Bonding and Debt Service

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Legislative Fiscal Division

MONTANA LEGISLATIVE FISCAL DIVISION

Contents

Acronyms/Abbreviations in This Brochure

CP – Capital project funds
DS – Debt service
GF – General fund
GO – General obligation (bonds)
IDGF – Indirect general fund
LRBP – Long-Range Building Program
REV – Special revenue bonds
SS – State Special Revenues

Definitions of Terms as used in this Brochure

- Debt service – The annual payments of principal and interest on state bond issues
- State Debt – Bond issues used for purposes authorized by the legislature, does not include long-term notes, bonded debt issued by MUS, or pension obligations
- Indirect General Fund – debt payments using dollars that would flow into the general fund if not paying debt service

Introduction

This primer provides a comprehensive overview of the long-term bonded debt position of the Montana state government, including an analysis of the current outstanding debt and the associated debt service. The state has used debt financing sparingly over the past decade. The authorization of new bonded debt has been low in recent biennia, and most new bond issues sold by the state have been for the purpose of refunding/replacing existing issues with lower interest rate issues.

Montana Debt Ratings

Montana continues to maintain a favorable debt rating[1] from the bond rating agencies on general obligation bond issues (GO). The rating agencies site the following as strengths in the rating[2]:

- Conservative fiscal management
- Low debt levels
- A growing and diversifying economy

The state does not have the highest rating of AAA for stated reasons that include:

- Continued dependence on natural resources, agriculture, and tourism in the tax base
- High pension liabilities and low funded ratios

Montana ranks well when compared to the country as a whole as provided in the 2015 State Debt Medians Report by Moody's Investor Services. In comparison with the 44 states that issue tax supported debt, with lower debt states having a higher rank, Montana ranks as follows:

- 43rd in gross tax supported debt
- 42nd in tax supported debt per-capita; $247
- 41st in net tax supported debt as a percent of personal income; 0.6%

[1] Standard and Poor's (S&P) – AA/Stable and Moody's Investor Service – Aa1/Stable on 2015C GO bonds
[2] Moody's and Standard and Poor's (S&P) as paraphrased for this report.

In summary, Montana has a high ranking, but not the highest, on GO bonds and compares favorably to the other states that issue GO bonds, given the state's low outstanding debt. The ratings could improve with diversification of the tax base and further improvements to the state's pension system, and could deteriorate with substantial declines to the state's economic outlook and the general fund reserves or the issuance of substantial amounts of new debt.

State Debt Requirements and Authority

The Constitution, as excerpted below, guides Montana state government in the issuance of bonded debt.

"Article VIII. Section 8. State debt. No state debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon. No state debt shall be created to cover deficits incurred because appropriations exceeded anticipated revenue."

Article 8 includes two requirements that the legislature must abide by when authorizing and using debt financing, explained as:

- New debt must be approved by two-thirds of each house of the legislature
    - The state citizens, through voter initiative, may approve debt with a majority vote
- The second sentence has historically been interpreted to mean that bond proceeds cannot be used for the ongoing costs of state government operations
    - Debt financing may be used for the purposes of capital construction and land acquisition
    - Debt financing may be used for non-continuing costs or unusual state government costs, such as the state's costs of tribal water compacts

The Constitution does not include any limitations on the amount of debt that may be issued. However, statutory limitations exist for certain reoccurring bond issue types. A full list of the debt limitations is available upon request.

