

**X00A00
Public Debt**

Operating Budget Data

(\$ in Thousands)

	FY 05	FY 06	FY 07	FY 06-07	% Change
	<u>Actual</u>	<u>Working</u>	<u>Allowance</u>	<u>Change</u>	<u>Prior Year</u>
Special Fund	\$553,783	\$625,208	\$656,224	\$31,016	5.0%
Total Funds	\$553,783	\$625,208	\$656,224	\$31,016	5.0%

- Debt service costs continue to climb, reflecting increased bond issuances and debt outstanding.
- Fiscal 2007 costs increase by \$31 million (5%) when compared to fiscal 2006, and total \$656 million.
- Annuity Bond Fund balances and revenues are sufficient to support the entire appropriation, and no general funds are needed in fiscal 2007.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Major Trends

State Maintains AAA Bond Rating and Long-term Debt Is Affordable: The State continues to carefully manage its debt and maintain its AAA bond rating. All three rating agencies reaffirmed the State's AAA rating prior to the July 2005 bond sale. Out-year projections remain within affordability limits.

Issues

Analysis of the Capital Debt Affordability Committee's Recommendations: The Capital Debt Affordability Committee has proposed authorizing \$690 million in general obligation (GO) bonds and deemed that this level is affordable. It is estimated that there is sufficient capacity to issue an additional \$180 million annually in debt. **The Treasurer should be prepared to brief the committees on the State's debt affordability process and State debt capacity.**

Increased Property Tax Assessments and Bond Premiums Generate a Surplus in the Annuity Bond Fund: In November 2005, the State Department of Assessments and Taxation increased its estimate of the fiscal 2007 assessable property tax base. Revenues are now projected to generate a \$201 million surplus in the Annuity Bond Fund (which supports GO bond debt service) at the end of the forecast period in fiscal 2011. **The Treasurer should be prepared to brief the committees on the status of the fund.**

Annuity Bond Fund Surplus Options: This issue summarizes the various approaches to reducing the surplus in the Annuity Bond Fund. **It is recommended that the Treasurer's Office consider issuing short-term debt to reduce State borrowing costs.**

The Fiscal 2007 Budget Increases PAYGO Funding and Reduces Fiscal 2007 Taxable Bond Authorizations but Does Not Deauthorize Prior Years' Taxable Authorizations: In previous years, PAYGO funds were reduced in the operating budget and moved to the capital bond program. The update examines the effect of this policy and notes that funds are once again provided in the PAYGO budget for projects that do not qualify as federally tax exempt. Nonetheless, there still is some previously authorized but unissued taxable debt. **It is recommended that this debt be deauthorized and that general funds be appropriated for these programs in a supplemental budget.**

Treasurer's Office Expresses Concerns about Open Auctions Bidding Procedures in Response to Joint Chairmen's Report Information Request and the University of Connecticut Responds to Those Concerns: In the interim, the Treasurer's Office responded to an information request in the 2005 *Joint Chairmen's Report*. The office expressed concerns about open auctions bidding procedures. This issue has been examined by professors at the University of Connecticut, who project that these procedures can reduce costs. Their testimony is included in **Appendix 6**. **The**

Treasurer should brief the committees on the State’s policies with respect to bond sale bidding procedures. This should include the benefits associated with open and closed auction processes.

Recommended Actions

1. Concur with Governor’s allowance.

Updates

Recognition of Retiree Health Care Cost Liability Could Affect the State’s AAA Bond Rating: Accounting rules have been modified so that the State will be required to account for accrued retiree health insurance costs in fiscal 2008. The update examines the potential effect of this new ruling on the State’s AAA bond rating.

X00A00 – Public Debt

X00A0 Public Debt

Operating Budget Analysis

Program Description

There are two programs in the Public Debt:

- debt service, which funds principal and interest payments on general obligation (GO) bonds. GO bond debt service payments are supported by the Annuity Bond Fund (ABF). Funds are generated from property tax revenues, general funds, and repayments from certain State agencies, subdivisions, and private organizations. All property taxes generated by the State are deposited in the ABF to support debt service. The fund can also receive reimbursable funds first appropriated as general funds in the Maryland State Department of Education (MSDE) budget to pay debt service on public school construction loans. The ABF has not received MSDE funds since fiscal 2003 when there was a general fund appropriation; and
- related expenses on State bonds, which includes arbitrage penalty payments. Until fiscal 2005, special funds resulting from refunded bonds would also be appropriated in this program. Chapter 444, Acts of 2005 amended the statute so that refunded bonds no longer need to be budgeted in the State's operating budget. The funds generated by refunding bonds are used to purchase government securities that provide the debt service payment to the bondholders. For purposes of setting debt limits, refunded bonds are not included in State debt calculations.

Governor's Proposed Budget

The fiscal 2007 allowance totals \$656.2 million. This is \$31 million (5.0%) greater than the fiscal 2006 debt service appropriation. The increase is attributable to higher GO bond authorizations and issuances in recent years. New GO bond issuances increased from about \$425 million annually in fiscal 2001 and 2002 to \$725 million in fiscal 2003, \$500 million in fiscal 2004, \$775 million (including taxable issuances) in fiscal 2005, and an estimated \$750 million (including taxable issuances) in fiscal 2006.

Exhibit 1 shows the activity of the ABF which supports the State's GO bond debt service. As in previous years, most of the revenues supporting debt service are generated through property tax receipts. This allowance represents a change in debt service policy by the Administration. From fiscal 2004 to 2006, the State property tax rate was \$0.132 per \$100 of assessable base. Recent assessments were considerably higher than previously estimated, generating substantially more revenues. The Governor's fiscal 2007 budget proposes that the property tax rate be reduced to \$0.112 per \$100 of assessable base. The implications of this policy are discussed in Issue 2.

Exhibit 1
Annuity Bond Fund Activity
Fiscal 2005 – 2007
(\$ in Thousands)

	FY 2005 <u>Actual</u>	FY 2006 Work. <u>Approp.</u>	FY 2007 <u>Allowance</u>
<u>Special Fund Income</u>			
Beginning Balance	\$48,998	\$106,275	\$121,975
Property Tax Receipts	516,534	572,969	547,119
Interest and Penalties on Property Taxes	1,831	1,500	1,500
Local Loan Repayments	2,452	2,411	2,308
Miscellaneous Receipts	707	200	200
Accrued Interest on Bonds Sold	500	0	0
Bond Premium	89,036	63,827	29,950
Transfer to Reserve	-106,275	-121,975	-46,828
Total Appropriations for Debt Service	\$553,783	\$625,208	\$656,224

Note: Numbers may not sum to total due to rounding.

Source: Governor's Fiscal 2007 Budget, Volume III, Page 765

The GO bonds' coupon interest rates are projected to remain at or below 5% through calendar 2006 so the State is still expecting some bond premiums in the March and summer 2006 bond sales. These bond sales' premiums are expected to generate \$30 million.

Revenues generated by the ABF are expected to be \$75 million less than fiscal 2007 debt service requirements. Consequently, the fiscal 2007 end-of-year balance is projected to be \$47 million, down from \$122 million at the end of fiscal 2006.

Issues

1. Analysis of the Capital Debt Affordability Committee's Recommendations

Chapter 43, Acts of 1978, created the Capital Debt Affordability Committee (CDAC). The committee is required to recommend an estimate of State debt to the General Assembly and Governor. The committee is chaired by the State Treasurer, and other committee members are the Comptroller, Secretaries of Transportation and Budget and Management, and an individual appointed by the Governor. The committee meets each summer and fall to evaluate State debt levels and recommend prudent debt limits to the Governor and General Assembly. The Governor and General Assembly are not bound by the committee's recommendations.

When reviewing State debt, CDAC considers GO bonds, consolidated transportation bonds, Grant Anticipation Revenue Vehicles (GARVEEs), stadium authority bonds, bay restoration bonds, and capital leases supported by State revenues. Bonds supported by non-State revenues, such as the University System of Maryland's Auxiliary Revenue bonds or the Maryland Transportation Authority's revenue bonds, are not considered to be State source debt and are not included in CDAC's debt affordability calculation.

Exhibit 2 shows that CDAC proposed \$690 million in GO debt for the 2006 session. The recommendation, which is \$20 million more than was authorized in the 2005 session, reflects a change in application of the committee's authorization policy. In 1992 the committee adopted a policy to increase authorizations by 3% annually, which allowed for a 2% growth attributable to inflation and 1% growth in the program size. In 1992, 3% growth provided for a \$15 million annual increase. In subsequent years, the committee simply increased authorizations by \$15 million annually, with exceptions made if additional authorizations were affordable and justifiable.

