DEBT CAPACITY ADVISORY COMMITTEE
COMMONWEALTH OF VIRGINIA
December 18, 2014

3:00 P.M.
TREASURY BOARD CONFERENCE ROOM
James Monroe Building
101 North 14th Street, 3rd Floor
Richmond, Virginia 23219

Members Present:	Richard D. Brown, Chairman Elizabeth B. Daley Manju S. Ganeriwala Harold E. Greer Martha S. Mavredes Ronald L. Tillett Robert P. Vaughn David A. Von Moll
Members Present Via Teleconference:	William K. Butler
Members Absent:	Daniel S. Timberlake
Others Present:	Evelyn R. Whitley, Department of the Treasury Bradley L. Jones, Department of the Treasury Sherwanda Cawthorn, Department of the Treasury Neil Miller, Deputy Secretary of Finance Jason Powell, Senate Finance Committee Staff Susan Hogge, House Appropriations Committee Staff Deidre Jett, Department of the Treasury Sandra Stanley, Department of the Treasury Michael Walsh, Department of the Treasury Leah Schubel, Davenport & Company Ty Wellford, Davenport & Company Chris Whyte, Vectre Corporation Vasyl Zuk, JP Morgan

Call to Order and Opening Remarks

Chairman Brown called the meeting to order at 3:12 p.m. and welcomed everyone to the Debt Capacity Advisory Committee ("DCAC" or the "Committee") meeting.

Public Comment Period and Approval of Minutes

Chairman Brown asked if there were any public comments. Ms. Whitley brought to the Chairman's attention that Mr. Butler was listening via conference call. Hearing no other comments, he asked the Committee for a motion to approve the minutes of the October 2014 meeting. Mr. Tillett made a motion to approve the minutes. The motion was seconded by Mr. Vaughn and it was approved unanimously.

Review of the 2014 DCAC Report

Chairman Brown asked Mr. Jones to proceed in presenting the 2014 DCAC report (Exhibit 1). Mr. Jones directed the members to the "Potential Challenges to Fiscal Stability" section of the report. He commented that although Virginia has had some economic challenges over the last year, the Commonwealth has seized new opportunities through the new Virginia Economy with new private sector investment, new and enhanced global export relationships and increased tourism. He added that Virginia continues to face several significant challenges going forward. He proceeded to review the five challenges noted in the report.

Mr. Jones said, as with last year's report, federal fiscal policy remains a top concern for the Virginia economy. He reviewed the issues over the past year regarding withholding and non-withholding revenues. Noted were changes to the capital gains tax that led to a revenue shortfall in non-withholding revenues. He also explained that reductions in federal spending due to sequestration and the federal government shutdown impacted the Commonwealth's higher paying jobs and resulted in a reduction in withholding revenues. Mr. Jones further explained that newly created jobs in Virginia are helping the economy, but that the jobs have not been as high paying as jobs recently lost. Therefore, in fiscal year 2014, Virginia experienced a $66 million shortfall in withholding revenues and it is expected to grow in the current biennium to as much as a $365 million decline in revenues in fiscal year 2016 from what was anticipated last year. Mr. Jones also mentioned that the threat of the elimination of tax-exempt bonds still exists and he stated that higher borrowing costs are anticipated should tax-exempt bonds be eliminated.

Mr. Jones then discussed a second potential challenge to Virginia. He informed the committee that changes in banking regulations, particularly the Basel III Liquidity Coverage Ratio ("LCR"), could become an issue. He explained that the LCR is being implemented to make sure large banks hold a sufficient amount of High Quality Liquid Assets ("HQLA") to cover certain cash outflows that could be experienced in a 30-day period. He informed the Committee that as the rule currently stands, high quality state and local government debt instruments, such as Virginia bonds, do not qualify as HQLA. This treatment of municipal bonds might cause banks' interest in purchasing these bonds to decline. Chairman Brown commented that in the past there has been healthy demand for Virginia paper and the State's bonds have been welcomed by all investors. He then asked if it is staff's opinion that LCR will be a very significant issue. Mr. Jones said that over the past five years bank ownership of outstanding municipal debt grew to $433 billion up from $228 billion in 2009. With banks becoming a larger holder of municipal bonds, the LCR could be a deterrent for them to continue to hold additional municipal debt; therefore, it could have a potential impact on Virginia paper. Ms. Whitley reiterated that banks may be less interested in holding Virginia paper if LCR is indeed implemented in its current form. Mr. Tillett stated he was under the impression that some national level organizations were pushing back on this issue and asked if there is any movement or a feel for what organizations such as the National Association of State Treasurers ("NAST") are doing. Ms. Ganeriwala responded that NAST has actively written letters stating that they do not agree with this policy and that certain rated municipal securities should be included as HQLA. She added that no response has been received from the Securities and Exchange Commission ("SEC"). SEC lawyers have had some discussion with NAST but have not given any indication that the SEC is willing to budge and this could be a potential threat that could result in an increased price of issuing debt. Chairman Brown said the issue was raised with the Virginia congressional delegation earlier in the year, but he has not seen any movement on the SEC's part to change the rule. Mr. Jones said there is one additional impact that LCR will have on Virginia debt. The Commonwealth has a small amount of variable rate debt (1 percent) and those variable rate notes that banks support through liquidity facilities are considered within LCR as an immediate 100 percent cash out flow in a 30 day bank run scenario. Banks have informed the Virginia Treasury that there is a potential for higher costs related to liquidity facilities used to support variable rate debt.

