Legislative Fiscal Office

Ken Rocco
Legislative Fiscal Officer

900 Court Street NE
H-178 State Capitol
Salem, Oregon 97301
503-986-1828

Budget Information Brief / 2016-8

State Pension Obligation Bonding Capacity

In June 2016, the Legislative Fiscal Office issued a brief on the history of state agency use of pension obligation bond funding (see *State Agency Pension Obligation Bonding*, LFO Budget Information Brief 2016-6). LFO has since been asked about the state's capacity to issue additional Pension Obligation Bonds (POBs). When evaluating the state's capacity to issue POBs, consideration must be given to the Public Employees Retirement System (PERS) Unfunded Accrued Liability (UAL) to be bonded, Oregon's constitutional limitation on pension bonding, the state's capacity to issue debt, the effect on the state's debt burden and credit ratings, and the availability of future General Fund and other sources of revenue to support debt service payments. Additionally, consideration is given to whether the state has the legal authority to issue POBs for school district and local government UALs.

Executive Summary

The Oregon Constitution limits the total outstanding POBs to one percent of the real market value (RMV) of the state. Based on the state's 2015 RMV ($506.2 billion), the debt limit for a POB issuance would be a maximum of $3.2 billion, after taking into consideration the outstanding balance from a 2003 state- POB issuance ($1.8 billion). This is the limit for state agencies, excluding local governments, which would continue to rely upon their own, rather than the state's, legal authority and financial capacity to issue POBs.

Currently, the state agency portion of the PERS UAL is $4.3 billion, after taking into account the employer side account funded by the 2003 POB issuance. The state portion of the UAL exceeds the $3.2 billion constitutional debt limit by $1.1 billion. Additionally, the state's debt capacity for a POB issuance up to the $3.2 billion maximum would consume $1 billion of General Fund debt capacity and $2.2 billion of non-General Fund debt capacity. When compared to the current State Debt Policy Advisory Commission's General Fund Debt capacity recommendation, the state could issue the entire $1 billion in POBs; however, such an issuance would consume approximately 95% of all the state's $1.1 billion in General Fund debt capacity for the 2017-19 biennium. The associated debt service on such an issuance would be an estimated $240.3 million per biennia for the next 20 years, of which approximately $76.9 million (32%) would be General Fund. Such a large issuance would crowd out virtually all other state bonding needs and potentially lead to downgrades in the state's credit rating, resulting in higher bonding costs. If that were to occur, local governments that rely upon the state's credit rating to issue bonds would likely also experience increased borrowing costs. A POB issuance is premised on investment returns exceeding the cost of debt service. Higher bond costs could narrow the investment speculation differential possibly calling into question the viability of another POB issuance.

PERS Unfunded Accrued Liability

PERS has determined a system-wide UAL, as of the end of calendar year 2015, of $21.8 billion, which includes UALs for both Tier One, Tier Two, and the Oregon Public Service Retirement Plan (OPSRP) pension plans; however, this amount is reduced by pre-paid employer contributions that are commonly referred to as "side accounts." After taking $5.6 billion of side account value into account, the UAL is rounded to $16 billion for a system-wide funded status of 79%. The Tier One/Tier Two portion of the UAL is allocated between the State and Local Government Rate Pool ($8.2 billion); School Districts ($4.9 billion); and Independent Employers ($1.5 billion). The OPSRP UAL is an additional $1.4 billion.

The $8.2 billion State and Local Government Rate Pool UAL is the pension UAL for "State Agencies," which includes: state government agencies, public universities, and other entities such as the Oregon Lottery, State Accident Insurance Fund, Oregon State Bar, and semi-independent agencies comprised of smaller boards and commissions. These entities originally participated in the $2 billion POB issuance in 2003. State Agencies are also allocated a share of the OPSRP pension UAL. The entire state agency UAL is $6.2 billion before the side account offset of $1.9 billion and $4.3 billion after the offset.

Constitutional Debt Limitation and Capacity

Article XI-O of the Oregon Constitution authorizes the State of Oregon to issue bonds to finance the State's pension liabilities and limits pension liability indebtedness to one percent of the RMV of all property in the state. The Department of Revenue publishes the total RMV of property in Oregon in the spring of each year. With an estimated calendar year 2015 RMV of $506 billion, the maximum authorized pension liability would total $5 billion; however, this amount would have to be reduced by previously authorized and still outstanding state POBs issued in 2003. As of June 30, 2015, $1.8 billion in state agency POBs was outstanding, thereby leaving $3.2 billion in available constitutional capacity.

State Debt Capacity and State General Fund Debt Capacity

ORS 286A.250 to 286A.255 establishes the State Debt Policy Advisory Commission to advise the Governor and the Legislative Assembly regarding policies and actions that enhance and preserve the state's credit rating and maintain the future availability of low-cost capital financing. The Commission annually reports its recommendations related to General Fund debt capacity. According to the most recent Commission report, dated January 2016, the General Fund debt service capacity is estimated at $1.1 billion per biennium through fiscal year 2023.