As the capital program has grown, the \$15 million increase resulted in an even smaller percentage growth rate. To allow the program to grow 3% annually, the committee has now adopted the practice of increasing authorizations by 3%, instead of a fixed amount (e.g., \$15 million annually). While this is not exactly a new policy (since the policy had been to increase authorizations by 3% annually since 1992), this does reflect a change in practice that is expected to result in additional authorizations, issuances, and debt service costs. Through the 2008 session, this adds \$20 million in authorizations annually. Beginning in 2009, the growth is \$25 million annually.

Another adjustment to out-year authorizations is to eliminate the dip in the program that was previously recommended for the 2009 session. In its 2003 report, the committee recommended that authorizations be increased by \$100 million in each session from 2004 to 2008, to realize an additional \$500 million in authorizations. At the time, the justification for the additional authorizations was to keep a more stable capital program. The concern was that surplus general funds that had previously supported the PAYGO capital program were no longer available, resulting in a decline in funds to maintain the capital program. At the time, it was also agreed that the authorizations be reduced again in 2009 to previously proposed levels.

Exhibit 2
Capital Debt Affordability Committee
Recommended Levels of GO Bond Authorizations
(**\$ in Millions**)

<u>Fiscal Year</u>	<u>Proposed GO Bond Authorizations</u>	<u>Change from Previous Year's Authorization</u>
2006	\$690	\$20
2007	710	20
2008	730	20
2009	745	15
2010	770	25
2011	795	25

Source: *Report of the Capital Debt Affordability Committee on Recommended Debt Authorizations for Fiscal 2007*, September 2005

Exhibit 3 shows that the committee now recommends a total of over \$3.6 billion in authorizations from 2006 to 2010. This is an increase of \$270 million over the five-year period. Beginning in fiscal 2010, this adds at least \$125 million to annual authorizations.

Exhibit 3
Effect of New Policy on GO Bond Authorizations
2006 – 2010 Legislative Sessions
(**\$ in Millions**)

<u>Fiscal Year</u>	<u>2004 Report Recommended Authorizations</u>	<u>2005 Report Recommended Authorizations</u>	<u>Increased Authorization</u>
2006	\$685	\$690	\$5
2007	700	710	10
2008	715	730	15
2009	630	745	115
2010	645	770	125
Total	\$3,375	\$3,645	\$270

Source: *Report of the Capital Debt Affordability Committee on Recommended Debt Authorizations*, September 2004 and 2005

While CDAC did not link the increase in funding to additional public school construction, the committee was aware of Chapters 306 and 307, Acts of 2004 which established the goal that the State authorize \$2 billion for public school construction from fiscal 2006 to 2013. This increased capacity could be used for that purpose. The allocation of these additional resources is discussed in the Capital Fiscal Briefing.

Proposed Levels of State Debt Are Affordable

CDAC currently uses two criteria to evaluate debt. Total State debt outstanding should be limited to 3.2% of State personal income, and total State debt service should be limited to 8% of State revenues supporting debt service. **Exhibit 4** shows that the State currently meets both criteria, as debt outstanding peaks at 2.92% of personal income in fiscal 2010 and debt service peaks at 6.50% of revenues in fiscal 2011. This analysis does not assume any changes in laws or policies. As will be discussed later in the analysis, the Administration is proposing a 2 cent reduction in property tax rates, which is not reflected in this analysis. If this reduction is adopted, the proposed debt authorizations remain affordable.

Exhibit 4 Capital Debt Affordability Committee's Criteria Proposed Debt Levels Are Affordable

<u>Fiscal Year</u>	<u>Debt Outstanding/ Personal Income</u>	<u>Debt Service/ Revenues</u>
2006	2.74	5.63
2007	2.75	5.76
2008	2.89	5.87
2009	2.89	6.25
2010	2.92	6.30
2011	2.89	6.50

Source: Department of Legislative Services, February 2006

Excess Debt Capacity Totals \$900 Million

Based on the CDAC criteria, the State also has significant unused debt capacity. The Department of Legislative Services (DLS) examines two approaches to increasing issuances:

- \$850 million could be issued one-time in fiscal 2007, and the State would still remain within the debt affordability criteria. Issuing \$850 million leaves the State without any excess capacity until fiscal 2010; and

- \$180 million could be issued for five continuous years from fiscal 2007 to 2011.

Exhibit 5 shows that issuing this debt would increase debt service payments to over \$900 million before the end of the forecast period. With respect to increasing issuances by \$180 million annually, debt service is increased by \$95 million in fiscal 2012. With respect to issuing an additional \$850 million in fiscal 2007, debt service costs peak at \$90 million. The slow growth in debt service is attributable to how the State amortizes GO bonds. In the first two years, the bonds only pay interest. Debt is retired from year 3 to year 15.

Exhibit 5
Capital Debt Affordability Committee
Effect of Issuing Maximum GO Bonds on Debt Service
Fiscal 2007 – 2011

<u>Fiscal Year</u>	<u>Current Debt Service</u>	<u>\$180 Million Annually Issued Additional Debt Service</u>	<u>\$850 Million One-time Additional Debt Service</u>
2007	\$656	\$9	\$42
2008	696	20	42
2009	745	39	90
2010	778	60	90
2011	822	78	90

Source: Department of Legislative Services, February 2006

This capacity analysis examines increasing GO bonds while maintaining all other debt issuances at currently projected levels. If the State were to maximize GO bond debt, it would preclude the State from issuing any other State debt and maintaining State debt within the limits set by CDAC. Specifically, this would limit transportation bonds, GARVEE debt, stadium authority debt, bay restoration bond debt, and capital leases to currently forecasted levels.

The Treasurer should be prepared to brief the committees on the State's debt affordability process and State debt capacity.

2. Increased Property Tax Assessments and Bond Premiums Generate a Surplus in the Annuity Bond Fund

GO bond debt service costs are supported by the ABF. Until fiscal 2003, property tax rates remained constant at \$0.084 per \$100 of assessable base. At this level, State property taxes supported approximately 55 to 60% of debt service costs. Any bond sale premiums generated increased the fund balance. In subsequent years, these accumulated fund balances were reduced by appropriating the funds for debt service payments, which reduced the general fund requirement. Since property taxes, bond sale premiums, and other revenues were insufficient to pay the entire debt service amount, general funds were appropriated to support the remaining debt service costs.

The State did not appropriate general funds for the ABF in the fiscal 2004 budget. Consequently, the Board of Public Works (BPW), which sets the State property tax rate, increased the State property tax rate to \$0.132 per \$100 of assessable base. With these actions, the State moved from maintaining a constant property tax rate and funding any remaining debt service with general funds to funding the entire debt service payment with property taxes (as well as some smaller revenue sources).

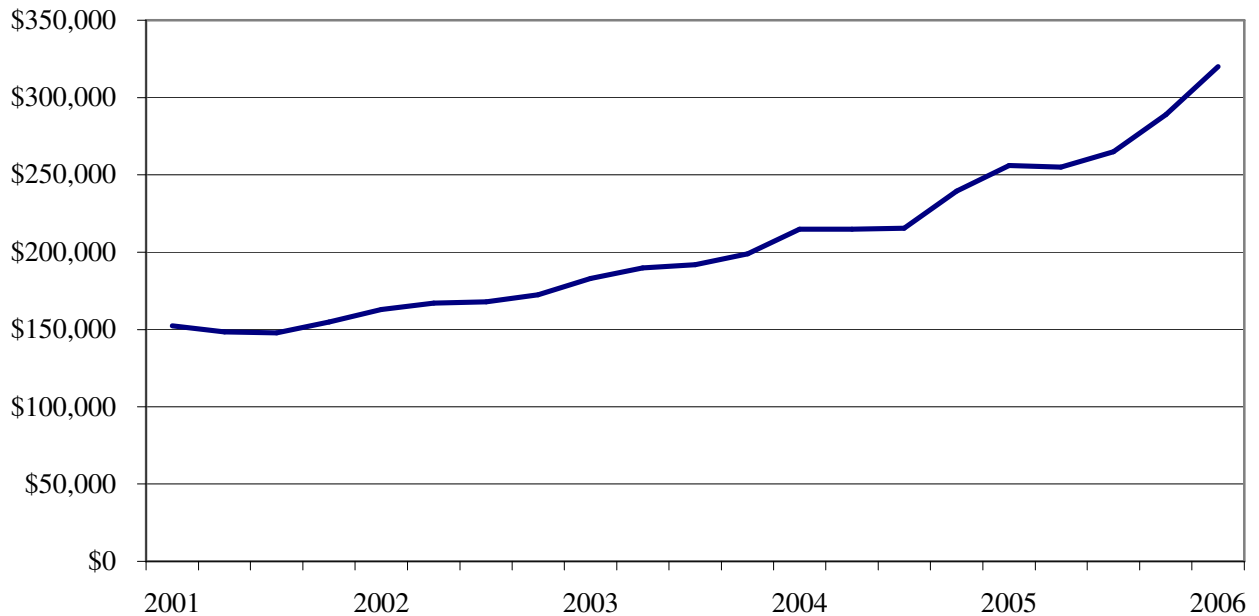
In November 2005, the State Department of Assessments and Taxation (SDAT) revised its projected property tax assessable base upward. Consequently, property tax revenues are expected to rise. This creates both an opportunity and a problem. The opportunity is to eliminate the projected out-year deficit in the ABF. The problem is that even without raising the rates, State taxpayers living in the same house that they have lived in for years will be paying as much as 10% more in State property taxes in fiscal 2006. Proposals to reduce property tax rates to allow for some property tax relief have been introduced.

