Bonding and Debt Service

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MONTANA LEGISLATIVE FISCAL DIVISION

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Acronyms/Abbreviations in this brochure

CPF – 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
SSR – State Special Revenues

Definitions of Terms used in this brochure

- Amortization schedule - a complete table of periodic loan payments, showing the amount of principal and the amount of interest that comprise each payment until the loan is paid off at the end of its term.
- Bond proceeds - the funds that are advanced by the bond purchaser to the bond issuer.
- Debt service – the annual payments of principal and interest on state bond issues.
- General fund general obligation bonds/debt – bonds issued as general obligation bonds of the state that are payable from the general fund and that are not payable from or secured by funds or specific sources of revenue outside the general fund (17-5-802, MCA).
- Indirect general fund – debt payments using dollars that would flow into the general fund if not paying debt service.
- 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.

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, but the 2019 Legislative session authorized $79.9 million of general fund general obligation debt. The 2019 Legislature also placed limitations on the amount of state general fund general obligation bond debt that the legislature may authorize. More information on debt limitations is provided throughout this brochure.

Montana Debt Ratings

Montana maintains a favorable debt rating as evidenced in the recent ratings related to the series of 2020 bond issues. The bond ratings on general obligation bond issues (GO) for Montana bonds are: Aa1 (Moody's), AA (Standard and Poor's), and AA+ (Fitch). The rating agencies have historically cited the following as strengths in the rating:

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

The state does not have the highest rating of AAA, and the reasons historically cited include:

- Continued dependence on natural resources, agriculture, and tourism taxation in the tax base
- Pension liabilities and low funded ratios
- Loss of management control resulting from public initiatives

Montana ranks well when compared to the country as provided in a report by Moody's Investor Services[i]. In a comparison with all the states, with lower debt states having higher rankings, Montana ranks as follows:

- 47th in net tax supported debt (thousands); $113,753
- 47th in tax supported debt per-capita; $106
- 47th in net tax supported debt as a percent of personal income; 0.2%
- 47th in net tax supported debt as a percent of gross state product, 0.22% (an improvement of 0.17% since 2017)

In summary, Montana's GO bonds are highly ranked, but not as high as possible. The state debt rankings show the state to be among those with the lowest amount of debt prior to the recent issues of FY 2020 and FY 2021, especially when considering that two of the states that are more highly ranked do not issue GO bonds. The state debt ratings could improve with diversification of the tax base and further improvements to the state's pension system. The ratings could deteriorate with substantial declines to the state's economic outlook and/or the general fund reserves.

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 are provided in 17-5-802, MCA, where the amount of debt the legislature can authorize and the amount of debt service the state is obligated to pay from the general fund are limited.

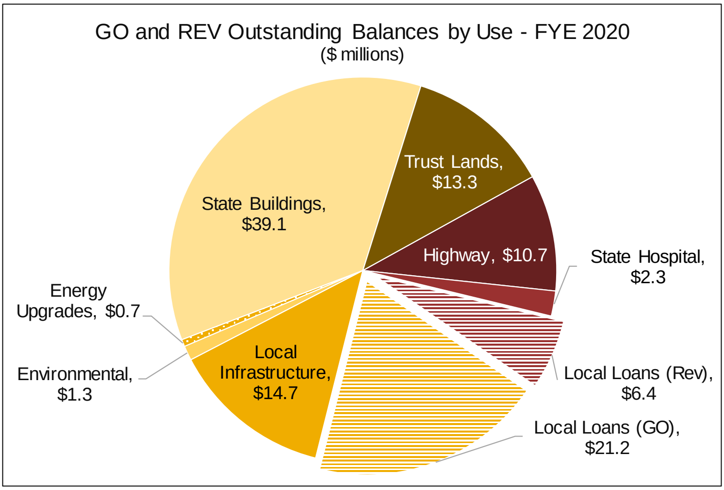
In recent history, bond issues have only been authorized by the legislature. Each biennium coal severance tax (CST) bonds, which are special revenue bonds, are authorized in the Renewable Resources Loan program. Recent GO bond authorizations include:

- 2019 Legislature, HB 652 – Authorized $79.9 million for state and local government infrastructure projects (in the issuance process)
- 2011 Legislature, HB 49 – Authorized $16.0 million for the state share of a tribal compact (not issued to date)
- 2005 Legislature, HB 540 – Authorized a total of $68 million for state building projects, the state share of a tribal water compact, and a water infrastructure project (partially issued)