Mr. Jones moved on to the third challenge – Interest Rate Volatility. He commented that rates have not increased, as was anticipated last year, and that the Commonwealth has been able to take advantage of the low rates for new money issuances and the refinancing of older debt. As an example, he mentioned that the Virginia Public Building Authority ("VPBA") recently issued approximately $300 million in refunding bonds resulting in approximately $27 million in savings for the Commonwealth. He said the economy has in some sense been improving and there has been discussion about the Federal Reserve Bank raising interest rates. Speaking of that week's Federal Reserve meeting, he said the Federal Reserve Bank has said that rates will likely begin to rise in the near term, but not in the next couple of months. Mr. Jones added that based on the current amount of authorized and unissued debt that a one percent increase in interest rates could cause a decline in capacity of $52 million annually.

The fourth challenge discussed was the spotlight on retirement liability. Mr. Jones said that in tough budget situations one of the items that can be overlooked is funding pension contributions. He stated Virginia has recently undergone pension reforms that the rating agencies have looked upon very favorably. He mentioned a Moody's report in November 2014 stated that Virginia was at a 41.2% actuarially determined contribution ratio. He said this data contains a lag and the Commonwealth's pension reforms have helped this figure, but Commonwealth leaders should note pension funding is being strongly considered as rating decisions are made.

Mr. Jones then discussed the fifth and final challenge mentioned in the report, financing significant infrastructure needs. The choice for Virginia and the rest of the nation is: to pay costly repairs now, or be faced with even higher replacement costs in the future. He highlighted the steps Virginia has taken to increase transportation funding for infrastructure, which include the gas tax conversion, a sales tax increase, an increasing General Fund transfer and an increase in the car titling tax. He also mentioned that if the Marketplace Equity Act is not passed by Congress by January 1st that Virginia will experience an increase in its wholesale tax on gas. He said that as federal contributions towards transportation and other projects are reduced and delayed, states and local governments must be prepared to fund a larger share of those critical projects. Mr. Jones asked if the Committee had any questions about the challenges presented.

Mr. Jones proceeded to review the 2014 Debt Capacity Recommendations portion of the report. He noted the current capacity calculation result is $459 million.

Mr. Jones then reviewed the three Other Recommendations for the Committee's consideration. The first recommendation was that the General Assembly and the Governor rescind any bond authorizations for projects that are not likely to be issued. This has been included in past reports for the General Assembly and the Governor.

