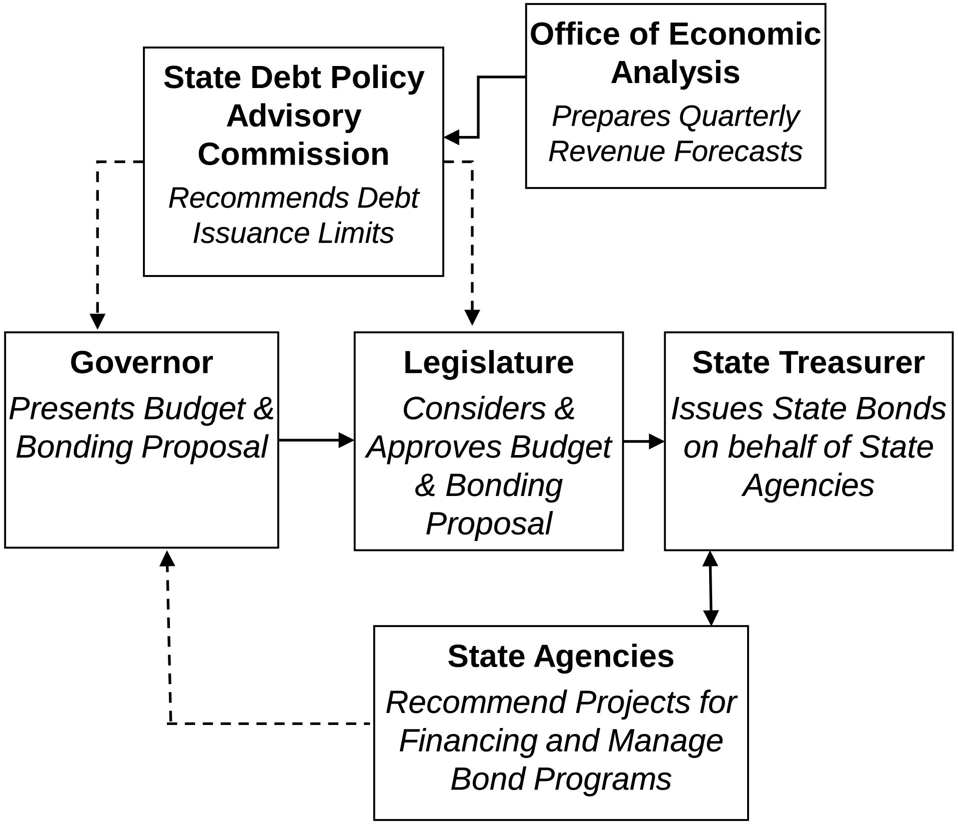
- Examples of state infrastructure financed with bonds and repaid with General Fund, Lottery Revenue, or Transportation Revenue funds include:
  - State office buildings and institutional facilities
  - State highway, bridge, and multimodal network upgrades, expansions, and repairs
  - Public university and community college facilities

- The State also issues debt repaid with either General Fund or Lottery revenues to support a wide variety of local needs including:
  - Economic and rural development
  - Transit projects
  - Water/wastewater upgrade and expansion projects
  - Repair and upgrade of K-12 public schools, public safety facilities, and county courthouses
  - Low-income multifamily housing



State of Oregon's bond authorization and issuance process

- Oregon has disciplined debt management policies and procedures
- State Debt Policy Advisory Commission (SDPAC) is composed of five members, including the State Treasurer, 2 legislators, the DAS Director, and a public member
  - Annually review state debt capacity and recommend prudent new debt issuance levels
- Governor presents bonding recommendations as part of proposed State capital construction budget
- Biennial budget process requires legislative authorization for all new bond issuances during a biennium ("bond bill")
- State Treasurer's office provides central debt management oversight and is issuer of all State bonds
- State agencies manage funds related to various bond programs



