DEBT CAPACITY ADVISORY COMMITTEE
COMMONWEALTH OF VIRGINIA
December 16, 2022

10:00 A.M.

Members Present:	Stephen Cummings, Chairman Staci A. Henshaw April R. Kees Michael Maul L. Randy McCabe Anne Oman David Richardson Ronald L. Tillett
Members Not in Attendance:	Hal Greer Hossein Sadid
Others Present:	Donald Ferguson, Attorney General's Office Ty Wellford, Davenport Vernita Boone, Department of the Treasury Sherwanda Cawthorn, Department of the Treasury Jay Conrad, Department of the Treasury Bradley L. Jones, Department of the Treasury Richard Rhodemyre IV, Department of the Treasury David Swynford, Department of the Treasury Andrea Peeks, House Appropriations Committee Justin Brown, Joint Legislative Audit and Review Commission John Markowitz, Secretary of Finance Office Anya Pfeiffer, Senate Finance and Appropriations Committee Jason Powell, Senate Finance and Appropriations Committee Tyler Williams, Senate Finance and Appropriations Committee

Call to Order

Chairman Cummings called the meeting to order at 10:05 a.m. and welcomed the attendees.

Opening Remarks and Public Comment Period

Chairman Cummings asked if anyone present desired to make public comments. There were no public comments.

Approval of Minutes from December 21, 2021 Meeting

Chairman Cummings asked the Committee if there were any edits to the draft minutes of the December 21, 2021 meeting. Hearing no changes, the Chairman asked if there was a motion to approve the minutes as presented. April Kees made a motion to approve the minutes. Ron Tillett seconded the motion with a unanimous vote by the Board.

Review of the 2022 DCAC Report

Chairman Cummings asked Richard Rhodemyre to present the 2022 Draft DCAC Report (Exhibit 1). Mr. Rhodemyre stated that the cover letter for the report would be reviewed at the end of the presentation.

Mr. Rhodemyre reviewed the background of the DCAC and its establishment in 1991 and discussed the purpose and duties of the DCAC.

Mr. Rhodemyre reviewed the model inputs, including an overview of the 5% debt service to revenues capacity measure, noting that the amount is not a legal limit, but a policy that is to serve as a guideline to the Governor and State policymakers. Treasurer Richardson asked what the debt capacity limit was before 1991, to which Mr. Rhodemyre responded that there was no established limit before 1991 since there was no prior measure of capacity. Mr. Rhodemyre then reviewed the definition of Blended Revenues used in the model, noting that they are comprised of general fund revenues, certain recurring non-general fund transfers including ABC profits, state revenues of the Transportation Trust Fund (TTF), and Virginia Health Care Fund revenues. Mr. Rhodemyre discussed what is included in tax-supported debt, noting that the model includes actual debt service as of June 30, 2022 on all existing tax-supported debt as well as estimated debt service on future issuances of tax-supported debt that has already been approved by the General Assembly but has yet to be issued. Mr. Rhodemyre then expanded on the various types of state debt that is considered tax-supported, noting that it includes general obligation (GO) bonds (with the exception of 9(c) GO bonds as these are supported by project revenues), debt supported by the TTF, obligations of the Virginia College Building Authority (VCBA) and Virginia Public Building Authority (VPBA) that are appropriation supported, and certain long-term leases and installment purchases.

Mr. Rhodemyre reviewed the potential influencing factors that could impact the Commonwealth's debt capacity in the coming year, including inflation risks, interest rate risk, and recent signs of weakening consumer spending. Inflation peaked at 9.1% in June 2022, the highest consumer price index rate in the last 40 years. Mr. Rhodemyre shared that fiscal year 2022 proved to be a record year financially for the Commonwealth with general fund revenue collections, inclusive of transfers, increasing by 16.0% from fiscal year 2021 and exceeding the 2022 caboose budget by approximately $1.9 billion. General expenditures also fell well below budgeted levels, and Virginia ended fiscal year 2022 with approximately $3.2 billion in surplus and increased its reserve balances to record levels of more than $2.6 billion. Chairman Cummings asked if this figure includes Rainy Day and Revenue Reserves, to which Mr. Rhodemyre confirmed that it did and that the amount was of June 30, 2022 and did not include what is also planned for deposit in fiscal year 2023. Discussion ensued. It was noted that while the revenue impacts of the Governor's proposed changes to tax policies are included in the revenue forecast used for the calculation of debt capacity, any changes made to the tax proposals would impact the revenue forecast and the resulting debt capacity. Mr. Rhodemyre reported that the Fed began increasing overnight borrowing rates in March of 2022 and has increased it a total of five additional times, resulting in a combined increase of 375 bps as of November 2022; this rise resulted in an increase to the cost of borrowing across the economy. It is expected that the Fed will continue its aggressive rate hikes into calendar year 2023. Similarly, an increase in municipal bond yields occurred over this period. The combined influence of increased prices and higher borrowing rates has a substantial impact on the Commonwealth's cost of capital projects. Mr. Rhodemyre reported that despite inflationary pressures and increased borrowing rates, consumer spending remained strong in calendar year 2022. Discussion ensued about including a section in the report on the December forecast that was used in preparing this report regarding both the note of the impacts from tax policies on revenues and the efforts made to forecast revenues. Mr. Tillet asked for clarification on how far the forecast goes out and how this information is used in the model. It was noted that for many of the revenue sources, the forecasts extended eight years and then the final years' growth rates were used for the last two years of the model. Discussion ensued.