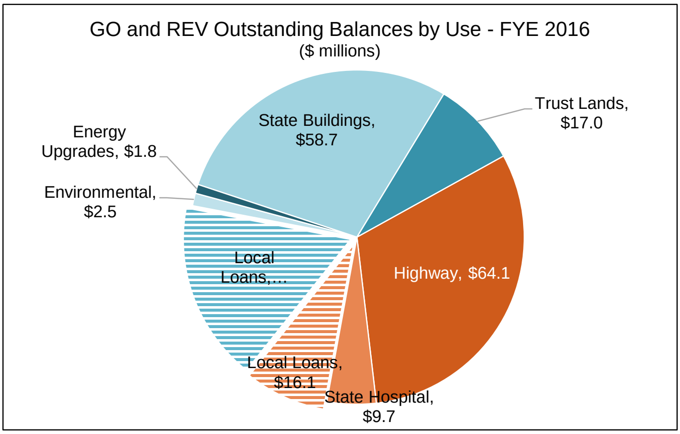
In recent history, bond issues have only been authorized by the legislatures, and with the exception of coal severance tax bonds (authorized in the Renewable Resources Loan program that are authorized in each biennium) the legislature has only authorized the issuance of GO bonds in a few cases, which include:

- 2005 Legislature, HB 540 – Authorized a total of $68 million for state building projects, the state share of a tribal compact, and a water infrastructure project (partially issued to date)
- 2011 Legislature, HB 49 – Authorized $16.0 million for the state share of a tribal compact (not issued to date)

Total State Bonded Debt

From information provided in Montana's FY 2016 Comprehensive Annual Financial Report (CAFR), the total state bonded debt, including general obligation bonds (GO) and special revenue bonds (Rev), is $205.3 million (GO-$115.5m, Rev-$89.8m). This debt financed activities such as:

- Costs of state land purchases, building construction and improvements, and state building energy upgrades
- Highway construction
- State share of environmental (superfund site) cleanup
- Loans to local governments for infrastructure improvements



The pie chart on the previous page provides the fiscal year end 2016 outstanding bond balances for all GO and Rev bonds. Sections of the pie shown in blue are GO bonds while the orange sections highlight the Rev bonds.

Debt Service

The Constitution, as excerpted below, guides state government in the payment of the state debt obligation:

"Article VIII. Section 14. Prohibited payments. Except for interest on the public debt, no money shall be paid out of the treasury unless upon an appropriation made by law and a warrant drawn by the proper officer in pursuance thereof."

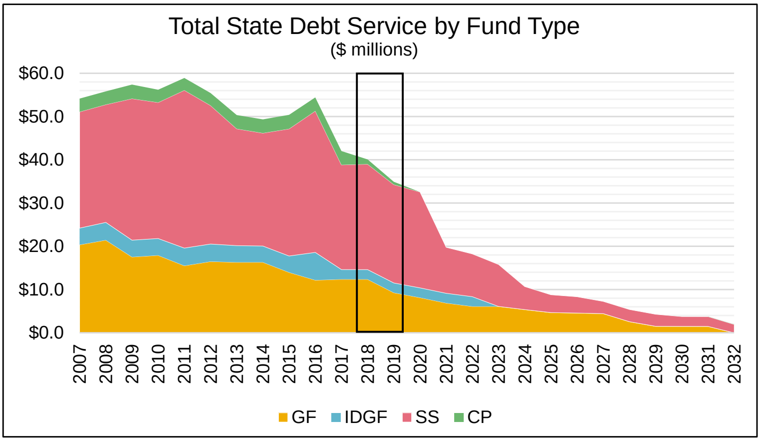
However, the laws do accommodate the payment of debt service, including interest and principal, via statutory appropriation as provided in law as follows:

"17-7-502 (4) There is a statutory appropriation to pay the principal, interest, premiums, and costs of issuing, paying, and securing all bonds, notes, or other obligations, as due, that have been authorized and issued pursuant to the laws of Montana."

The debt service associated with all bond issues is an obligation to various fund types including:

- General fund (GF) - Gold
- Indirect general fund (IDGF), which are dollars that would flow into the general fund if not paying debt service - Blue
- State special revenue funds (SS) - Pink
- Capital project funds (CP) - Green

The figure on the following page provides the total debt service related to the state's bond issues by fund type over a 25 year period. The observations through FY 2016 are actual payments while the remaining observations through 2032 are projections based on the amortization schedules of the various issues. In the 2019 biennium, the total debt service on bond issues is expected to average $37.5 million per year.