Legal authority for State general obligation bond programs

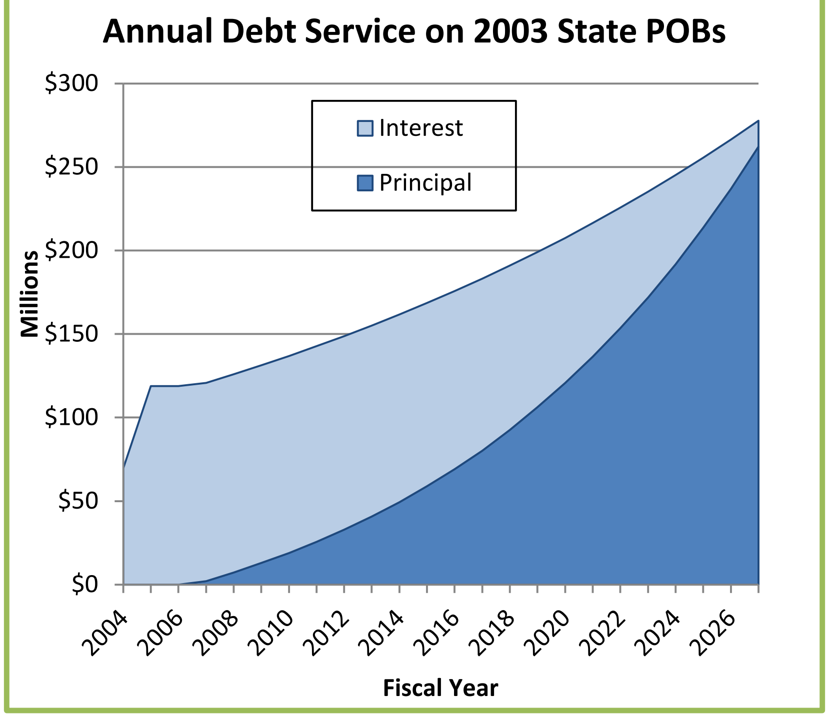
- The Oregon Constitution provides authority for the State to issue general obligation ("GO") bonds for specific purposes and programs
  - Separate GO bond programs are created by Constitutional amendments approved by Oregon's voters
  - GO Bonds have the best credit rating among state bonding programs and the lowest interest cost, as they include our unconditional pledge to repay investors from any legally available revenue
- State GO Constitutional debt limits are linked to the real market value (RMV) of property in the state
  - e.g., Higher Education (XI-G) Bonds have a debt limit of 0.75% RMV = $ 3.79 billion
  - As of June 30, 2016, $695 million in XI-G GO debt outstanding
  - There are numerous other GO bond authorizations, each with its own sizable debt limit
- At the State level, Pension Obligation Bonds (POBs) are authorized to be sold as GO Bonds
  - The debt limit for the Pension Obligation Bonds is 1% of RMV, or $5.0 billion, of which $1.76 billion was outstanding at the end of fiscal year 2016

State Debt Capacity Considerations

- The State Debt Capacity Advisory Commission (SDPAC) has established overall guidelines for prudent borrowing levels that have helped us maintain strong credit ratings over the years
- SDPAC's General Fund debt capacity approach is based on the following target:
    - Annual General Fund debt service as % of General Fund Revenues should not exceed 5%
  - Based on this debt capacity target, the State can borrow up to **$1.15 billion** in each of the next four biennium in General Fund supported debt
  - The Governor's Recommended 2017-19 Budget includes recommendation for General Fund supported bonding of **$969 million** in high priority capital projects throughout the state
- Many state GO bond programs are self-supporting loan programs that do not rely on general fund appropriations for repayment of debt service. These programs are not subject to this debt capacity limitation
- As of June 30, 2016, the State had $5.6 billion in GO bonds outstanding with approximately $1.7 billion related to outstanding Pension Obligation Bonds.