There is an important distinction related to the Commission's recommendation, which is that the recommendation referenced relates only to the *General Fund* debt capacity limit and does not include debt capacity limitations funded with Lottery, Other, and Federal Funds. Approximately 32% of the debt service for a potential *POB issuance* would be counted toward the state's *General Fund* debt capacity limit and 68% would be counted toward the "capacity" of Lottery, Other, and Federal Funds funding. This ratio is explained by the fact that POB debt service is allocated to General Fund and non-General Fund sources of revenue based on the funding composition of underlying payroll costs.

National Debt Ratings Agencies

While only 32% of the state's POB debt is categorized as General Fund supported, the entire POB issuance, if it were to occur, would be considered "net tax-supported debt" by the three national rating agencies. These private rating agencies evaluate an issuer's (the State of Oregon) creditworthiness based, in part, on the state's overall debt burden compared to its resources. The higher a government is rated, the lower the interest rate paid on bonds issued. The lower the credit rating, the higher the interest rate and cost of borrowing across all bond types. Among other factors, rating agencies commonly use two measures to gauge a government's overall debt burden: (a) net tax-supported debt per capita; and (b) net tax-supported debt as a percentage of personal income. If the state were to issue up to the maximum constitutional debt limit of $3.2 billion in POBs, this would substantially increase the net tax-supported debt per capita, which would likely have a negative effect on Oregon's credit rating, driving up the cost of all state-issued debt, not just POBs. This could also narrow the investment speculation differential between investment returns and debt service costs, thereby increasing the risk of a POB issuance. The inherent risk of POBs is that they could actually increase total employer costs related to PERS in the future, if investment returns fall below debt service costs.

Competing Demand for State Debt

The issuance of POBs, by utilizing debt service capacity, may crowd out the state's ability to fund many other high priority projects with state debt, including capital construction and other projects related to state and local economic development, as well as improvements to public schools, public universities, and state agencies. For example, 2017-19 agency request budgets include $1.2 billion of General Fund supported debt requests for projects such as:

- $202.3 million for seismic rehabilitation of schools and emergency services buildings
- $160.1 million for the Oregon School Capital Improvement Match Program
- $187.1 million for University and Community College capital construction
- $41.9 million for an Integrated Eligibility Determination System at the Department of Human Services, a Child Support Enforcement System at Department of Justice, and the Core Tax Revenue System Replacement System at the Department of Revenue
- $68.7 million for capital improvements to Oregon Youth Authority facilities

While no decisions have been made about the projects identified above, these requests, and others, could not be funded through debt issuance if the General Fund debt capacity of the State was used almost entirely for POBs.

Debt Service

State POB principal and interest payments, or debt service, are funded as a percentage of PERS-eligible payroll expenses for state agencies. Important to the understanding of POB debt service is that debt service is budgeted separate from the PERS employer contribution rate. If an employer has issued POBs, an employer must also pay the PERS employer contribution rate in addition to debt service on the POBs. For state agencies, the current percentage of payroll that is charged for the POB debt service for the 2015-17 biennium is 6%; the rate is expected to remain around this level for the 2017-19 biennium. This rate is charged against General, Lottery, Other, and Federal funded PERS-eligible position costs. For the 2015-17 biennium, the debt service on pension obligation bonds will cost state agencies, the university system, and other non-state "state" entities $358.9 million, and will grow to $390.1 million, an increase of $31.2 million (or 8.7%), during the 2017-19 biennium. POB debt service will continue to increase 8.7% each biennium until the debt is paid off in 2027, under the terms of the 2003 POB issuance. If the state were to issue up to the maximum constitutional debt limit of $3.2 billion in POBs, the estimated total debt service cost would be $240.3 million per biennium, assuming a 20-year bond and level, or fixed, debt service payments. Of the total debt service, General Fund would be responsible for paying approximately $76.9 million (32%). The total cost of interest over the 20-year life of the bond would be approximately $1.5 billion at an assumed interest rate of 4%, considering that the bond would be sold as a taxable issuance. A 20-year POB duration equates to the current 20-year PERS UAL amortization period.

Local Government Pension Bonding

Schools districts and local government's UAL is estimated at $11.7 billion, which is the system-wide $16 billion UAL after side account offset less the $4.3 billion UAL attributable to state agencies. Statute, rather than the Oregon Constitution, provides local governments with the authority to issue revenue bonds to finance pension liabilities (ORS 238.694). Such bonds, which have been issued by some school districts and municipalities, are limited-tax obligations that may be secured by the full-faith-and-credit and taxing power of the issuing municipality. POBs may be issued without voter approval; however, counties may only issue up to 5% of the RMV of the taxable property within the county. As noted previously, even if the state had the legal authority to issue POBs for local government, the state would not have the excess capacity to issue an additional $11.7 billion in POBs.