Rise in Property Values Increase the State's Assessable Base

Property values have risen substantially across Maryland in recent years. According to data from SDAT, the median sale price of houses sold in Maryland has increased in all jurisdictions since fiscal 2002. **Exhibit 6** shows the steady increase in housing values since fiscal 2001 – by fiscal 2005, the median price of a home sold in Maryland was \$320,000, which is 110% greater than the price in the first quarter of fiscal 2001.

The effect of the increased sale price of housing can be seen in the increase in the real property assessable base. For example, the assessable value of real full-year property increased from \$314.9 billion in fiscal 2002 to \$521.3 billion in fiscal 2007. In November 2005, SDAT increased fiscal 2007 real full-year property values by 7.2%, from \$486.1 billion to \$521.3 billion. Also, this increase is expected to be sustained, resulting in an upward revision of the fiscal 2008 to 2011 assessable base estimates.

Exhibit 6
State Property Taxes
Increase in Median Sale Price of Improved Residential Properties
First Quarter of Fiscal 2001 – First Quarter of Fiscal 2006



Source: Department of Assessments and Taxation

In recent years, the assessable base has consistently exceeded the estimates. There is now some evidence that the housing market, which accounts for more than three-quarters of real property assessments, is beginning to slow. According to the Maryland Association of Realtors, statewide housing inventories have almost doubled from over 12,000 in December 2004 to over 24,000 in December 2005. As late as April 2005, inventories totaled over 13,000 units, roughly the same as April 2004 inventories. Inventories began increasing in May 2005. The association also reports that this has not yet had a significant effect on price appreciation, so the data is contradictory. However, rising inventories and interest rates suggest that it is less likely that subsequent increases in the State's assessable real property base will be as substantial as in recent years.

Property Value Increases Eliminate Out-year Revenue Shortfall and Generates a Surplus in the ABF

This increase in property values has eliminated the structural deficit in the ABF over the fiscal 2007 to 2011 forecast period. If the State property tax rate is maintained at the current level,

the current estimate projects that there are sufficient funds in the ABF to support debt service through fiscal 2011. **Exhibit 7** shows that there are sufficient funds to provide a \$201 million fund balance at the end of fiscal 2011. Under the current assumptions, annual State property tax receipts exceed annual debt service costs.

Exhibit 7
Annuity Bond Fund Forecast
State Property Tax of \$0.132 Per \$100 of Assessable Base
Fiscal 2007 – 2011
(\$ in Millions)

	<u>FY 07</u>	<u>FY 08</u>	<u>FY 09</u>	<u>FY 10</u>	<u>FY 11</u>
Special Fund Revenues					
Property Tax Receipts	\$644	\$719	\$746	\$788	\$833
Bond Sale Premiums	30	0	0	0	0
Other Revenues	4	3	3	2	2
ABF Fund Balance Transferred from Prior Year	122	144	170	174	187
Subtotal Special Fund Revenues Available	\$800	\$866	\$919	\$965	\$1,023
General Fund Revenues	0	0	0	0	0
Total Revenues	\$800	\$866	\$919	\$965	\$1,023
Projected Debt Service Expenditures	\$656	\$696	\$745	\$778	\$821
ABF End-of-year Fund Balance	\$144	\$170	\$174	\$187	\$201

Source: Department of Legislative Services, February 2006

One perspective on this fund balance is that this provides the State with \$200 million in one-time unallocated revenues that can be applied to various public purposes relating to debt service. The funds can support reducing taxes, increasing spending, or restructuring debt to reduce long-term debt service costs: they cannot be used for non-debt service expenditures.

The Treasurer should be prepared to brief the committees on the status of the fund.

3. Annuity Bond Fund Surplus Options

With respect to the ABF, the State is in a unique position. Instead of a long-term deficit, a \$200 million surplus is projected at the end fiscal 2011. One perspective on this fund balance is that this provides the State with \$200 million in one-time unallocated revenues that can be applied to

various public purposes. This Issue examines various approaches with respect to managing this ABF surplus. Each approach satisfies a different and ultimately competing goal. The various goals as well as the approaches to achieve the goals are summarized below:

- ***Maximize the Short-term State Property Tax Rate Reduction without a Fiscal 2007 General Fund Subsidy:*** This can be achieved by reducing the State property tax rate by 2 cents, yielding a rate of \$0.112 per \$100 of assessable base. The ABF has sufficient funds in fiscal 2007 to support debt service costs without general funds if the tax rate is reduced. However, this requires general fund subsidies or other revenue increases beginning in fiscal 2008.
- ***Maximize the State Property Tax Reduction without Increasing the State's Structural Deficit or Raising Other Taxes:*** Reducing rates by \$0.007 per \$100 of assessable base yields the minimum possible reduction under current assumptions without increasing the State's structural budget deficit. The effect is to reduce the State property tax from \$0.132 to \$0.125 per \$100 of assessable base.
- ***Increasing the Capital Program:*** The State is expected to generate \$61 million in bond sale premiums in fiscal 2006 and 2007. These funds can be used to increase funding for other capital projects. If this approach is adopted, the State cannot reduce State property taxes by 2 cents without a general fund subsidy in fiscal 2007. Insofar as there is a \$201 million surplus at the end of fiscal 2011, this does not increase the State's structural deficit.
- ***Reducing Out-year Debt Service Costs:*** The State can reduce total debt service costs by changing the mix of debt that is issued. If more short-term debt is issued, debt service costs increase in the short term. This is offset by decreased long-term costs and less total costs. The two approaches outlined are:
 - ***Issuing One-year Debt:*** By law, State bonds must mature within 15 years. Current practice is to issue GO bonds maturing between 3 and 15 years. Instead, the State could issue bonds that mature within a year: issuing \$100 million reduced total debt service costs by \$41 million over 15 years.
 - ***Changing Bond Maturities to Reduce Out-year Debt Service Costs:*** Debt service costs can be reduced by retiring debt sooner. In the short-term, this adds to costs. After an initial period of higher debt service costs, costs are lower than they otherwise would be. Retiring debt sooner also reduces debt outstanding and, insofar as the debt outstanding is the controlling CDAC ratio, this also provides for more debt capacity.

Option 1: Reduce Property Taxes by 2 Cents

Concerns have been raised that property taxes are becoming too much of a burden on property owners in Maryland. The Governor’s proposed budget provides some property tax relief. The fiscal 2007 budget assumes that State property tax rates will be reduced by 2 cents, to \$0.112 per \$100 of assessable base, by BPW. If SDAT’s median sale price is used, this proposed reduction would reduce an average household’s State property tax bill by \$64 (from \$422 to \$358). **Appendix 4** shows the savings for homeowners for housing values assessed from \$100,000 to \$3 million.

Exhibit 8 shows that reducing the State property tax rate by 2 cents requires a \$364 million general fund subsidy in the forecast period (from fiscal 2007 to 2011). This analysis assumes that the State does not increase debt service by increasing debt issuances and that no additional changes are made to State property tax credits.

Exhibit 8
Annuity Bond Fund Forecast
Effect of Reducing State Property Tax Rate 2 Cents
Fiscal 2007 – 2011
(\$ in Millions)

<u>Fiscal Year</u>	<u>General Fund Subsidy</u>
2008	\$37
2009	109
2010	106
2011	112
Total	\$364

Source: Department of Legislative Services, February 2006

Option 2: State Can Afford a \$0.007 State Property Tax Reduction (007 Bond Cut) without Increasing the Structural Deficit in the Forecast Period

Insofar as maintaining a \$0.132 State property tax rate is projected to leave the ABF with a \$201 million fund balance at the end of the forecast period, there is room to reduce State property taxes without adding to the State’s long-term structural deficit. If SDAT’s median sale price is used, this proposed reduction would reduce an average household’s State property tax bill by \$22 (from \$422 to \$400). Appendix 3 shows the savings for homeowners for housing values assessed from \$100,000 to \$3 million. Appendix 4 compares the fiscal effect of reducing State property taxes from 1 cent to 4.8 cents (the fiscal 2003 level).