Mr. Jones then spoke about a new recommendation to seek approval for 9 (b) General Obligation bonds ("9 (b)") which must be approved by a voter referendum. He explained that 9 (b) General Obligation bonds are rated "AAA", while the Commonwealth's 9(d) appropriation-backed debt ("9 (d)") is rated "AA+". He said the higher rated "AAA" General Obligation bonds have lesser interest costs than the recently authorized and issued 9(d) bonds. He continued that no 9 (b) debt has been approved since 2002. He stated that rating agencies have noted that 9 (d) appropriation backed debt has increased exponentially compared to 9(b) and the rating agencies have commented about this growth in recent ratings of the Commonwealth. Ms. Daley asked Ms. Ganeriwala for a better understanding of why the rating agencies want us to issue more 9 (b) debt. Ms. Ganeriwala responded that 9 (d) debt is subject to appropriation and there is the risk that not enough money will be approved by the General Assembly or that the budget will not be approved. The main security difference between 9 (b) and 9 (d) is that with 9 (b) you have the full faith and credit of the Commonwealth, so the Commonwealth is required to pay whether there is a budget or not. Chairman Brown reiterated that our "AAA" rating is on General Obligation 9 (b) debt and not 9 (d) debt; he mentioned we are keeping a stellar rating on this debt that we are not using. Mr. Vaughn asked if the rating agencies may be seeking reaffirmation that voters approve of debt issuances. Ms. Whitley said that rating agencies understand the political risk of putting a referendum up for voters. The rating agencies are not averse to our doing 9(d) bonds, but rather they have commented about the amount of appropriation debt outstanding compared to 9 (b) debt. Mr. Tillett stated that issuing some 9 (b) bonds is a good practice because it is cheaper debt and an easier sell to investors. Chairman Brown said that not all Commonwealth debt may be appropriate 9 (b) debt. Ms. Daley commented that politically it would be tough to get 9 (b) debt passed or accepted. Discussion continued among Committee members regarding the possibility of the Commonwealth seeking a referendum for 9 (b) debt.

Ms. Whitley referred everyone to the Outstanding Tax-Supported Debt by Category chart on page 11 of the report which illustrates the amount of General Obligation debt outstanding compared to other tax-supported debt. She mentioned that in the chart, the General Obligation debt includes both 9 (b) and 9 (c) revenue backed debt, but that at fiscal year-end 2014, the 9 (b) debt only amounted to $706 million. Mr. Jones said that there would be hurdles in seeking additional 9 (b) authorization, but that 9 (b) is something to consider as an additional debt tool. He added that a selling point to the voters is that 9 (b) is cheaper than 9 (d) that would otherwise be used. Ms. Ganeriwala commented that in addition to the comments by rating agencies, large investors have also asked about the issuance of 9 (b) debt. Mr. Vaughn asked was this questioning because those types of investors are looking for 9 (b) debt. Ms. Whitley confirmed that investors are interested in purchasing 9 (b) debt. Ms. Ganeriwala also said that a delay in adopting the 2014 budget generated many calls from institutional investors regarding the payments of 9 (d) appropriation debt. Mr. Tillett asked Mr. Wellford of Davenport, who was in the audience, his perspective when going out to investors to sell paper: do those investors have thresholds on certain types of debt that they will hold in their portfolio. Mr. Wellford stated that there are certain thresholds, especially with appropriation backed debt, but that investors would love to see more Commonwealth GO debt that is not dependent upon the budget being passed. He added that investors can reach their fill of a certain security type and may look to something other than VPBA or Virginia College Building Authority ("VCBA"), but rarely would they reach their fill on General Obligation debt.

Mr. Jones continued with a third and final Other Recommendation. He said that as has been included in past recommendations, the Commonwealth should continue to use traditional financing methods such as those offered through VCBA, VPBA and 9 (b) and 9(c) General Obligation debt rather than conduit borrowings and capital leases. He said that traditional financings are more affordable than capital lease obligations. Mr. Tillett mentioned that some financing programs such as Energy Performance Contracting can be good cost efficient tools, so we should make sure our comments don't discount this tool. Ms. Whitley agreed and suggested that the recommendation be changed to add bonded to the references to capital leases.

With no further discussion regarding the recommendations, Mr. Jones asked the Committee to review trends in the tax-supported debt section on page 10. He reminded the Committee that the charts on page 10 and 11 include long-term obligations such as pension liabilities, OPEBs and compensated absences. He reminded the Committee that these items are not included in the debt capacity model, but the obligations are items that rating agencies consider; therefore, these items are included in the tax-supported debt section of the report. Mr. Jones stated that there had been an increase of 164% in outstanding tax-supported debt over the last 10 years with an increase from $5.9 billion in fiscal year 2005 to $15.5 billion in fiscal year 2014. He commented that over the last year, tax-supported debt had 6 percent growth equating to an increase of $815 million. Mr. Vaughn asked if the increase of tax-supported debt in the comparison years accounted for changes to GASB's treatment of obligations such as pensions and OPEBs. Ms. Whitley and Mr. Von Moll stated that these items have been added over the years, so 2014 is not an apples to apples comparison with 2005. Mr. Jones said the OPEB item was added in 2008. Mr. Von Moll said the GASB and pension standards would be something to be considered with new pension standards coming in the next year and that it is going to be something the Committee will need to decide how to include in future reports. Mr. Von Moll continued by stating the OPEB items would not be a huge change, but the new pension standards will likely have a large impact. It was reiterated that the other liabilities aren't part of the model, so in terms of debt capacity there should not be an impact. Mr. Jones reminded the Committee that we show all of the information in the report because it's considered by rating agencies. Mixed with the pension and OPEB discussion, Mr. Jones reviewed the growth statistics of the General Obligation debt, the 9 (d) debt and the other long-term liabilities. Following the discussion of outstanding tax-supported debt, Mr. Jones reviewed highlights of the amounts and types of tax-supported debt recently authorized. He then reviewed the amounts of debt issued in recent years and stated that significant debt issuances will likely continue in the coming years as authorized and unissued debt goes to market. He reminded the Committee that the authorized and unissued debt as of