Mr. Rhodemyre then reviewed the standard debt capacity model result, noting that estimated debt capacity for fiscal years 2023 and 2024 was $1.18 billion. However, it is important to note that the standard model uses the last 12 quarters of historic interest rates to estimate the model interest rate and the historically low rates of 2020 and 2021 are being factored into this rate calculation. Mr. Rhodemyre noted the extended discussion of interest rates with the Secretary of Finance and the Commonwealth's financial advisors and noted that based on those deliberations, it is being recommended that the Modified 4.25% Interest Rate Scenario Model Solution – Average debt capacity calculation be used to determine the amount of tax-supported debt that can be authorized and issued in fiscal year 2023 and fiscal year 2024. April Kees requested including in the cover letter verbiage pertaining to the sensitivity to make it clear that we are in a volatile time period. Discussion ensued. Chairman Cummings requested that the model also be run without the tax policies. Ms. Kees asked that we be consistent with last year's letter regarding any such statement regarding the effects of tax policies. Anne Oman requested that the report make it clear why and how staff decided to go with the 4.25% interest rate instead of the 2.47% interest rate that the model presented. Discussion ensued. Mr. Rhodemyre reported that when using the recommended rate of 4.25%, $972.21 million in additional debt could be authorized and issued in each of the fiscal years of 2023 and 2024. Mr. Rhodemyre informed the Committee that the ACFR has had some delays on a lease item that could have a small effect on some tax-supported leases, but that the overall impact to debt capacity was mostly immaterial and would result in a decrease to capacity of approximately $2 million. Randy McCabe shared that the ACFR will be released later that day. Mr. Rhodemyre noted that a revised version of the DCAC report and letter would be provided after the ACFR was released. The Committee expressed its approval of the 4.25% interest rate for use in determining the capacity recommendation.

Mr. Rhodemyre then reviewed the other recommendations made in the report, including a continued recommendation to consider 9(b) GO bonds to secure the lowest possible interest rates, the recommendation to continue using other traditional financing methods such as the VPBA and VCBA when 9(b) GO bonds are not an option, the recommendation to continue to be conservative with the planning of any future tax-supported debt issuances, and the recommendation to continue to evaluate existing authorized projects that have not moved forward to determine whether these authorizations can be rescinded or amended. Chairman Cummings asked for clarification on the process for issuing 9(b) GO bonds. Bradley Jones explained the process. Discussion ensued. Treasurer Richardson asked the date of the last 9(b) GO bond approval. Mr. Rhodemyre answered that the last approval was in 2002. Michael Maul shared his insight on the process.

Mr. Rhodemyre shared that the Committee continues to express its support of other traditional financing methods for state projects through programs like the VCBA or the VPBA. Additionally, he recommended that any new tax-supported debt authorizations be planned carefully with the risk of economic recession in mind.

Next, Mr. Rhodemyre stated that continued consideration should be given to the impacts that the global supply chain delays, elevated inflation, and continued planned interest rate increases may have on the economy. Also, we should be mindful that construction costs have increased, thus there is the possibility that additional funding sources may be needed to fully fund projects that were previously authorized. Chairman Cummings recommended that a statement be added to the report about the $350 million in contingent funding that is included in the proposed budget for inflation driven cost increases associated with current projects.

Mr. Rhodemyre noted the continued awareness of the Commonwealth's increasing outstanding debt over the last 10 years. He discussed how Virginia compares to the country and triple AAA state medians for Net Tax-Supported Debt (NTSD) as reported annually by Moody's. Virginia has seen its tax-supported debt increase during this time period, and this is an area that rating agencies look at and consider. Ms. Kees asked if the rating agencies discussed this at the last rating agency meetings. Mr. Maul stated that the rating agencies seemed pleased with Virginia's level of tax-supported debt and did not mention it at the last meetings. Treasurer Richardson agreed. Discussion ensued.