Option 3: Provide a One-time Funding Source for Capital Projects

Federal law allows the use of bond proceeds for authorized additional capital projects and debt service payments. Section 8-129 of the State Finance and Procurement Article does not authorize the use of bond sale premium proceeds to support certain additional capital projects. If the law was changed, the State could use premiums generated in fiscal 2006 and 2007 to support additional capital projects. Bond counsel advises that there are no legal impediments if State law is changed. Premiums generated prior to fiscal 2006 cannot be used. These premiums have already been applied to debt service, and the fiscal years have been closed out. **Exhibit 9** shows that the State will receive an estimated \$61.2 million in fiscal 2006 and 2007.

Exhibit 9
Annuity Bond Fund
Bond Sale Premium Proceeds
Fiscal 2006 and 2007

<u>Bond Sale</u>	<u>Proceeds Available</u>
Actual July 2005	\$32,979
Estimated March 2006	16,250
Estimated July 2006	12,000
Total	\$61,229

Source: Estimate of 2006 premiums from the Department of Budget and Management, January 2006; and 2005 premium from the Treasurer's Office, July 2005

Actual premiums realized can vary substantially from estimated premiums. Recent premiums have been higher than projected. Also, if interest rates rise or the interest rate the State pays declines, bond premiums could be less than projected.

To use the premium to support other capital projects, the State would need to amend Section 8-129 of the State Finance and Procurement Article, or notwithstanding Section 8-129 amend the capital budget bill to allow the use of the premiums generated in fiscal 2006 and 2007 to support additional capital projects.

While the State can increase capital spending in fiscal 2007, it cannot increase it and also reduce the State property tax by 2 cents. Using premiums for public school construction reduces total available funds to \$641.8 million, which is \$14.4 million less than debt service costs. Consequently, the State would not be able to afford a full 2 cent State property tax reduction but could instead only afford a 1.7 cent State tax reduction, which reduces the State property rate to \$0.115 per \$100 of assessable base.

Option 4: Issue Short-term Debt

Another approach to the surplus is to restructure future debt issuances to reduce out-year debt service costs. Article 3, Section 34 of the Maryland Constitution requires that Maryland State debt mature within 15 years of issuance. With respect to GO bonds, State policy is to issue debt that begins to mature three years after issuance. From the third through fifteenth years, debt service payments are fairly constant. This reduces debt service payments in the first two years, since only interest payments are made and no debt is retired. The Attorney General's Office and bond counsel advise that there are no legal impediments to issuing one-year debt. This analysis suggests two approaches to restructuring debt issuances to reduce out-year debt service:

- ***Issuing 1-year Bonds Instead of Appropriating PAYGO General Funds:*** Under current market conditions, issuing 1-year debt would essentially be revenue neutral. If 1-year bonds are issued instead of appropriating general funds, costs are incurred by the ABF and general funds are not spent and instead those retained general funds derive investment earnings. This analysis compares the costs incurred by the ABF to interest earnings derived from retained general funds. The State borrows at low tax-exempt rates (taxable issuers must offer higher yield to compensate borrowers for their tax burden) and can invest general fund balances at slightly higher yields. The State does not pay taxes, it benefits from both lower borrowing costs and higher investment yields. Issuing 1-year bonds reduces debt service by \$41 million, when compared to traditional 15-year issuance. At the March 1 bond sale, the 15-year bonds are expected to generate a \$15 million premium, which offsets debt service costs. The 1-year bonds mature in fiscal 2007, resulting in a \$103.7 million debt service payment. Beginning in fiscal 2009, debt service costs are reduced by \$10.6 million annually; and
- ***Issuing a Bond Stream That Begins to Mature in the First Year Instead of the Third Year Reduces Total Debt Service Costs by \$26.6 Million:*** In fiscal 2007, the State plans on issuing \$675 million in GO bonds. If this debt begins maturing 1 year after issuance, debt service costs are increased by \$30.6 million in fiscal 2008 and 2009. Beginning in fiscal 2010, debt service costs are reduced by almost \$7 million annually. Over the life of the bonds, debt service costs are reduced by \$26.6 million. Because the costs of this are in the first 3 years and the benefits are spread over the final 13 years, a policy change to begin retiring debt after 1 year increases the State's structural deficit over the forecast period if State property tax rates are reduced by 2 cents.

Exhibit 10 summarizes the effect of the various options on general funds and the ending funding balance.

It is recommended that the Treasurer's Office consider issuing one-year bonds. It is also recommended that language be added to the capital budget bill that make any short-term debt authorization contingent on the availability of funds and maintaining the State property tax rate at \$0.132 per \$100 of assessable base in fiscal 2007.

Exhibit 10
Summary of Annuity Bond Fund Options

<u>Policy</u>	<u>GF Effect</u>	<u>Fiscal 2011 Ending Fund Balance</u>	<u>Comments</u>
Reduce State Property Taxes by 2 cents	Requires \$364 million GF subsidy	\$1 million	Administration's proposal
Reduce State Property Taxes by \$0.007 (007 Bond Cut)	None	\$4 million	Largest tax reduction possible without GF subsidy
Use Premiums to Support Capital Projects	None	\$140 million	Provides an estimated \$61 million for capital projects
Issue \$100 Million in 1-year Debt Instead of 15-year Debt	None	\$136 million	Reduces total debt service costs by \$41 million
Issue 15-year Debt Maturing in the First Year	None	\$153 million	Reduces total debt service costs by an estimated \$27 million

Source: Department of Legislative Services

4. The Fiscal 2007 Budget Increases PAYGO Funding and Reduces Fiscal 2007 Taxable Bond Authorizations but Does Not Deauthorize Prior Years' Taxable Authorizations

The State's capital program supports a number of different public policy objectives such as health, environmental, public safety, education, housing, and economic development objectives. Federal government regulations allow the State to issue debt that does not require the buyer to pay federal taxes on interest earnings. In cases where investors do not pay federal income taxes, they are willing to settle for lower returns. Conversely, investors in taxable debt require higher returns to offset their tax liabilities. Consequently, the State can offer lower interest rates on tax-exempt bonds. Data from 2005 taxable bond sales allow DLS to quantify the additional costs associated with taxable bond issuances.

Federal laws and regulations limit the kinds of activities the proceeds from tax-exempt bonds can support. One such requirement limits private activities or private use of the bond proceeds to 5% of the bond sales proceeds or \$15 million per bond sale. Another requirement limits private loans to

5% of bond sale proceeds or \$5 million per bond sale. Examples of programs that support private activities or private loans include the Rental Housing and Homeownership programs of the Department of Housing and Community Development (DHCD) and One Maryland Fund of the Department of Business and Economic Development.

Elimination of Operating Appropriations Results in Taxable Bond Issuances in 2005

To avoid exceeding the private activity limits imposed in the federal regulations, the State has previously appropriated funds in the operating budget instead of issuing debt for private activity programs and projects. Recent years' fiscal constraints have limited the amount of operating funds available for capital projects. To continue these programs, the State authorized GO bonds. Since fiscal 2004, the State has essentially migrated private use programs from the operating budget into the capital budget.

Through 2004, the State exclusively sold tax-exempt bonds. In 2005, the State reached its limit with respect to private activity exemptions in tax-exempt issuances, and the State was forced to sell taxable debt. These sales provide data from actual bond sales that can be used to test the hypothesis that taxable debt is more expensive than tax-exempt debt.

Hypothesis: Taxable Debt Is More Expensive Than Tax-exempt Debt

Because the holders of tax-exempt bonds do not pay federal taxes on interest earnings, the interest rates of tax exempt bonds tend to be less than taxable bonds. In theory, this should reduce the State's borrowing costs and debt service payments. Based on data provided by the State's financial advisor (Public Resources Advisory Group), DLS estimated that taxable debt's interest rate would exceed tax-exempt debt's interest rates by more than 100 basis points (for example, increasing the interest rate from 4.00 to 5.00%).

Analysis of March 2005 Bond Sale: Over \$500,000 in Additional Costs

At the time of the March 2005 bond sale there was considerable demand for Maryland's taxable debt. The State issued \$25 million of taxable debt which was bid on by 18 underwriters. The debt's TIC was 3.87%. (By contrast, the tax-exempt issuance generated five bids.)

The debt was structured differently than traditional bond sales. When issuing tax-exempt debt, the State issues a series of bonds with maturities ranging from 3 to 15 years. The average maturity is usually just under 10 years. The taxable bonds' maturities range from 1 to 3 years with annual debt service payments just under \$9 million.

Comparing the costs of this first taxable bond sale with the costs of a tax-exempt bond sale is fairly straightforward. Using interest rate data received from Raymond James & Associates, Inc., a financial services firm, DLS was able to estimate the costs of a similarly structured tax-exempt issuance and compare those costs with the costs of the taxable issuance. **Exhibit 11** shows that issuing taxable debt (rather than tax-exempt debt) increased debt service payments by an estimated \$531,000 from fiscal 2006 to 2008. Using the interest rates provided by Raymond James, a similar tax-exempt bond issuance yields a TIC of 2.62%, which are 125 basis points (1.25%) less than the taxable bonds' TIC.