Oregon School Bond Guaranty Program and Diversion Agreements

There are two statutory considerations related to local government bonding: diversion agreements and the Oregon School Bond Guaranty Program (OSBG). ORS 238.698 authorizes diversion agreements and allows public bodies that receive funds from the state to enter into a funds diversion agreement with the state agency for paying debt service on the bonds. ORS 328.346 allows the State Treasurer to recover funds (intercept payments from the General Fund, the State School Fund, and income of the Common School Fund) as provided in the diversion agreements. The Department of Education (DOE) enters into State School Aid fund diversion agreements for school district and community college POBs to improve their credit rating and lower borrowing costs. Under current law, there is no substantive state financial review of school districts and community college POB issuances that are guaranteed for repayment by the State. Additionally, DOE does not take into consideration any other state guarantees on school debt for which state school funding for that school is the source of repayment when processing diversion agreements.

The state OSBG program is the state's guarantee to make sure that bonds are paid back should the school district fail to do so. The state may issue bonds backed by the full faith and credit and taxing power of the state (ORS 328.321-356) to ensure that the state has the funds necessary to make good on the state's guarantee. This results in a higher credit rating and lower borrowing costs for school districts and community colleges because it reduces the likelihood of default. Statute allows the State Treasurer to either certify, revoke certification, or determine ineligible the state's guarantee of a school district or community college's eligibility for the OSBG. School districts and community colleges can issue POBs and GO bonds without the use of a state guaranty, but, if they do so, the school forgoes the credit rating and interest rate benefits afforded by the state guaranty.

The combination of a school district and community college's general obligation guaranty through the OSBG, which uses a state school aid intercept to repay the state in instances where the state makes a debt service payment on behalf of a district, plus POB diversion agreements, could potentially over-obligate state assistance payments to these entities.

State's Bonding Capacity Calculation

The table on the next page is the estimate of the state's POB bonding capacity as of November 2016. The conclusions drawn from this table are:

- Oregon's constitutional debt limit for a POB issuance would be a maximum of $3.2 billion, after taking into consideration the outstanding balance from the 2003 POB issuance as of June 2015.
- The State Agency UAL is $4.3 billion, after taking into account the existing employer side account, and exceeds the $3.2 billion constitutional debt capacity by $1.1 billion.
- The state's debt capacity for a POB issuance up to the $3.2 billion maximum would consume $1 billion General Fund debt capacity and $2.2 billion in non-General Fund debt capacity.
- When compared to the State Debt Policy Advisory Commission's General Fund Debt capacity recommendation as of January 2016, the state could issue the entire $1 billion in POBs; however, such an issuance would consume approximately 95% of the state's $1.1 billion in General Fund debt capacity for the 2017-19 biennium, leaving only $55.6 million for all other bonding projects.

Estimate of State's Capacity to Issue Pension Obligation Bonds (as of November 2016)

		In millions	
Oregon Constitutional Debt Limitation on Pension Bonding (article XI-O bonds)			
	Real Market Value (for calendar year 2015)	$ 506,175.5	
	One percent of Real Market Value limitation	1.0%	
	Maximum Oregon Constitution limit on pension indebtedness (***before*** outstanding POB debt)	$ 5,061.8	
	Outstanding pension obligation bonds from the 2003 POB issuance (as of June 30, 2015)	$ (1,835.4)	
	Maximum Oregon Constitution limit on pension indebtedness (***after*** outstanding POB debt)	$ 3,226.4	0.6%
State Agency Unfunded Accrued Liability			
	State Agency Unfunded Accrued Liability (as of December 31, 2015)	$ (6,247.5)	
	Pre-paid Employer Contributions or Side Accounts (as of December 31, 2015)	$ 1,898.2	
	State Agency UAL (***after*** side account offset)	$ (4,349.2)	
Oregon Constitutional Capacity			
	Maximum Oregon Constitution limit on pension indebtedness (***after*** outstanding POB debt)	$ 3,226.4	
	State Agency UAL (***after*** side account offset)	$ (4,349.2)	
	Shortfall in Constitutional capacity to issue Pension Obligation Bonds	$ (1,122.9)	
Statewide Debt Capacity			
	Pension Obligation Bonds funded with General Fund Debt Service	$ 1,032.4	32%
	Pension Obligation Bonds funded with other than General Fund Debt Service	$ 2,193.9	68%
	Total Pension Obligation Bond	$ 3,226.4	
Statewide General Fund Debt Service Capacity			
	State Debt Policy Advisory Commission - General Fund Debt Capacity Estimate (as of January 2016)	$ 1,088.0	
	Pension Obligation Bonds funded with General Fund Debt Service	$ (1,032.4)	95%
	Surplus General Fund Debt Service Capacity	$ 55.6	