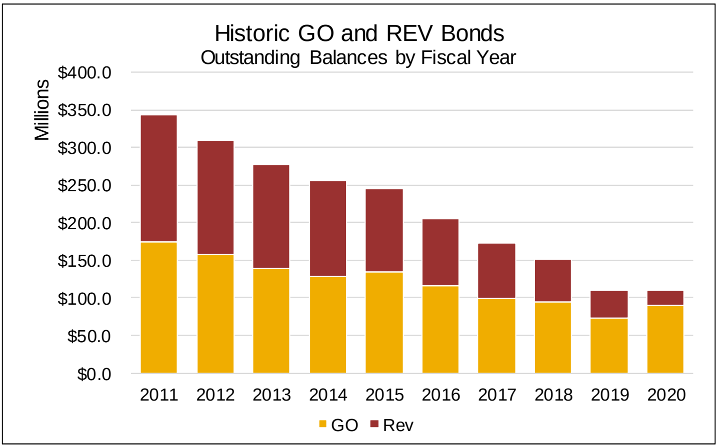
Total State Bonded Debt

From information provided in Montana's FY 2020 Comprehensive Annual Financial Report (CAFR)[ii], the total state bonded debt, including general obligation bonds (GO) and special revenue bonds (Rev), is $109.6 million (GO-$90.3m, Rev-$19.3m). This debt financed activities such as:

- Costs of state land purchases, building construction and improvements, and state building energy upgrades
- State assistance for local infrastructure improvements
- 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 2019 outstanding bond balances for all GO and Rev bonds. Sections of the pie shown in gold are GO bonds while the burgundy/red sections highlight the Rev bonds.



As shown in the figure above, the state's debt balances have declined over time. Between FY 2011 and FY 2020, the debt balances have declined by an annual average rate of 12%.

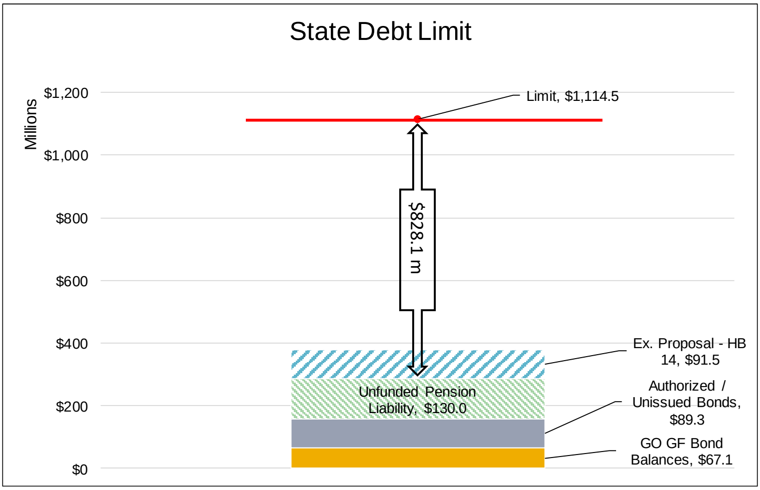
While the outstanding debt balances have been declining, the issuance of GO bonds authorized by the 2019 Legislature (HB 652) has and will continue to increase the outstanding balances of GO debt. In FY 2020, $32.8 million of the $79.9 million in HB 652 authority was issued. As of December 2020, the state issued $40.2 million of the bonds related to HB 652, $3.8 million of authority for the St. Mary's diversion system, and $6.7 million of the bonds authorized for the Montana Heritage Center[iii].

Authorization Limit – State Debt

As amended by the 2019 Legislature, 17-5-802, MCA prohibits the legislative from authorizing new general fund supported GO bonds if the authorization would cause "state debt" to exceed 0.6% of the fair market value of the taxable property of the state ($1,114.5 million). State debt is defined as:

- The outstanding principal of issued general obligation bonds paid from the general fund as of July 1 of the even numbered fiscal year ($67.1 million in 2020)

- The principal amount of all authorized but unissued general obligation bonds paid from the general fund ($89.3 million)
- The total amount of unfunded actuarial accrued liability of the public retirement systems established in Title 19 that does not amortize in 30 years as identified in those systems' most recent actuarial valuation of the assets and liabilities of their plans ($130.0 million)



The current calculation of the gap between the limit and current state debt is $828.1 million. This gap would allow a substantial amount of bonded debt to be issued, and it is unlikely that the legislature would authorize that amount of bonded debt. However, the gap also provides for the potential of increases in the unfunded pension liability in the future, as well as the authorization of new debt. Because this is a point-in-time measure, it will be subject to change each time the calculation is made. As seen in the figure above, the 2023 biennium proposal in the executive budget is allowed under this limit.