Exhibit 11
March 2005 Taxable Bond Sale
Taxable Debt Costs Compared to Estimated Cost of Similar Tax-exempt Debt
(\$ in Thousands)

<u>Fiscal Year</u>	<u>Actual Taxable Debt Service</u>	<u>Est. Tax-exempt Debt Service</u>	<u>Additional Cost for Taxable Debt</u>
2006	\$8,952	\$8,740	\$212
2007	8,954	8,745	210
2008	8,949	8,840	109
Total	\$26,855	\$26,325	\$531

Sources: Public Resources Advisory Group; Raymond James Municipal Market Snapshots

Analysis of July 2005 Bond Sale: Over \$1 Million in Additional Costs

In July 2005, the State had its second taxable bond sale. As with the March taxable bond sale, there was significant interest in the July bond sale. In the July bond sale, the State issued \$20 million of taxable debt. There were 14 bidders, and the debt's TIC was 4.43%.

The July issuance was structured differently than the March issuance, and the analysis is more complicated. The March issuance began retiring debt after one year and retired all debt within three years. As with tax-exempt issuances, the taxable debt issued in July only pays interest in the first two years and does not begin retiring debt until the third year. This issuance retires all taxable debt within seven years of issuance.

The July issuance was also unique because it did not sell at a substantial premium. Instead, the winning bid offered lower interest rates and a rather marginal premium totaling approximately \$36,000. By contrast, the tax-exempt issuance offered a high premium and higher coupon rate with greater debt service costs.

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In the July bond sale, taxable debt actually reduced out-year debt service costs by offering an interest rate lower than the interest paid on tax-exempt debt. Taxable debt interest rates range between 4.25 and 4.50%. By contrast, tax-exempt debt's interest rate is a constant 5.00% through fiscal 2012. The lower rates paid with taxable debt reduced interest payments by approximately \$600,000.

However, these savings are offset by a reduced bond sale premium. The TIC for GO bonds maturing by 2012 is 3.12%. This is 131 basis points (1.31%) below the TIC for taxable debt. DLS estimates that, had the taxable debt's TIC been 3.12% (instead of 4.43%), the taxable debt would have generated a premium totaling approximately \$1.7 million.

In sum, the taxable debt issued at this bond sale increased State expenditures by approximately \$1.1 million. This is the result of a reduced premium totaling \$1.7 million, offset by \$600,000 in reduced borrowing costs for taxable debt.

Recommendation to Reduce Costs Moving Taxable Debt Programs and Projects Back into Operating Budget PAYGO Program

Although both taxable issuances were structured differently resulting in different costs and premiums, both taxable issuances were more expensive than similarly structured tax-exempt issuances. The two taxable bond sales show that issuing taxable debt increases State costs. In sum, the State's issuance of \$45 million in taxable debt cost \$1.6 million more than issuing tax-exempt debt.

State policy has been to fund capital programs and projects that do not qualify as tax-exempt bonds with general funds. This policy has been shown to reduce borrowing costs. In times of fiscal stress, the amount of general funds appropriated for capital programs and projects has been reduced. As a by-product of the most recent fiscal downturn, the State has issued taxable debt, and the State has incurred higher borrowing costs. In the past, general fund appropriations have been restored to the capital program when the State's finances improved.

To reduce borrowing costs and provide for a more efficient capital program, the Spending Affordability Committee (SAC) recommended that the Administration appropriate general funds for capital programs and projects that are not eligible to receive bond proceeds from tax-exempt bonds.

Last year, SAC policy was to include revolving loan fund capital programs receiving general funds in the SAC spending limit. The committee expressed concerns that this could create a disincentive to move funding for these capital programs back into the general fund. To eliminate a potential disincentive to restore general fund appropriations for capital programs and projects that are not eligible to receive bond proceeds from tax-exempt bonds, SAC excluded PAYGO capital general fund appropriations made in the 2006 legislative session from the affordability calculation. This exclusion was to be limited to projects previously funded with taxable GO bonds that are funded with general funds instead.

It appears as though the Administration's policies are consistent with the committee's recommendations. The Department of Budget and Management (DBM) advises that the fiscal 2007 capital program includes only \$115,000 that is possibly subject to restrictions on the use of tax-exempt debt. The Treasurer's Office concurs with DBM's assessment but notes that there may be some small components in some projects (such as snack bars or news stands) which may involve some private activity, but that this should be accommodated within the 5% and \$15 million limit.

General Assembly Should Consider Deauthorizing Previously Authorized Taxable Debt

On March 1 the State will issue an additional \$20 million in taxable debt. The Treasurer's Office advises that, after the March 1 bond sale, the State still has approximately \$20.8 million of authorized but unissued taxable debt. The debt consists of:

- \$2.5 million in Maryland Technology Development Corporation debt;
- \$5 million in the Maryland Department of the Environment Water Quality And Hazardous Substance Removal debt;
- \$7.9 million in DHCD Community Legacy debt; and
- \$5.4 million in DHCD Rental Housing debt.

This is debt that is typically supported by general funds, instead of GO bonds. **To reduce debt service costs, it is recommended that the General Assembly deauthorize this debt and request that the Administration appropriate general funds for these programs in a supplemental budget. Because these appropriations are excluded from the SAC calculation, they would not increase SAC spending and would not require reductions in other programs. This would also provide additional capacity in the capital program for other needs. DLS will include this recommendation in the Capital Budget Overview analysis.**

The Treasurer should be prepared to brief the committees on taxable debt.

5. Treasurer's Office Expresses Concerns about Open Auctions Bidding Procedures in Response to *Joint Chairmen's Report* Information Request and the University of Connecticut Responds to Those Concerns

In committee narrative in the 2005 *Joint Chairmen's Report* (JCR), the budget committees requested that the Treasurer's Office examine the feasibility of implementing open auction's procedures. In the fall of 2005, the office responded. In its response, the office expressed concerns that the procedures would not yield the projected benefits. DLS has been in contact with Dr. Mark

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Robbins, professor at the University of Connecticut, who has studied open auctions bidding systems. His report on the Treasurer's Office's JCR response is included as **Appendix 6**.

The Treasurer should brief the committees on the State's policies with respect to bond sale bidding procedures. This should include the benefits associated with open and closed auction processes.

Recommended Actions

1. Concur with Governor's allowance.

Updates

1. Recognition of Retiree Health Care Cost Liability Could Affect the State’s AAA Bond Rating

The Government Accounting Standards Board (GASB) was created to establish standards of accounting and financial reporting applicable to State and local governmental entities. Recently, GASB issued Statement 45 requiring that governmental employers account for liabilities associated with commitments to Other Post Employment Benefits (OPEB) in fiscal 2008. The effect is to move OPEB from cash accounting to accrual accounting. This requires that the State not just appropriate funds when payments for services are due but rather appropriate funds for future commitments that the State has made.

Insofar as an employer has not fully funded the amount necessary to support the entire liability, there is an unfunded liability. Maryland provides OPEB in the form of health insurance for retired employees. Beginning in fiscal 2008, the State will need to show the amount of this entire liability on its balance sheet. The total liability, as estimated by AON Consulting, is \$20.4 billion.

Chapter 298, Acts of 2005 created the Task Force to Study Retiree Health Care Funding Options. The task force of nine members included three Senators, three Delegates, as well as the Treasurer, Comptroller, and Secretary of DBM, or their designees. The task force was charged with developing “options for addressing the unfunded liability associated with State retiree health care that will have to be included on the State’s financial statements ...as a result of Governmental Accounting Standards Board Statement 45, and evaluate the costs associated with each option.”

Relative to the State’s Public Debt, the concern raised by the new requirements is what effect it will have on the State’s bond rating. The State currently has a AAA bond rating, the highest rating available, from all three major rating agencies, Fitch, Moody’s, and Standard & Poor’s (S&P). In the fall, the task force heard testimony from S&P about potential effects of the new ruling on bond ratings. In their testimony, S&P noted “OPEB liabilities, like pension liabilities, are considered debt-like in nature.” They also noted that “disparities [among how different governments manage OPEB liabilities] may be large enough to cause rating distinctions.” Clearly, how the State manages the retiree health insurance liability will affect the State’s bond rating.

S&P also provided some insights into the factors that will be used to evaluate the State’s bond rating, such as:

- “Are the current level of benefits sustainable – economically and politically?”
- “If not, what can be done to lighten the burden?”
- “Can the budget afford the OPEB ARC [Annual Required Contribution]?”