Mr. Rhodemyre discussed the two types of tax-supported debt: GO bonds and various kinds of appropriation-supported obligations. GO bonds are secured by the full faith and credit of the Commonwealth and are rated in the highest rating category by the rating agencies. Mr. Rhodemyre shared that 9(b) bonds require state-wide approval by voters through referendum. He further stated that 9(c) bonds are first secured by project revenues, but also are provided the back-stop of the Commonwealth's full faith and credit in the event that net project revenues are insufficient to service debt. Voter approval is not required for 9(c) bonds, but they do require a 2/3 super majority vote of both houses of the General Assembly. While 9(c) debt is considered tax-supported debt for financial reporting purposes, it is not included in the debt capacity model due to the project revenue pledge. The upcoming budget does not include any new 9(c) bond authorization. Ms. Kees inquired about any pending financial feasibility studies. Mr. Maul answered that there are no such pending studies. Discussion ensued. Next, Mr. Rhodemyre discussed the 9(d) bonds. This debt is authorized by the General Assembly. Principal and interest payments on these obligations are made from annual appropriations from the general fund or from the TTF. These bonds are rated slightly lower than Virginia's GO bonds. The Commonwealth has increasingly relied on appropriation-supported debt to provide financing for capital projects. We have not seen new 9(b) debt authorization in approximately 20 years. Discussion ensued.

Mr. Rhodemyre then discussed the Commonwealth's transportation debt. The TTF was established in 1986 and the rating agencies also consider any transportation debt paid for by generally applied state-wide taxes as tax-supported debt. Historically, transportation specific debt service as a percentage of TTF revenues has been high relative to the general fund. There has been discussion about separating transportation debt into its own capacity limit, but it has been determined by the Committee that this is not necessary or appropriate. Mr. Rhodemyre explained the transportation-only debt capacity model and noted that projected TTF debt service to TTF revenue ratios range from 10.4% to 13.6%. However, this number is expected to decline as existing tax-supported transportation debt is being paid-off more quickly than new tax-supported transportation debt is being issued. He noted that to the extent that TTF debt service to TTF revenues exceeds 5%, the TTF is essentially utilizing the capacity of the General Fund to issue additional tax-supported debt. Discussion ensued regarding the General Assembly still having to authorize any new transportation debt.

Mr. Rhodemyre then reviewed the trends in Virginia's tax-supported debt over the last 10 fiscal years, noting that Virginia's tax-supported debt has increased by 45.6% or $6.5 billion, also noting that this is primarily due to increasing 9(d) appropriation supported debt and increasing pension liabilities and other post-employment benefits. Mr. Rhodemyre did note however that outstanding tax-supported debt decreased by $3.2 billion, or 13.1% in fiscal year 2022 as a result of declining pension obligations. John Markowitz discussed the current state of pension liabilities. Discussion ensued. Chairman Cummings asked that the major contributors (in particular, pensions) of the Commonwealth's outstanding debt be reflected graphically in the report. General obligation debt totaled $1.1 billion in 2022 and declined by $526 million over the 10-year period from its peak in 2013. In fiscal year 2022, total GO debt outstanding decreased by 8.4%. Section 9(d) debt increased to $13.0 as of June 30, 2022, and increased by $4.5 billion, or 53.2%, over the 10-year period. The outstanding balance of Section 9(d) debt increased 9.6% or $1.3 billion in fiscal year 2022. Mr. Maul shared that two jails totaling approximately $20 million are the only new authorizations of tax-supported debt in the proposed budget. Discussion ensued. The Commonwealth had $4.0 billion in authorized and unissued tax-supported debt remaining to be issued at fiscal year-end 2022. Other long-term obligations actually decreased by $4.3 billion, or 61.8%, from fiscal year 2021 to fiscal year 2022 as the Commonwealth saw pension liabilities decline sharply. Chairman Cummings asked if authorizations have expiration dates and if there is an unused balance that normally does not get drawn. Treasurer Richardson stated that they do not expire and that we may want to have a sunset. Mr. Maul shared that the Secretary of Finance has encouraged staff to close-out projects, but that rescinding authorization for a project is just as difficult if not more so than getting it approved initially. Mr. Tillett shared that when there is a long period of time between authorization and issuance, it creates an inefficiency. Discussion ensued.

Mr. Rhodemyre discussed how the Commonwealth has utilized tax-supported debt over the last 10 years. Of the $9.67 billion issued, 57% has been used for capital projects and teaching and research equipment at state institutions of higher education. Transportation projects paid from the TTF is the next highest category, at 20%.

Next, Mr. Rhodemyre discussed the debt service on the Commonwealth's tax-supported debt. Existing debt service as a percentage of revenues is projected to increase through fiscal year 2023 before declining annually through fiscal year 2032 to 1.9% in 2032. Mr. Rhodemyre then reviewed the interest rate sensitivity for debt service on planned issuances for fiscal years 2023 – 2027. Mr. Maul asked where we are today between taxable and non-taxable debt in the market. Mr. Jones and Ty Wellford responded around 40bps. Discussion ensued.