Debt Service

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

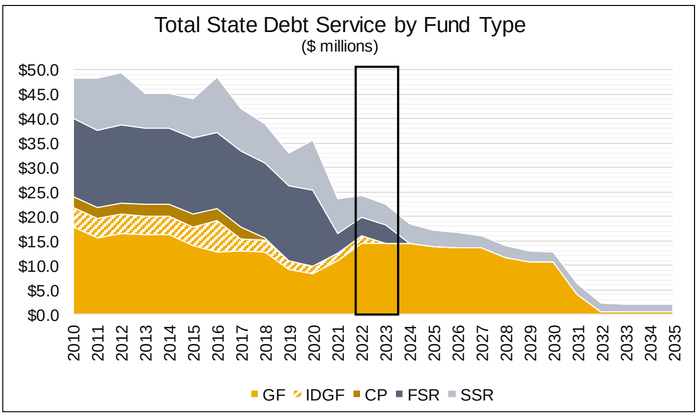
"Article VIII. Section 14. Prohibited payments. Except for interest on the public debt, no money shall be paid out of the treasury unless upon an appropriation made by law and a warrant drawn by the proper officer in pursuance thereof."

However, the laws do accommodate the payment of debt service including bond issuance costs, interest, and principal via statutory appropriation 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."

Total State Debt Service

The figure below provides the total debt service related to the state's bond issues by fund type over a 25-year period.



The chart above shows the debt service for all GO and Rev bonds issued through October of FY 2021. The observations through FY 2020 are actual payments while the remaining observations through 2036 are projections based on the amortization schedules of the various issues. In FY 2020 total debt service on bond issues was $35.7 million and in the 2023 biennium is expected to average $23.4 million annually barring any additional issues.

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

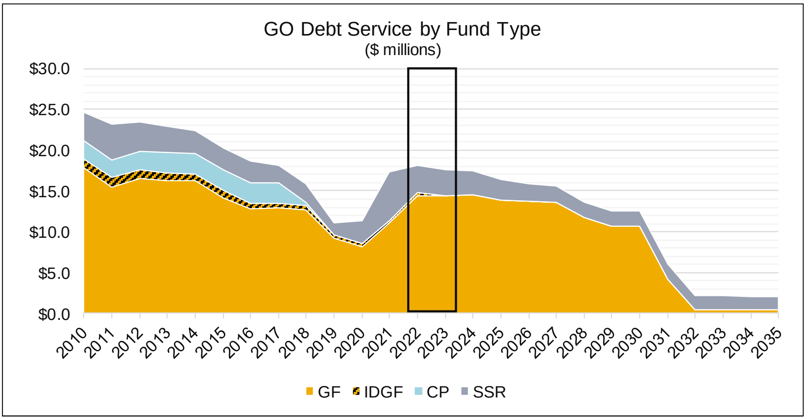
- General fund (GF) - Gold
- Indirect general fund (IDGF), which are dollars that would flow into the general fund if not paying debt service – Gold Hatched
- Capital project funds (CPF) - Tan
- Federal special revenue funds (FS) – Dark Gray
- State special revenue funds (SS) – Light Gray

This chart includes debt that the state has issued to make loans to local governments for infrastructure improvement projects. The proceeds of the bonds are primarily used for drinking water, wastewater, and irrigation system projects. The payment of debt service associated with these bonds, while paid from state special revenue funds (SSR), consists of loan payments made to the state on the debt. In the 2023 biennium, an annual average of $4.0 million or 16.7% of the total debt service, is made through loan repayments.

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. 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.

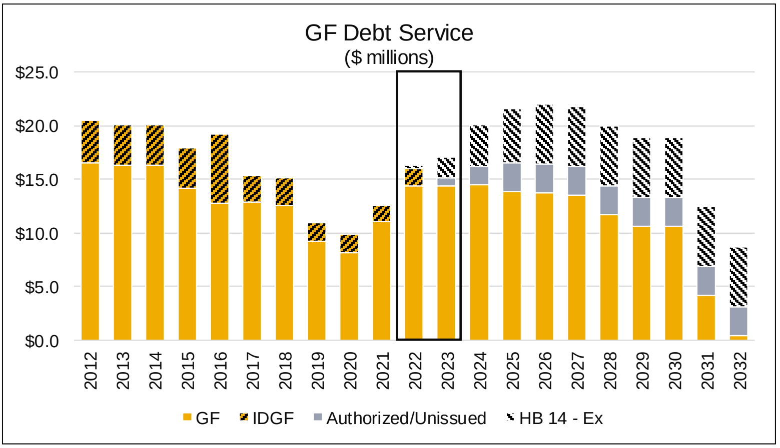
The following figure shows the mix of funding used to pay the debt service on the current $90.3 million of outstanding GO debt. The mix has changed over time. In the 2023 biennium, total GO debt service will average $17.9 million/year.



Of that amount, the general fund will directly pay for 80.7% of the debt service costs on GO bonds (81.6% when including the IDGF) and 16.4% of the total will be paid through loan repayments.

General Fund Supported GO Debt Service

The following table illustrates current debt service and includes projections for authorized but unissued debt service, as well as projections in the executive proposal to authorize bonds for state and local infrastructure improvements (HB 14-$91.5 million).