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- “How does the employer stack up to its peers?”
- “Will total carrying charges of bond debt service, pension contributions, plus OPEB contributions be sustainable given existing (or projected) resources?”

The task force was required to report to the General Assembly by December 31, 2005. The task force was also terminated at the end of 2005. In its report, the task force recommended that the State appropriate funds sufficient to support normal costs in fiscal 2007, so that the liability does not grow. This would require an estimated \$100 million appropriation in fiscal 2007. The Administration supports this recommendation and has included a \$100 million general fund appropriation in the State’s Dedicated Purpose Account allowance.

The task force also recommended that the State create an ongoing commission that examines factors influencing the costs of the liabilities as well as various alternatives to address the costs, and alternatives which would allow the State to prefund the large liabilities while balancing the needs of State employees and retirees.

Current and Prior Year Budgets

Current and Prior Year Budgets Public Debt (\$ in Thousands)

	<u>General Fund</u>	<u>Special Fund</u>	<u>Federal Fund</u>	<u>Reimb. Fund</u>	<u>Total</u>
Fiscal 2005					
Legislative Appropriation	\$0	\$560,360	\$0	\$0	\$560,360
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	-45	0	0	-45
Reversions and Cancellations	0	-6,531	0	0	-6,531
Actual Expenditures	\$0	\$553,783	\$0	\$0	\$553,783
Fiscal 2006					
Legislative Appropriation	\$0	\$623,106	\$0	\$0	\$623,106
Budget Amendments	0	2,101	0	0	2,101
Working Appropriation	\$0	\$625,208	\$0	\$0	\$625,208

Note: Numbers may not sum to total due to rounding.

Fiscal 2005

Expenditures totaled \$553.8 million, which is \$6.5 million less than the fiscal 2005 legislative appropriation. The changes include:

- an additional \$1,875,000 in expenditures attributable to increasing the par value of the bonds sold from \$325 million to \$400 million, thus increasing debt service payments; and
- \$8,451,236 in reduced debt service payments derived from the October 2004 bond refunding.

Fiscal 2006

To date, one budget amendment, which provided an additional \$2.1 million, has been approved. The amendment was necessary because the legislative appropriation understates expenditures. The appropriation assumed that the State would sell \$325 million in tax-exempt bonds in July 2005. Instead, the State issued \$430 million in tax-exempt debt and \$20 million in taxable debt. This increases the fiscal 2006 debt service payment by \$2.1 million.

**Object/Fund Difference Report
Public Debt**

<u>Object/Fund</u>	<u>FY05 Actual</u>	<u>FY06 Working Appropriation</u>	<u>FY07 Allowance</u>	<u>FY06 - FY07 Amount Change</u>	<u>Percent Change</u>
Objects					
13 Fixed Charges	\$ 553,783,370	\$ 625,207,862	\$ 656,223,770	\$ 31,015,908	5.0%
Total Objects	\$ 553,783,370	\$ 625,207,862	\$ 656,223,770	\$ 31,015,908	5.0%
Funds					
03 Special Fund	\$ 553,783,370	\$ 625,207,862	\$ 656,223,770	\$ 31,015,908	5.0%
Total Funds	\$ 553,783,370	\$ 625,207,862	\$ 656,223,770	\$ 31,015,908	5.0%

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Appendix 2

Policy Options for the Annuity Bond Fund Surplus

Option 1: Reduce the State Property Tax Rate

Concerns have been raised that property taxes are becoming too much of a burden on property owners in Maryland. The Governor's proposed budget provides some property tax relief. The fiscal 2007 budget assumes that State property tax rates will be reduced by 2 cents, to \$0.112 per \$100 of assessable base, by BPW. If SDAT's median sale price is used, this proposed reduction would reduce an average household's State property tax bill by \$64 (from \$422 to \$358). **Appendix 4** shows the savings for homeowners for housing values assessed from \$100,000 to \$3 million.

Table 1 shows that reducing the State property tax rate reduces revenue received by \$564 million in the forecast period (from fiscal 2007 to 2011). In fiscal 2007, the fund balance is sufficient so that the entire \$97 million shortfall is made up by reducing the fund balance. In fiscal 2008, the fund balance is drawn down \$46 million and another \$26 million of fund balance increases are foregone (if the rate remained at \$0.132 per \$100 of assessable base, the fund balance would have increased by \$26 million). The remaining \$37 million shortfall is supported by general funds. By fiscal 2011, the general fund subsidy is increased to an estimated \$112 million. This analysis assumes that the State does not increase debt service by increasing debt issuances.

Table 1
Annuity Bond Fund Forecast – Effect of Reducing State Property Tax Rate 2 Cents
Fiscal 2007 – 2011
(\$ in Millions)

	<u>FY 07</u>	<u>FY 08</u>	<u>FY 09</u>	<u>FY 10</u>	<u>FY 11</u>	<u>Total</u>
Reduced State Property Tax Revenues						
State Property Tax Revenues at \$0.132 Rate	\$644	\$719	\$746	\$788	\$833	\$3,731
State Property Tax Revenues at \$0.112 Rate	547	610	633	669	707	3,167
Total Reduced State Property Tax Revenues	\$97	\$109	\$113	\$119	\$126	\$564
General Fund (GF) Revenues and Fund Balance Changes						
GF Revenues	\$0	\$37	\$109	\$106	\$112	\$364
Draw Down Fund Balance	97	46	0	0	0	143
Fund Balance Increase Foregone	0	26	4	13	14	57
Total GF Revenues and Fund Balance Changes	\$97	\$109	\$113	\$119	\$126	\$564
Comparison of End-of-year Fund Balances						
ABF End-of-year Fund Balance at \$0.132 Rate	\$144	\$170	\$174	\$187	\$201	
ABF End-of-year Fund Balance at \$0.112 Rate	47	1	1	1	1	

Source: Department of Legislative Services, February 2006

State Can Afford a \$0.007 State Property Tax Reduction (007 Bond Cut) without Increasing the Structural Deficit in the Forecast Period

Insofar as maintaining a \$0.132 State property tax rate is projected to leave the ABF with a \$201 million fund balance at the end of the forecast period, there is room to reduce State property taxes without adding to the State's long-term structural deficit. **Table 2** shows that the State property tax rate could be reduced by \$0.007 and still provide sufficient funds for projected GO bond debt service needs. If SDAT's median sale price is used, this proposed reduction would reduce an average household's State property tax bill by \$22 (from \$422 to \$400). Appendix 3 shows the savings for homeowners for housing values assessed from \$100,000 to \$3 million.

Table 2
Annuity Bond Fund Forecast
007 Bond Cut
State Property Tax Reduced to \$0.125 Per \$100 of Assessable Base
Fiscal 2007 – 2011
(\$ in Millions)

	<u>FY 07</u>	<u>FY 08</u>	<u>FY 09</u>	<u>FY 10</u>	<u>FY 11</u>
Special Fund Revenues					
Property Tax Receipts	\$610	\$681	\$706	\$747	\$789
Bond Sale Premiums	30	0	0	0	0
Other Revenues	4	3	3	2	2
ABF Fund Balance Transferred from Prior Year	122	110	98	63	34
Subtotal Special Fund Revenues Available	\$766	\$794	\$807	\$812	\$825
General Fund Revenues	0	0	0	0	0
Total Revenues	\$766	\$794	\$807	\$812	\$825
Projected Debt Service Expenditures	\$656	\$696	\$745	\$778	\$821
ABF End-of-year Fund Balance	\$110	\$98	\$63	\$34	\$4

Source: Department of Legislative Services, February 2006

Appendix 5 compares the fiscal effect of reducing State property taxes from 1 cent to 4.8 cents (the fiscal 2003 level).

Option 2: Use Fiscal 2006 and 2007 Bond Sale Premiums to Provide a One-time Funding Source for Capital Projects

Every GO bond sale since fiscal 2000 has generated a premium. When bonds are sold they have a par value (cost of the bond as shown in the Official Statement) and a coupon rate (interest rate of the bond listed in the Official Statement). When the bonds are structured for sale, the Treasurer's Office determines the amount of the bonds sold and when the bonds mature. The market determines the coupon rate and the sale price of the bonds. In the current low-interest rate climate, the coupon rate has been substantially higher than the market interest rate, as measured by the True Interest Cost (TIC). If the TIC is less than a bond's coupon rate, the market tends to bid up the price of the bonds to a level that is higher than the par value. The difference between the par value and the sale price of the bonds is a premium. Conversely, when the TIC is above the coupon rate, the bonds cannot sell at par value and sell for less. This difference is referred to as a discount.

Federal law and Maryland's Official Statements allow the use of bond proceeds for authorized capital projects and debt service payments. Section 8-129, of the State Finance and Procurement Article does not authorize the use of bond sale premium proceeds to support capital projects. If the law was changed, the State could use premiums generated in fiscal 2006 and 2007 to support capital projects. Bond counsel advises that there are no legal impediments, if State law is changed. Premiums generated prior to fiscal 2006 cannot be used. These premiums have already been applied to debt service and the fiscal years have been closed out.