Background on the State's 2003 POB sale

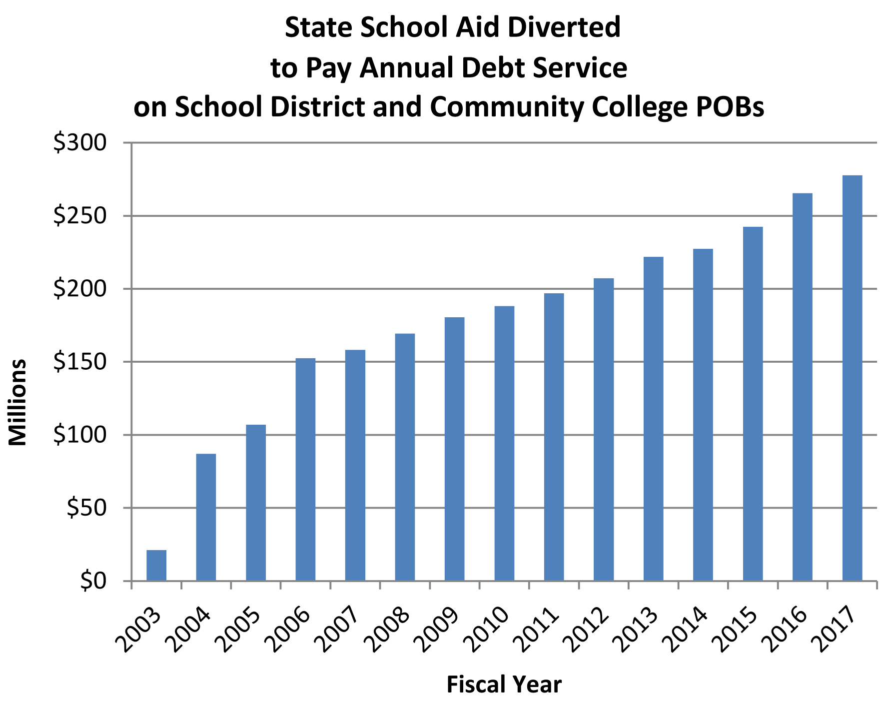
- Following voter approval to sell POBs as a General Obligation Bond, the State issued $2.08 billion in federally taxable POBs in October 2003 at an all-in interest cost of roughly 5.75% which was 2.25% below the assumed actuarial PERS rate at that time
- The bond proceeds were placed in a PERS side account and have been used to offset a portion of the State's annual UAL employer costs
- The bonds were structured to be repaid over 25 years, but with minimal principal retired for the first several years