- Gold-GF – General obligation (GO) bonds paid by the general fund. The bond issues related to this debt service primarily funded the construction of state government buildings and beginning in FY 2019 local government infrastructure projects ($30.2 million in the 2023 biennium)
- Gold Hatched IDGF – This category includes special revenue bonds that are paid indirectly through the general fund. The related bond issue covered the costs of improvements at Montana State Hospital. Debt service on this bond is paid by funds that would otherwise flow into the general fund. The issue is expected to be paid in full in FY 2022 ($1.5 million in the 2023 biennium)
- Grey (Authorized/Unissued) – This category includes the projections for debt services costs on authorized but unissued bonds ($38.3 million of authority). The bonds are authorized for the costs of two tribal compacts, the St. Mary's diversion system improvements, and the balance of the bonds authorized by the 2019 Legislature (HB 652). With uncertainty for when these bonds may be issued, only the remaining authority for HB 652 is projected to be issued in the 2023 biennium, the remainder is projected to be

issued in the 2025 biennium ($0.7 million in the 2023 biennium)
- Black Hatched (HB 14-Ex Projection) – This category illustrates the debt service costs of the HB 14 as shown on the executive balance sheet ($2.4 million in the 2023 biennium)

The debt service paid directly and indirectly through the general fund for existing bond issues is expected to be $16.0 million in FY 2022 and $15.1 million in FY 2023. The debt service for the executive proposal in HB 14, as calculated by the executive, is based on 20-year maturities and are expected to be sold in five issues. The bonds are projected to have a general fund debt service cost of $0.4 million in FY 2022 and $2.0 million in FY 2023. Including HB 14, total debt service is expected to be $16.4 in FY 2022 and $17.1 million in FY 2023. Once all bonds are issued, the projected annual cost HB 14 debt service would be $5.6 million per year.

Long-Range Building Program Debt Service

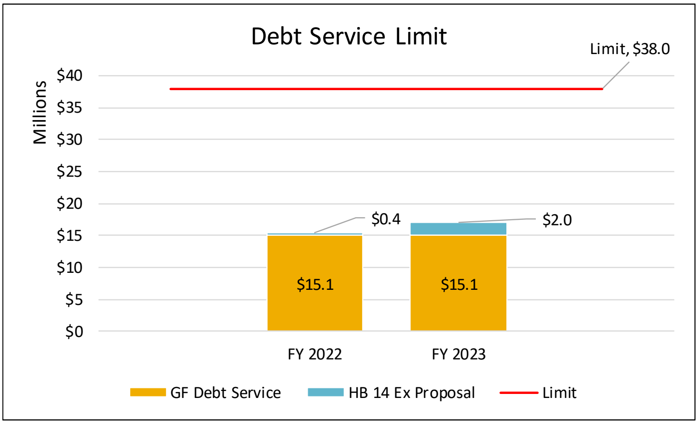
In the mid-1990's, when debt financing for capital construction and maintenance was more commonly used, the legislature chose to pay GO debt service with the revenues of two Long-Range Building Program (LRBP) capital project funds. In FY 2019, the obligation to the LRBP capital project funds concluded.

For years, the debt service paid from the LRBP funds reduced available revenues that might have otherwise been used for state building construction and maintenance projects. These funds are now available for major maintenance/repairs projects.

Authorization Limit – Debt Service

Under the provisions of 17-5-802, MCA the legislature may not authorize new general fund general obligation (GFGO) bond debt if the projected debt service cost exceeds 1.5% of general fund revenues ($38.0 million) measured at 7/1/2020 less:

- GFGO debt service for the upcoming biennium ($15.1 million in FY 2022 and FY 2023)
- The projection of debt service for proposed bond issues ($0.4 million in FY 2022 and $2.0 million in FY 2023)



The total debt service cost measured for this limit is $15.5 million in FY 2022 and $17.1 million in FY 2023. Both fiscal years are within the limit of 1.5% of projected general fund.

Conclusion

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, aiding local governments with their infrastructure needs, and remediating damage to state lands. Given the new limitations on debt financing in state law, the legislature has determined the amount of debt that the body is comfortable in considering and has established the parameters to ensure that state government retains the high rankings provided by the debt rating entities.

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[i] Moody's Investors Service, *State government – US Medians-State debt declined in 2019…*

[ii] Data from 2020 CAFR is provided by the Department of Administration and is pre-release and unaudited.

[iii] HB 540 passed by the 2005 Legislature provided $10 million of authority to issue bonds as a match to federal funding for improvements to the St. Mary's diversion system. The legislation also provided $7.5 million of authority to issue bonds for the Montana Heritage Center project. The issuance of the bonds for these two projects leaves balances of authority: $6.2 million for the St. Mary's project.