Table 3 shows that the State will receive an estimated \$61.2 million in fiscal 2006 and 2007. The estimate assumes that the TIC for the bond sales will be 4.13% in March 2006 and 4.70% in the summer of 2006. The decline in the summer 2006 premium is attributable to rising interest rates. No premium is expected in 2007 bond sales.

Table 3
Annuity Bond Fund – Bond Sale Premium Proceeds
Fiscal 2006 and 2007

<u>Bond Sale</u>	<u>Premium</u>	<u>Issuance Costs and Underwriter Discount</u>	<u>Proceeds Available</u>
Actual July 2005	\$33,821	\$842	\$32,979
Estimated March 2006	17,100	850	16,250
Estimated July 2006	12,850	850	12,000
Total	\$63,771	\$2,542	\$61,229

Source: Estimate of 2006 premiums from the Department of Budget and Management, January 2006; and 2005 premium from the Treasurer's Office, July 2005

Actual premiums realized can vary substantially from estimated premiums. For example, last year it was estimated that the July 2005 bond sale would yield a premium totaling \$11.4 million. The actual premium was \$33 million. When the estimate was prepared in December 2004, it was estimated that the interest rates for 10-year bonds would rise, thus reducing the premium. This did not occur and a higher premium was realized. It is also possible that a premium may be overestimated. In a recent bond sale, Howard County sold over \$90 million bonds at or near par. This means that the bond sale's TIC was similar to the coupon rate offered, and the premium was negligible. If this occurs in Maryland's March or summer bond sales, the sale would not generate a large premium.

To use the premium to support other capital projects, the State would need to amend the capital budget bill to allow the use of the premiums generated in fiscal 2006 and 2007 to support specific capital projects. Because of federal arbitrage regulations, it is recommended that these premiums support projects that are ready to go and will be spent early in the fiscal year.

While the State can increase capital spending in fiscal 2007, it cannot both increase it and also reduce the State property tax by 2 cents. **Table 4** shows that using the entire fiscal 2006 and 2007 bond sale premiums for capital projects results in a \$14.4 million ABF shortfall in 2007. Using premiums for public school construction reduces total available funds to \$641.8 million, which is \$14.4 million less than debt service costs.

Table 4
Annuity Bond Fund
Effect of Using Bond Sale Premium Proceeds for Other Capital Projects
Fiscal 2007

Debt Service Costs	\$656.2
Funds Available	
Prior Year's Fund Balance	\$122.0
Property Tax Receipts after 2 cent Reduction	547.1
Other Receipts	34.0
Subtotal	\$703.1
Less: Premiums Supporting Other Capital Projects	61.2
Total Available	\$641.8
Revenue Shortfall with 2 Cent Tax Reduction	\$14.4

Source: Department of Legislative Services, February 2006.

However, if the entire fiscal 2006 and 2007 bond sale premiums are used for capital projects, the State will not be able to afford a 2 cent reduction in the State property tax in fiscal 2007. Current estimates provide for a 1.7 cent State tax reduction, which reduces the State property rate to \$0.115 per \$100 of assessable base, if the premiums are used for capital projects.

Option 3: Reduce Long-term Debt Service Costs by Issuing More Short-term Debt

Another approach to the surplus is to restructure future debt issuances to reduce out-year debt service costs. Article 3, Section 34 of the Maryland Constitution requires that Maryland State debt mature within 15 years of issuance. With respect to GO bonds, State policy is to issue debt that begins to mature three years after issuance. From the third through fifteenth years, debt service payments are fairly constant. This reduces debt service payments in the first two years, since only interest payments are made and no debt is retired. This analysis suggests two approaches to restructuring debt issuances to reduce out-year debt service:

- issue 1-year bonds instead of appropriating general fund PAYGO or issuing bonds that mature between 3 and 15 years; and
- issue a bond stream that begins to mature in the first year instead of the third year.

Issuing One-year Bonds to Reduce Long-term Debt Service Costs

The Attorney General's Office and bond counsel advise that there are no legal impediments to issuing one-year debt. Short-term debt is usually less expensive because interest rates for short-term debt are usually less than long-term debt and because the shorter maturities mean less interest payments. Issuing short-term debt generates issuance and interest costs. These costs are offset by the investment earnings, since the State carries a higher fund balance when debt is issued.

Table 5 examines the costs and investment earnings associated with issuing \$100 million in one-year bonds in June 2006. It is estimated that with a \$100 million bond sale, issuing debt is actually \$136,000 less expensive than using the State's cash balances (e.g., appropriating general fund PAYGO). Costs total almost \$4 million while investment earnings for general funds retained are expected to slightly exceed \$4 million.

Issuing bonds may not always be less expensive than using cash balances; this just happens to be the case under current conditions and assumptions. The point of this analysis is to show that interest costs are offset by investment earnings and often issuing bonds will essentially be revenue neutral.

Table 5
Annuity Bond Fund
One-year Debt Costs Compared to Interest Earnings
\$100 Million Bond Sale

Amount Issued	\$100,000
Interest Rate	3.66%
Cost of Issuing Debt	
Issuance Costs	\$150
Underwriter Discount	154
First Debt Service Payment	1,830
Second Debt Service Payment	101,830
Total Costs	103,964
Issuance and Interest Costs	\$3,964
Earnings Associated with Maintaining Funds in General Fund	
Investment Rate of Return	4.10%
Investment Earnings	\$4,100
Net Savings of Issuing Debt	\$136

Notes: Bond interest rate used is based on February 3, 2006, rate reported by Delphis Hanover Corporation adjust for estimated increase in one-year rates as projected by Global Insight.

Investment earnings are what the Treasurer's Office estimates average fiscal 2006 earnings will be.

Source: Department of Legislative Services, February 2006

With respect to short-term debt, the State is benefiting from the tax-exempt status of the debt. Issuing one-year debt is essentially revenue neutral because the State borrows at low tax-exempt rates (taxable issuers must offer higher yield to compensate borrowers for their tax burden) and can invest at higher yields. Since the State does not pay taxes, it benefits from both lower borrowing costs and higher investment yields.

Issuing 1-year bonds substantially reduces total debt service costs. **Table 6** shows that issuing 1-year bonds reduces debt service by \$41 million, when compared to traditional 15-year issuance. At the bond sale, the 15-year bonds are expected to generate a \$3.7 million premium, which offsets debt service costs. The 1-year bonds mature in fiscal 2007, resulting in a \$103.7 million debt service payment. Beginning in fiscal 2009, debt service costs are reduced by \$10.6 million annually.

Table 6
Annuity Bond Fund
Comparison of Cost of Issuing 1-year and 15-year GO Bond Debt

<u>Fiscal Year</u>	<u>1-year Debt Service</u>	<u>15-year Debt Service</u>	<u>15-year Premium</u>	<u>Net 15-year Costs</u>	<u>Savings (Additional Cost)</u>
2006	\$0	\$0	\$3,733	-\$3,733	-\$3,733
2007	103,660	5,000	0	5,000	-98,660
2008	0	5,000	0	5,000	5,000
2009	0	10,645	0	10,645	10,645
2010	0	10,648	0	10,648	10,648
2011	0	10,646	0	10,646	10,646
2012	0	10,645	0	10,645	10,645
2013	0	10,643	0	10,643	10,643
2014	0	10,645	0	10,645	10,645
2015	0	10,645	0	10,645	10,645
2016	0	10,647	0	10,647	10,647
2017	0	10,645	0	10,645	10,645
2018	0	10,648	0	10,648	10,648
2019	0	10,645	0	10,645	10,645
2020	0	10,645	0	10,645	10,645
2021	0	10,647	0	10,647	10,647
Total	\$103,660	\$148,393	\$3,733	\$144,660	\$41,000

Source: Department of Legislative Services, February 2006

Because of the large cash-flow needs in the first year, issuing one-year bonds can only be done if there is a substantial fund balance. If the State property tax is reduced by 2 cents, the amount of one-year bonds that can be issued is substantially reduced.

This approach also increases the State's debt capacity. Insofar as debt outstanding is the State's controlling affordability criterion, retiring debt early increases debt capacity \$1 for each \$1 that is retired.

Issuing Bonds that Mature in the First Year, Instead of the Third Year

Article 3, Section 34 of the Maryland Constitution requires that Maryland State debt mature within 15 years of issuance. With respect to GO bonds, State policy is to issue debt that begins to mature three years after issuance. From the third through fifteenth years, debt service payments are fairly constant. This reduces debt service payments in the first two years, since only interest payments are made and no debt is retired. Over the long term, the State maintains a higher amount of debt outstanding and appropriates more for debt service payments, than if debt is retired in the first year.

