FUNDING CONCEPTS FOR STATE BUILDING PROJECTS

A Report Prepared for the
Legislative Finance Committee

By
Cathy Duncan

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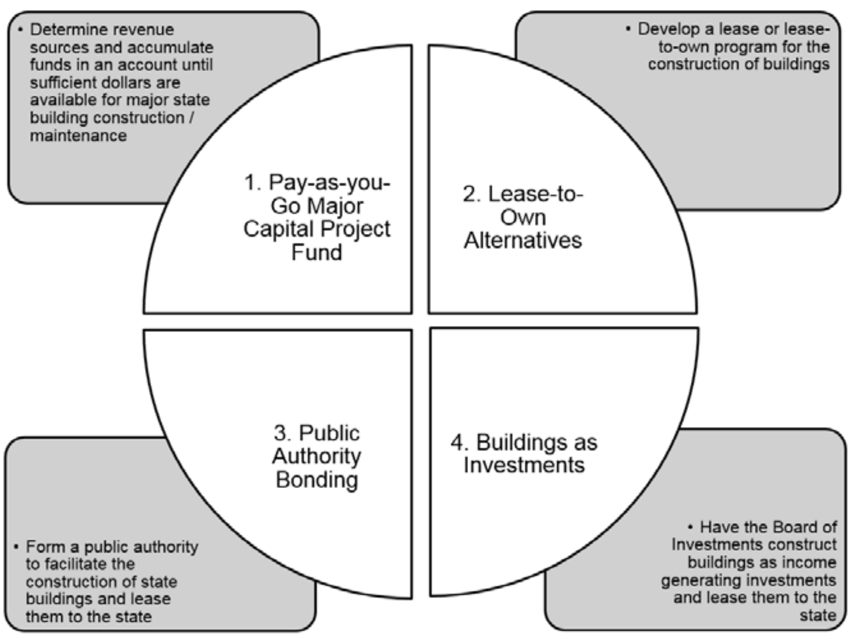
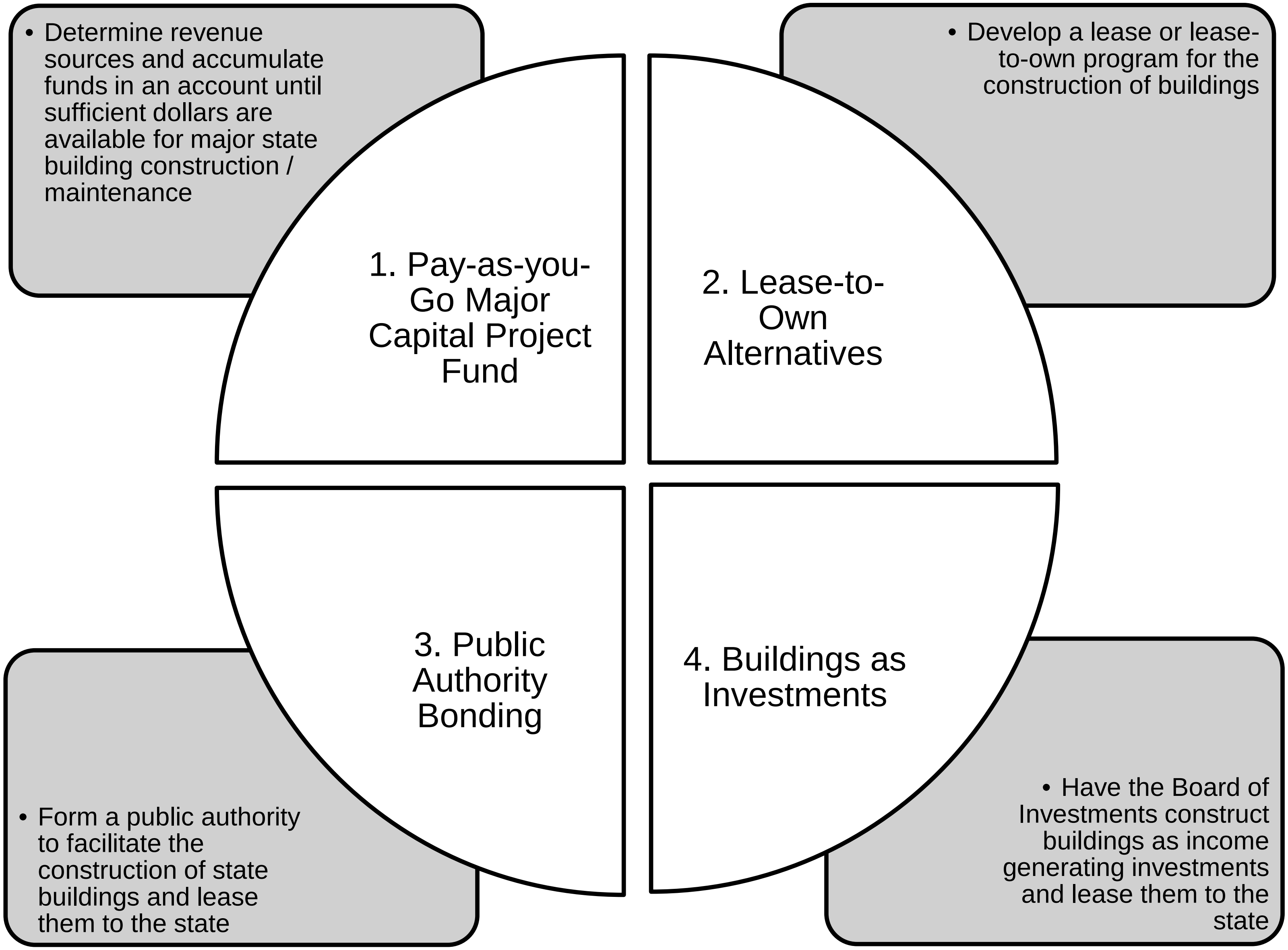