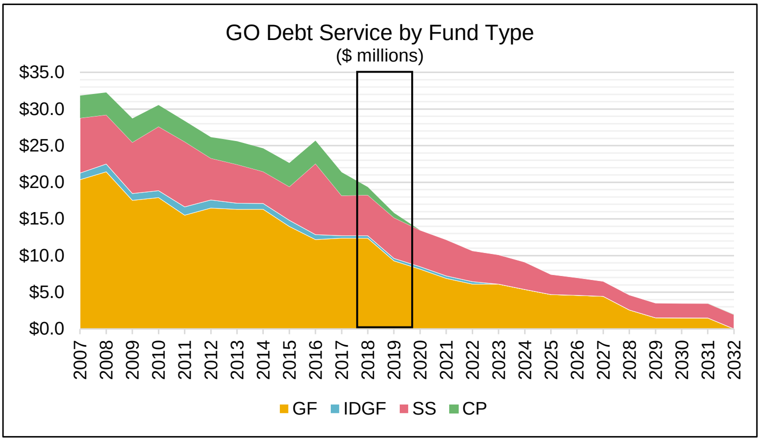


Among the data in the chart is debt that the state has issued to make loans to local governments for infrastructure improvements. Projects consist primarily of drinking water, wastewater, and irrigation systems. The debt service associated with these bond issues, while paid from state special revenue funds (SS), consists of loan payments made to the state on the debt. In the 2019 biennium, an average of $7.6 million or 20.2% of the total debt service, is made through loan payments.

General Obligation (GO) Debt Service

GO bonds are bonds that are guaranteed with the full faith, credit, and taxing power of state government. GO bonds are used for most of the same purposes as discussed in the total state debt section, with the exception of highway construction funding. While pledged with the full faith and taxing power of the state, the debt service on the bonds is not always paid by the state general fund.

The following figure shows the mix of funding that used to pay the debt service on the $115.5 million of outstanding GO debt. The mix of funding has changed over time. In the 2019 biennium, GO debt service will average $17.6 million/year.



Of that amount, the general fund will pay for 61.5% of the debt service costs on GO bonds and 29.4% of the total will be paid through loan payments.

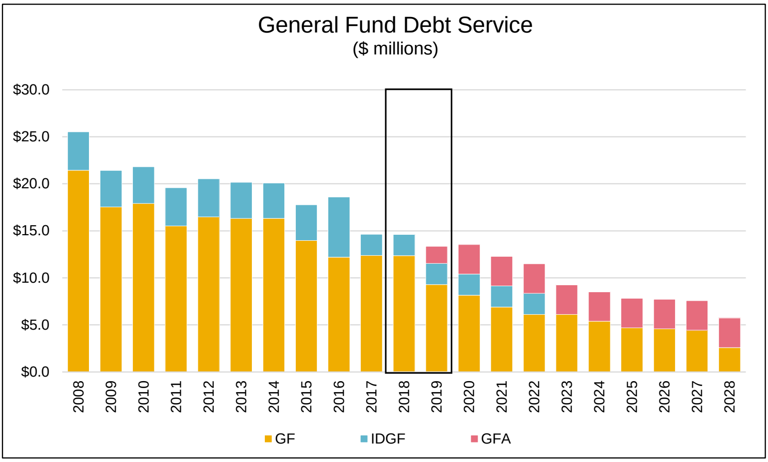
General Fund Supported GO Debt Service

Gold Bars: The general fund is projected to be obligated to the payment of an average of $10.8 million/year of GO bonded debt in the 2019 biennium, as shown in the gold bars as GF, when considering only the currently issued debt. Currently issued general fund debt service is projected to be fully paid by FY 2032.