In fiscal 2007, the State plans on issuing \$675 million in GO bonds. **Table 7** shows that having debt mature after one year increases debt service costs by \$30.6 million in fiscal 2008 and 2009. Beginning in fiscal 2010, debt service costs are reduced by almost \$7 million annually. Over the life of the bonds, debt service costs are reduced by \$26.6 million.

Table 7
GO Bond Debt Service Costs
Savings Associated with Issuing Bonds That Begin Maturing in One Year
Fiscal 2007 Bond Sales

<u>Fiscal Year</u>	<u>Debt Service – Debt Begins to Mature in the Third Year</u>	<u>Debt Service – Debt Begins to Mature in the First Year</u>	<u>Difference</u>
2007	\$8.8	\$8.8	\$0.0
2008	34.6	65.2	-30.6
2009	34.6	65.1	-30.6
2010	71.9	65.1	6.8
2011	71.9	65.1	6.8
2012	71.8	65.1	6.8
2013	71.8	65.0	6.8
2014	71.8	65.0	6.8
2015	71.7	65.0	6.8
2016	71.7	65.0	6.8
2017	71.7	64.9	6.8
2018	71.7	64.9	6.7
2019	71.6	64.9	6.7

<u>Fiscal Year</u>	<u>Debt Service – Debt Begins to Mature in the Third Year</u>	<u>Debt Service – Debt Begins to Mature in the First Year</u>	<u>Difference</u>
2020	71.6	64.8	6.7
2021	71.5	64.8	6.7
2022	71.5	64.8	6.7
Total	\$1,010.1	\$983.4	\$26.6

Notes: Numbers may not sum to total due to rounding.

Source: Department of Legislative Services, February 2006

This debt service analysis assumes that changing maturities does not affect interest rates. This is not always going to be the case. Usually, short-term interest rates are less than long-term interest rates. Consequently, retiring debt in the first two years will reduce a bond sales TIC decreasing debt service costs further. For example, the Delphis Hanover Corporation reports that on February 3, 2006, 10-year bonds (the average maturity for Maryland GO bonds) yielded 3.89% and one-year bonds yielded 3.26%. Under these conditions, issuing debt that begins to mature in the first year reduces debt service costs by approximately \$300,000 over the life of the bonds. However, this will not always be the case. At times, short-term interest rates will be higher than long-term interest rates. If this is the case, issuing bonds that mature in the first year will increase the TIC and debt service costs. The bottom line is that maturities affect interest rates and that reducing maturities usually reduces borrowing costs slightly.

Issuing debt that matures in the first year also reduces total debt outstanding. **Table 8** shows that issuing \$675 million in 2006 reduces debt outstanding by \$31 million at the end of fiscal 2008. This climbs to \$63.6 million in fiscal 2009 and then slowly declines. Insofar as debt outstanding is the State's controlling affordability criterion, debt capacity is increased correspondingly.

Table 8
GO Bond Debt Service Costs
Savings Associated with Issuing Bonds That Begin Maturing in One Year
Fiscal 2007 Bond Sales

<u>Fiscal Year</u>	<u>Debt Outstanding – Debt Begins to Mature in the Third Year</u>	<u>Debt Outstanding – Debt Begins to Mature in the First Year</u>	<u>Difference</u>
2007	\$675.0	\$675.0	\$0.0
2008	675.0	644.0	31.0
2009	675.0	611.4	63.6
2010	637.2	577.2	60.0
2011	597.4	541.1	56.3
2012	555.6	503.3	52.3
2013	511.7	463.5	48.2
2014	465.5	421.7	43.9
2015	417.0	377.7	39.3
2016	366.0	331.5	34.5
2017	312.3	282.9	29.4
2018	255.9	231.8	24.1
2019	196.7	178.1	18.5
2020	134.4	121.7	12.7
2021	68.9	62.4	6.5

Notes: Numbers may not sum to total due to rounding.

Source: Department of Legislative Services, February 2006

Because the costs of this are in the first three years and the benefits are spread over the final 13 years, a policy change to begin retiring debt after one year increases the State's structural deficit over the forecast period if State property tax rates are reduced by 2 cents.

Annual State Property Tax Savings for Homeowners
Effect of Reducing Property Tax Rate 2 Cents and \$0.007
Per \$100 of Assesable Base
From \$0.132 to \$0.112 per \$100 of Assessable Base

<u>Home Value</u>	<u>Current Annual Taxes Paid</u>	<u>Savings with 2 Cent Reduction</u>	<u>Savings with \$0.007 Reduction (007 Bond Cut)</u>
\$100,000	\$132	\$20	\$7
200,000	264	40	14
300,000	396	60	21
400,000	528	80	28
500,000	660	100	35
600,000	792	120	42
700,000	924	140	49
800,000	1,056	160	56
900,000	1,188	180	63
1,000,000	1,320	200	70
1,100,000	1,452	220	77
1,200,000	1,584	240	84
1,300,000	1,716	260	91
1,400,000	1,848	280	98
1,500,000	1,980	300	105
1,600,000	2,112	320	112
1,700,000	2,244	340	119
1,800,000	2,376	360	126
1,900,000	2,508	380	133
2,000,000	2,640	400	140
2,100,000	2,772	420	147
2,200,000	2,904	440	154
2,300,000	3,036	460	161
2,400,000	3,168	480	168
2,500,000	3,300	500	175
2,600,000	3,432	520	182
2,700,000	3,564	540	189
2,800,000	3,696	560	196
2,900,000	3,828	580	203
3,000,000	3,960	600	210

Source: Department of Legislative Services, February 2006

General Fund Subsidies Required to Backfill State Property Tax Rate Reductions
Fiscal 2007 – 2011
(\$ in Millions)

	<u>FY 2007</u>	<u>FY 2008</u>	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>Total</u>
Rate Reduced 1 cent to \$0.122 Per \$100 of Assessable Base	\$0.0	\$0.0	\$0.0	\$32.0	\$49.0	\$81.0
Rate Reduced 2 cents to \$0.112 Per \$100 of Assessable Base (Administration's Proposal)	0.0	37.0	109.0	106.0	112.0	364.0
Rate Reduced 3 cents to \$0.102 Per \$100 of Assessable Base	2.0	137.0	165.0	166.0	175.0	645.0
Rate Reduced 4 cents to \$0.092 Per \$100 of Assessable Base	51.0	191.0	222.0	225.0	238.0	927.0
Rate Reduced to \$0.084 (Fiscal 2003 Rate)	90.0	235.0	266.0	274.0	288.0	1,153.0

Source: Department of Legislative Services, February 2006

The seal of the University of Connecticut is a large, faint watermark in the background. It features a central oak leaf design within a circular border containing the text "UNIVERSITY OF CONNECTICUT".

Using Open Auctions for General Obligation Bond Sales

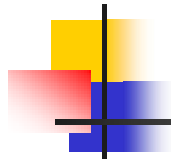
**Prepared for the Legislature of the State of Maryland
February, 2006**

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Our Research

- Our research focuses on possible ways financial managers can improve the debt issuance process and lower costs
 - Examples include our studies of
 - Sale type
 - Interest rate calculations
 - Debt structure
 - Use of professionals
 - Use of bond auctions
 - Management capacity



Open Auctions of Municipal Bonds

- Underwriters bid over internet
 - Observe where they stand in bidding
 - Improve bids as often as they like
 - Bid with lowest interest rate wins
- Issuer pays fee to host of internet bidding
- All other sale details identical to sealed bids



Open Auctions Research

- Robbins, Simonsen & Rocco (2004) study published in *Municipal Finance Journal*
 - Compared open auctions to other competitive sales using data from 2002
 - Findings: Interest costs lower for open auctions
 - On average 9 basis points nationally
 - On average 21 basis points less in states with most experience (CA & PA)

Robbins, Mark D; Bill Simonsen and Christine Rocco. 2004. “Municipal Bond Auctions and Borrowing Costs.” *Municipal Finance Journal* 25(1): 1-16.



Arguments for and against bond auctions

- Arguments for open auctions
 - Best method available today to exploit market demand for high quality bonds
 - Evidence that lower borrowing costs result
- Arguments against open auctions
 - Avoid method if interest costs higher
 - Avoid method if no firms will bid



Frequent bidders for Maryland bonds

- Bear Stearns
- Citigroup
- JPMorgan
- Lehman Brothers
- Merrill Lynch
- Morgan Stanley

All of these firms bid in an open auction on 8/10/2005 for \$400 million of MA GO bonds.

Many regularly bid in other open auctions



Conclusions

- Open auctions have an established track record
 - Evidence of multiple bidders and multiple bids
- Open auctions have potential to lower borrowing costs
- We recommend State of Maryland adopt open auctions and evaluate their performance



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