  - While this approach provided the State with temporary budget relief during the height of the 2001-03 recession, delaying principal repayment increased overall interest costs and resulted in the retirement of only 15% of the original bond issue after 13 years



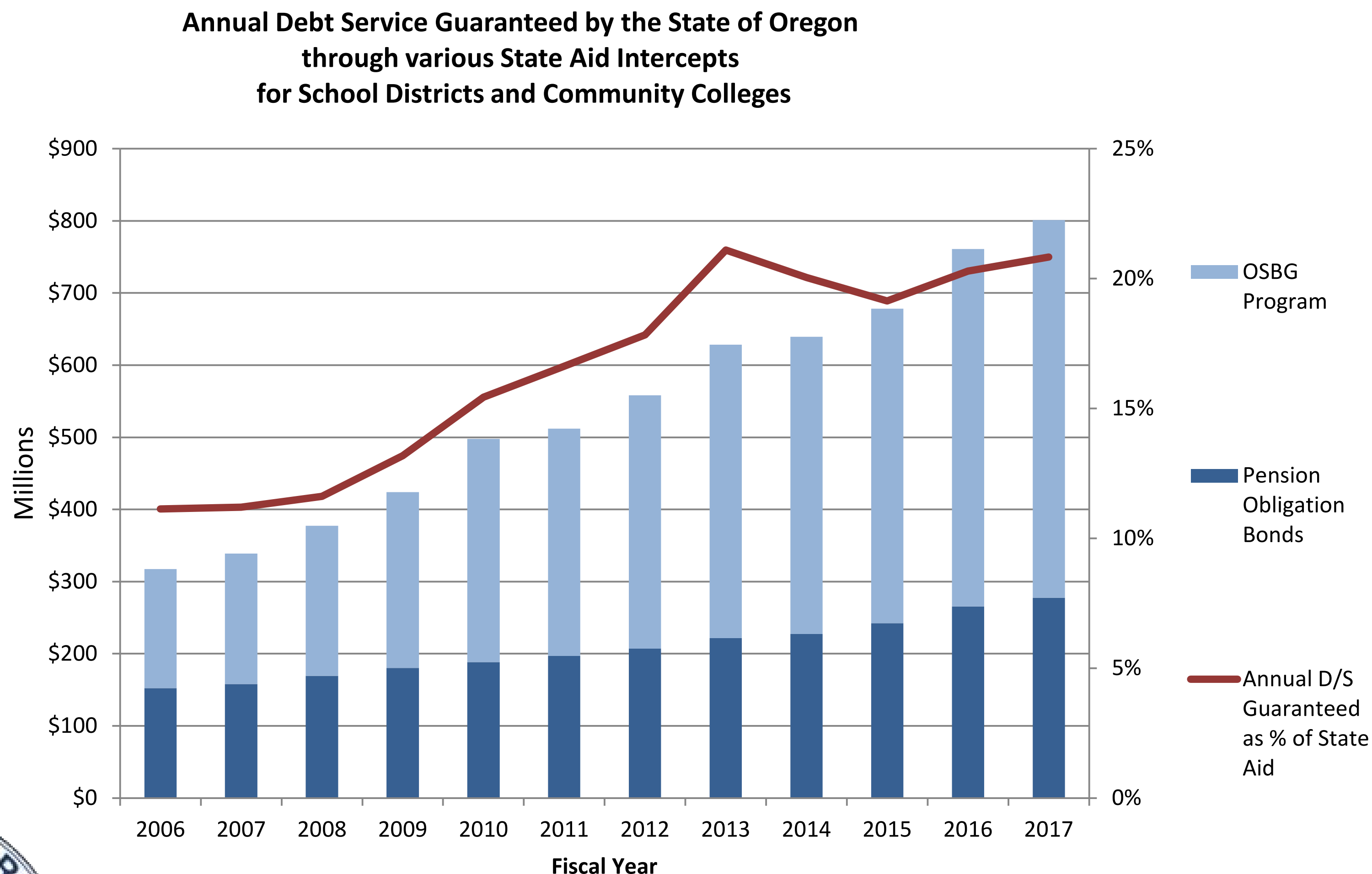
Given this debt service structure, the 2003 State POBs continue to absorb significant state debt capacity that might otherwise be available to fund critical capital projects and infrastructure around the state