Blue Bars: The figure includes indirect general fund shown as IDGF in the blue bars. As mentioned earlier, this is debt service paid by dollars that would flow into the general fund if not paying debt service and in the figure includes some special revenue bond debt service. In the 2019 biennium, this category of debt service adds an average of $2.2 million/year to the general fund debt service, bringing total general fund supported debt service to an annual average of $13.1 million.

Pink Bars: In addition to the current issued debt, the legislature has provided the authority to issue $42.2 in GO bonds, which if issued would be an obligation of the general fund. The associated projected debt service, shown as GFA in the pink bars, includes:

- o The Montana Heritage Center, $6.715 million, 2005 Legislature HB 540: would be issued if additional project funding through donations or the state becomes available
- o The St. Mary's Diversion System, $10.0 million, 2005 Legislature HB 540: must be a match to federal appropriations for the project
- o Ft. Belknap Tribal Water Compact, $9.5 million, 2005 Legislature HB 540: as the state share only issued with Congressional and Tribal approval of the compact
- o Blackfeet Tribal Water Compact, $16.0 million, 2011 Legislature HB 49: as the state share only issued with Congressional and Tribal approval of the compact- Note: Congress passed the Blackfeet Tribal Water Compact in December, 2016. At this time, there continues to be uncertainty related to when the bonds will be issued.

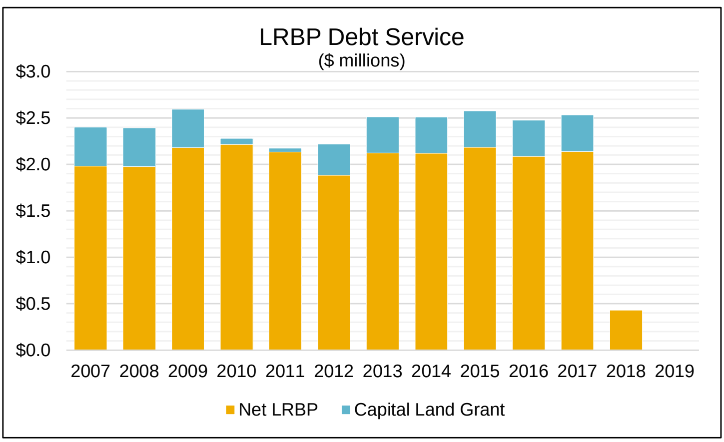


Should the state start issuing all the currently authorized bonds in the 2019 biennium, under LFD assumptions, the general fund debt service obligation is projected to increase by $1.8 million in FY 2019.

Long-Range Building Program Debt Service

Over time, legislatures have been resourceful in their payment of bonded debt. In the mid to late 1990's, when debt financing for capital construction and maintenance was more commonly used, the legislature chose to pay GO debt service with the revenues of two Long-Range Building Program (LRBP) capital project funds. This debt is nearing maturity and when it does in FY 2019, the debt service will cease.

The following figure provides the "net LRBP" debt service expenditures. The data is shown as net due to a 1997 Legislative decision that required the general fund to offset the LRBP debt service payments on three specific bond issues at an amount of $665,000 per year. Since that time, the specific bonds have been refunded, or replaced with lower interest rate issues, but that offset has continued on the refunding issues. In FY 2019, the offset would be greater than the remaining debt service cost, and it is assumed that the LRBP costs will be fully paid by the funding offset.



For 20 years, the debt service paid from the LRBP funds has reduced available revenues that might have otherwise been used for construction and maintenance projects. As the debt service obligation concludes, there will be approximately $5.0

million per biennium from both of the funds that would become available for either capital projects or new debt service.

Conclusion

While the legislature has not provided authority for new debt financing recently, the use of debt financing has historically been an important capital improvement financing tool for the state. With debt financing, the state has been able to fund the costly endeavors of maintaining and constructing buildings, providing the state share of tribal compacts, affording assistance to local governments for infrastructure needs, and remediating damage to state lands. The overall decline of debt service costs will make state funds available for other state needs or to support new debt financing in future years.