Mr. Rhodemyre then reviewed the state's non-tax supported debt, noting that this section of the report was also expanded on in recent years to give a more thorough review of these obligations. Mr. Rhodemyre noted that non-tax supported debt includes the 9(d) obligations of the higher education institutions for which general revenues of the schools are pledged, the obligations of Virginia's various authorities that issue debt that is not supported by general tax revenues of the Commonwealth, GARVEE's for which the debt is secured by Federal grants, obligations of various state Foundations, and portions of long-term leases, installment purchases, and pension obligations for which the state is not responsible. Mr. Maul inquired if we had heard from the rating agencies on GARVEE's. Discussion ensued. Other debt not supported by taxes totaled $32.4 billion as of June 30, 2022, increasing by 43.6% over the last 10 years. As of June 30, 2022, Virginia's total debt outstanding was $53.6 billion, an increase of $16.4 billion, or 44.0%, over the last 10 years.

Mr. Rhodemyre then reviewed the State Credit Rating Overview section of the report. He noted that Virginia continues to be rated AAA by all three major rating agencies, with its appropriation supported debt falling one notch below at AA+. Mr. Rhodemyre then noted that Virginia ended fiscal year 2022 with reserves of $2.6 billion with projected reserves of more than $4.0 billion by fiscal year-end 2024. Mr. Rhodemyre emphasized that for the Commonwealth to maintain its strong credit ratings, it is important to continue its practices of balanced budgeting. Mr. Rhodemyre then reviewed how Virginia compares to other triple AAA states. Discussion ensued regarding what the rating agencies consider as tax-supported debt in their analyses and why Virginia ranks where it does relative to other triple AAA states.

Mr. Rhodemyre provided an overview of the comparative ratios for state NTSD from the most recent Moody's Medians Report. Mr. Rhodemyre noted that Moody's changed the way that they compare states, now comparing on each state's fiscal year-end rather than calendar year end as in the prior reports. Chairman Cummings asked about short-term financing comparisons. Chairman Cummings asked that a sentence be added noting that Virginia has stability in its debt service given it does not have variable rate and short-term financing and how that position is beneficial during a period of increasing rates. Discussion ensued. Moody's 2022 Report showed that adjusted net pension liabilities increased by nearly $2 trillion nationwide in fiscal year 2021 as a result of continued historic lows in interest rates and investment returns. Moody's reported that the 2021 median NTSD per capita was $1,179, an increase of 13.5% compared to 2020. Virginia moved down from 15th highest to 16th highest NTSD per capita. Virginia's NTSD as a percentage of personal income remained flat in 2021 at 2.8%. Virginia fell from 17th highest to 19th highest in this ranking. Moody's upgraded Minnesota from Aa1 to Aaa, making it the 14th triple AAA rated state in the country.

Mr. Rhodemyre then reviewed the model results for the recommended 4.25% model. Mr. Rhodemyre noted that the average model solution will result in Virginia exceeding its 5% capacity limit in three of the ten projected fiscal years. Mr. Rhodemyre asked if there were any questions on the model results and discussion ensued.

Mr. Rhodemyre then reviewed the sensitivity analyses. Mr. Rhodemyre noted that additional sensitivity analyses had been added to the report to show debt capacity at various interest rates ranging from 2.47% to 6%. Mr. Rhodemyre then noted that an additional sensitivity analysis had been included to model a severe economic downturn scenario, explaining that the revenue projections used for this scenario were based on historical revenue declines averaged for Virginia during the three most recent recessionary periods. Discussion ensued.

Mr. Rhodemyre then reviewed the State's contingent liability and moral obligation debt. Discussion ensued.

Mr. Rhodemyre then reviewed the cover letter to the report and asked if the Committee had any recommended changes. Chairman Cummings recommended that a statement regarding the money set-aside for prior pools in the budget be added to the cover letter. Mr. Tillett requested that a cautionary statement be added to the cover letter. Ms. Oman suggested that the sensitivity in the Appendix be only on the recommended model and not the standard interest rate model. Discussion ensued. Chairman Cummings asked that a redline version of the report and cover letter with the suggested changes be sent to the committee for a final review before the final report is submitted.

Chairman Cummings asked for a motion to approve the cover letter and report subject to the edits necessary to incorporate the comments of the Committee. Treasurer Richardson made the motion and Mr. Tillett seconded, with unanimous approval by the Committee.

Other Business

With no further business, the meeting adjourned at 11:55 a.m.

Exhibits may be obtained by contacting the Department of the Treasury at (804) 786-3669.