Additional state resources dedicated to repayment of Public School and Community College District POBs

- 2001 Legislative Assembly authorized the State Department of Education to enter in to Fund Diversion Agreements with School and Community College Districts to pay debt service on their POBs
  - These fund diversion agreements allowed the local POBs to achieve ratings equal to the State's credit rating , lowering their borrowing costs substantially
  - Since 2002, some $3.16 billion in POBs have been sold with this state guaranty
- As with the State POBs, these local POBs were sold with upward sloping amortization of principal
  - In FY 2017, approximately 7.2% or $278 million in State School Aid is being diverted to pay debt service on these POBS

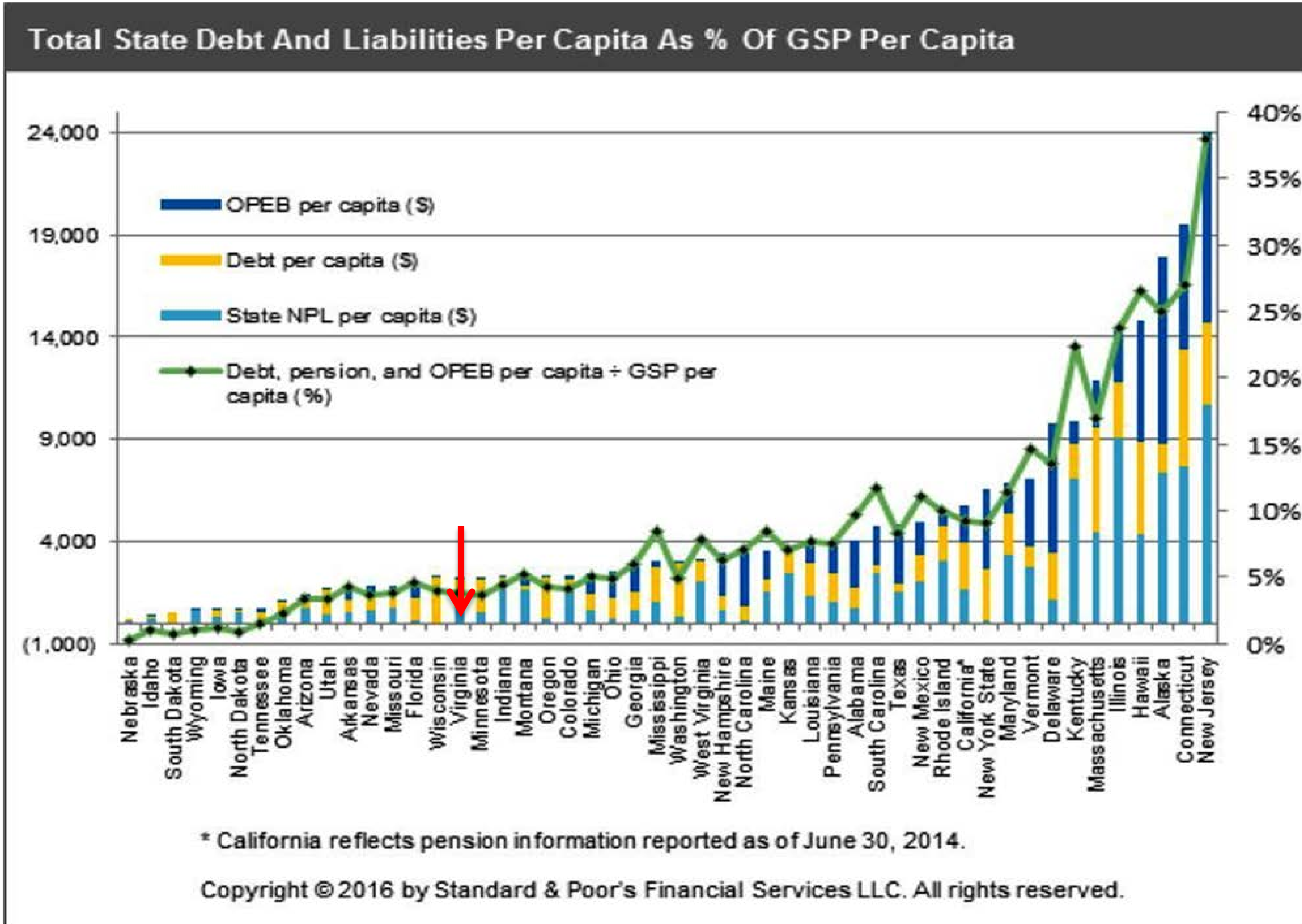


Overall state guaranties of School and Community College District debt service continue to grow at a steady pace



Rating Agency View of State's Unfunded PERS liability

- A jurisdiction's outstanding debt and projected pension liability is one of many factors that rating agencies consider when determining their credit rating
  - Other important areas include their governmental framework, financial management, economic outlook and budget performance
- The State recently completed a comprehensive presentation on all these areas with the three national rating firms and were reconfirmed at the **AA+/Aa1/AA+** level with a stable outlook by Standard & Poor's, Moody's and Fitch Investor Services respectively
  - The rating agencies acknowledge the sharp growth in the State's unfunded OPERS liability in recent years
  - Nevertheless, Oregon receives high marks for maintaining a fiscally disciplined approach to managing both its debt portfolio and OPERS liabilities



Source: S&P Report, "U.S. State Pensions: Weak Market Returns Will Contribute to Rise in Expense," September 12, 2016; info used in table above comes from reported net pension liability in FY 2015 State Comprehensive Annual Financial Reports. "GSP" means gross state product.

Should the State sell more POBs to address the PERS funding situation?

- While communities who sold POBs in the early 2000s were able to earn an overall rate of return on their PERS side accounts that to date remains higher than the interest cost on their POBs, many Oregon jurisdictions who sold POBs later in the decade have not been so fortunate
  - These jurisdictions are worse off than if they had never borrowed because of lower capital market returns in 2008 and beyond
  - Economic modelling suggests that the likelihood of POBs being a good "bet" often depends on the interest earned in the first few years after a POB is sold
- The Government Finance Officers' Association (GFOA) recommends that due to their speculative nature, state and local governments avoid issuing pension obligation bonds, especially if the issuance is not part of a more comprehensive plan to address pension funding shortfalls
- Any new State POB issuance will further crowd out needed investments in state infrastructure and capital facilities