June 30, 2014 amounted to $5.44 billion, of which $4.79 billion is for 9 (d) projects. Mr. Jones reviewed the recent uses of tax-supported debt saying that in the last 10 years, 53 percent was used for higher education capital projects and teaching and research equipment. He mentioned transportation projects were the next highest category at 19 percent.

Mr. Jones then commented on the Review of State Credit Ratings section of the report. He informed the Committee that the rating agencies continue to note Virginia's credit strengths: long-standing history of pro-active and conservative financial management, a manageable debt burden controlled through a debt affordability model, strong financial policies and practices, pension reform, and a diverse economy that has fared better than the nation. He also mentioned challenges noted by rating agencies that include: spending pressures from education and transportation needs, managing the effects of a sluggish economy, and the state economy's direct linkage to the U.S. Government.

He said it is apparent the rating agencies are closely watching Virginia's actions. He stated that in an August 2014 G.O. ratings report, S&P applauded the Commonwealth's prompt actions to correct the revenue shortfall, but expressed concern about the planned depletion of the revenue stabilization fund. Mr. Jones said it should be noted that another deposit estimated at $160 million will be made in fiscal year 2017 if the current revenue forecast holds true.

Mr. Jones concluded the review of the report by discussing a Review of Comparative Ratios. He provided an overview of Moody's *2014 State Debt Medians Report*. He noted that Moody's commented that there has been a decline in the issuance of tax-supported debt by states due in part to a new conservative attitude towards debt. He then mentioned Virginia is ranked in 2014 as having the 19th highest debt per capita with a level of $1,302, a slight decline from $1,315 in 2013 with no change in ranking. Nationally net tax-supported debt as a percentage of personal income decreased to 2.6 percent from 2.8 percent, a level that has been maintained since 2011. Virginia experienced a decline in net tax-supported debt as a percentage of personal income with a 2014 level of 2.7 percent compared to 2.9 percent in 2013. The Commonwealth's ranking fell from 22nd to 24th in the net tax-supported debt as a percentage of personal income category.

Mr. Jones asked if members had any questions about the aforementioned items in the report. Upon hearing no further questions on the report, Mr. Jones asked the Committee to refer to the Appendix portion of the report. He began by reviewing the target result of the model and the inputs and assumptions. He informed the Committee that the 2014 model interest rate is 4.09%, which is an 8 basis point decline from last year. He then reminded the Committee of the inputs to form the Blended Revenues figure. Mr. Jones also reviewed the types of debt included in the model. He reminded the Committee that Moral Obligation debt, which is issued through the Virginia Resources Authority ("VRA"), is not included in the standard model. He explained that only if a default on the Moral Obligation debt occurred would the debt be factored into the model. Mr. Jones stated that the Committee looks at the Moral Obligation debt default as a worst case scenario and that the capacity calculation of this scenario follows in the Moral Obligation and Contingent Liabilities section of the report.

Mr. Jones proceeded to review the currently authorized tax-supported debt issuance assumptions section. He stated that as of June 30, 2014, $4.8 billion of debt is authorized and unissued. He reminded the Committee that the amount excludes the additional 9 (c) debt since that is not factored into the model. He also reminded members that no debt is proposed for 9 (b) and that option is something to be considered for the future. Mr. Tillett asked if staff were aware of any requested legislation at this point to increase debt capacity, such as the creation of new debt financing mechanisms or an increase in Moral Obligation capacity. Chairman Brown commented that he isn't aware of any new mechanisms or requests to increase Moral Obligation capacity, but that in the introduced budget there is approximately $83 million in tax-supported debt of which $28 million is allocated for voting machines through VPBA, $50 million is for equipment and $5 million is for maintenance reserve.

Mr. Jones then reviewed the Debt Capacity model solution and noted that the last six years have significant amounts of capacity that result in an average capacity of $459 million. This is a decline from last year's capacity of $560 million. He explained that the decrease is due to the revenue decline and the additional debt authorized in last year's budget. He then reviewed the average model which assumes that average capacity of $459 million is authorized and issued in each model year. He explained that with the average model the five percent threshold would be exceeded in six of ten years with a high of 5.66% in fiscal year 2017. There was also a bottleneck last year with a high of 5.48% in fiscal year 2017. Last year, modeled capacity exceeded 5 percent in 5 years rather than 6 years. Chairman Brown asked if the Committee had any questions. Mr. Vaughn asked if the currently proposed debt from the introduced budget is included in the debt capacity report. Chairman Brown said the current capacity calculation does not include the proposed debt as debt is not included until it is authorized by the General Assembly. He said staff can run options of what the model would look like including the proposed budget items if the Committee desires to see those options. Mr. Jones said the model also does not take into consideration any savings generated by refundings or debt service caused by debt issuances after June 30, 2014, such as a $275 million Commonwealth Transportation Board ("CTB") bond issuance and VPBA bonds of which $161 million was new money and $300 million was refunding which generated savings of $27 million. For model purposes it was explained that the model interest rate is assumed for these issuances rather than the true interest rates, which were fortunately lower than the model. Mr. Jones asked if there was any further discussion on the solution pages. Hearing none, he then mentioned to the Committee that a chart is included on page A-9 showing the basis of the Blended Revenues.

Mr. Jones then reviewed the sensitivity analysis in the Appendix. He explained that if the model was altered to reduce the standard two-year excess capacity to one year, the resulting capacity would increase to $501 million and with no excess capacity the capacity would increase to $551 million. He then explained that if the model solution is altered to assume a change in revenues of $100 million in each and every year the incremental change is $5.73 million. He stated that if a 1 percent change of revenue is assumed in each and every year the incremental change would be $15 million. The final sensitivity scenario assumed a change in interest rates. By adding 100 basis points to the base rate, the capacity was explained to decline to $407 million and with a 100 basis point decrease to the base rate capacity would increase to $519 million.

Mr. Jones then transitioned to review the moral obligation and contingent liability section of the Appendix. He began by quickly reviewing a chart showing all debt of the Commonwealth. He reminded the Committee that the tax-supported debt totals $15.5 billion. He mentioned VRA is currently the only Moral Obligation debt issuer and they have $831 million outstanding through the Moral Obligation program. He mentioned the Virginia Public School Authority ("VPSA") has two items considered to be contingent liability debt: the VPSA's 1997 resolution debt and the VPSA's equipment and technology notes, which collectively total $2.88 billion. He stated other debt not supported by taxes totals $18.3 billion for a grand total of $37.5 billion of Commonwealth related debt. Ms. Daley asked if the compensated absences shown are for just state employees, or is it for the State's share of all employees. Ms. Whitley said the number comes from the CAFR and Mr. Von Moll confirmed the number would be for all employees. Ms. Daley also asked if the same would hold true for OPEB and pension liability. Mr. Jones said the CAFR has two amounts and it's the collective amounts that are shown for the other debt in the report. Mr. Tillett asked Mr. Von Moll how lottery prizes are categorized and why it shows up as a debt obligation. Mr. Von Moll said the number represents unclaimed lottery prizes.

Mr. Jones then discussed the moral obligation section of the appendix. He stated that if the Model solution was altered to include the conversion of all VRA moral obligation debt that the model would result in an average capacity amount of $390 million. He then explained that if the model solution was altered to include the VPSA's sum sufficient appropriation related debt that it would result in a decrease in the capacity to $219 million. Ms. Whitley added that there are several safety mechanisms in place that would have to fail before the sum sufficient VPSA debt would be factored into the model.

Motion to Adopt Final Report and Recommendation of Debt Authorization

Chairman Brown then asked for a motion to adopt the final report and a cover letter that is to include a recommendation that $459 million can be prudently authorized in 2015 and 2016. Mr. Von Moll made the motion, which was seconded by Mr. Vaughn. The Committee voted unanimously to approve the motion; however, Mr. Butler abstained since he was participating via teleconference and his alternate location hadn't been included in the notice of public meeting.

With no further business, the meeting adjourned at 4:25 p.m.

Exhibits may be obtained by contacting the Department of Treasury at (804) 225-2142.