MONTANA LEGISLATIVE FISCAL DIVISION

FUNDING CONCEPTS FOR STATE BUILDING PROJECTS



Introduction

Major capital investments in state-owned buildings in Montana have not happened for a number of biennia. This applies to both major repair and renovation projects as well as new construction. With high capital costs, these building projects are generally too costly to be exclusively funded from the Long-Range Building Program (LRBP) capital projects account and without some additional form of funding, these projects do not get done.

In the past, the legislature assumed debt through general obligation bonds (GO) to finance major capital improvements for state buildings, but more recently the legislature has been debt averse and unable to obtain the required two-thirds vote of each house for the approval of debt. In biennia with large general fund balances, the legislature has at times chosen to use "surplus/excess general fund balance" to finance the construction of new buildings or major improvements to existing buildings. However, without bond or general fund excess financing, building projects have not moved forward and a long list of unfunded agency projects has developed. This report seeks to provide concepts for the financing of new state buildings and major building maintenance with a simple majority vote of each house of the legislature.

In the simplest terms, there are three ways to provide new or improved space for state agency and university system needs:

1. Pay for the space with bond proceeds,
2. pay for the space with cash, or
3. lease the space.

As shown in the figure on the preceding page, four funding concepts have been developed for Legislative Finance Committee (LFC) consideration. This report will provide information about the concepts and include relevant programmatic considerations. The four concepts discussed in this report are:

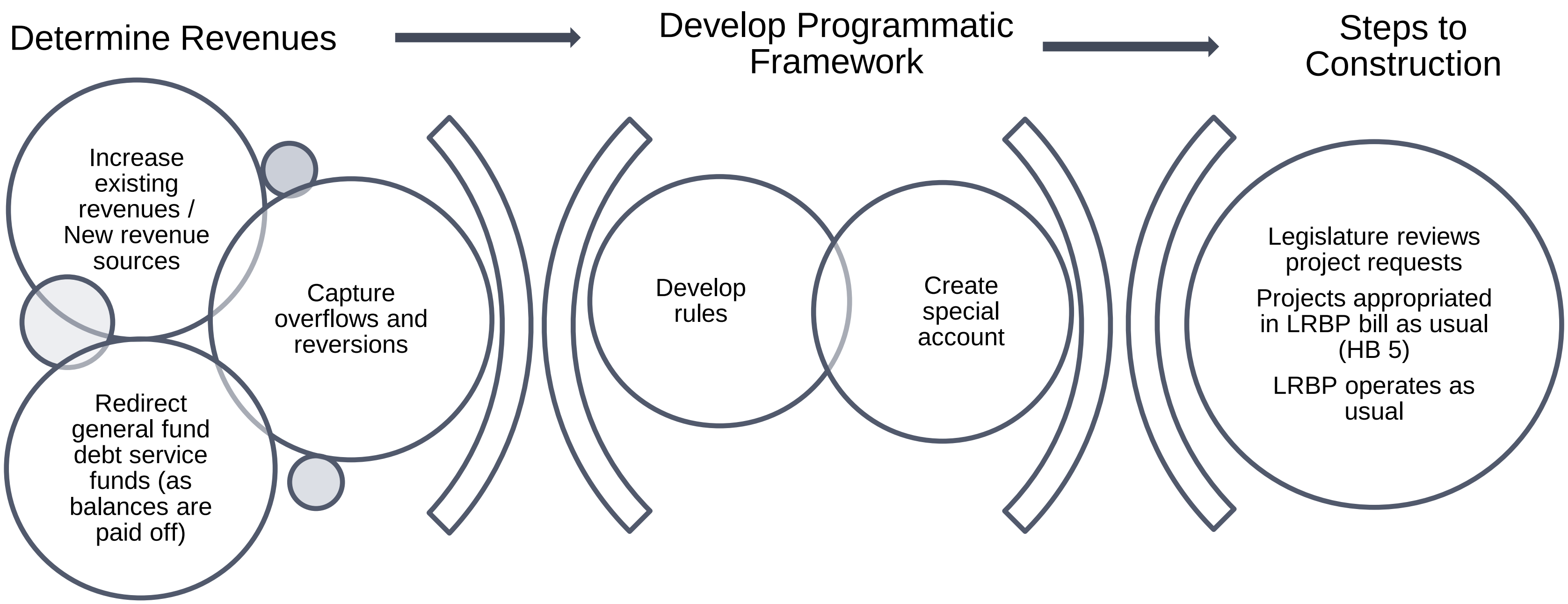
1. Pay-as-you-go capital project fund (cash alternative),
2. lease-to-own alternatives (lease alternative),
3. public authority bonding (lease alternative for state agencies), and
4. buildings as investments (lease alternative for state agencies).

Each of the concepts stand alone as a unique method for financing new state buildings or the renovation of existing buildings. If the LFC chooses to proceed with any of the concepts, the development of a statutory program framework is recommended. With a framework in place, all pertinent programmatic conditions could be outlined, making the legislature aware of the process and limitations of the program. Furthermore, in developing the framework, the LFC may want to consider consulting with experts in the related fields (state financial advisor, bond counsel, Board of Investments investment counselors) as well as obtaining further guidance from legal staff.

The four concepts provided are not mutually exclusive, and the LFC might choose to consider several of the concepts and/or knitting together several of the concepts to develop a unique Montana solution for the problem of financing state building construction. Staff is available to work on further development of any of the ideas included in this report, as well as any additional concepts the committee may choose to consider.

Concept 1. Pay-as-You-Go Major Capital Projects Fund

This figure outlines the process of developing a pay-as-you-go (cash) process for state building projects, or capital construction.



Discussion

It takes a significant capital investment to construct state office and educational buildings, with the costs of major renovation or new construction ranging between $10 and $45 million per project (and increasing over time). The LRBP fund, created over 50 years ago by the legislature, has revenues of approximately $16 million per biennia, which is not sufficient to address both the ongoing major repair and maintenance needs of existing buildings and also finance major renovations or new construction.

In developing a pay-as-you-go (or "cash") capital construction program, the most significant task would be determining a reliable source of income that would provide enough funding for the needs of the program. The figure above outlines some of the choices that staff and previous iterations of legislation have developed. Those sources of revenue are not mutually exclusive or fully inclusive.

<u>Increase existing/create new revenue source</u> - This source could include but is not limited to increasing the percentage distribution from traditional revenue sources flowing into the LRBP fund, creating a new flow into the fund from other existing revenue sources, or tapping into

a new revenue source. Recent examples of this in Montana include funding the state share of the Butte Veterans' Home through temporary redirection of cigarette tax revenues, and the proposal to fund construction of the Montana Heritage Center through a temporary redirection of increases in accommodation tax revenues.

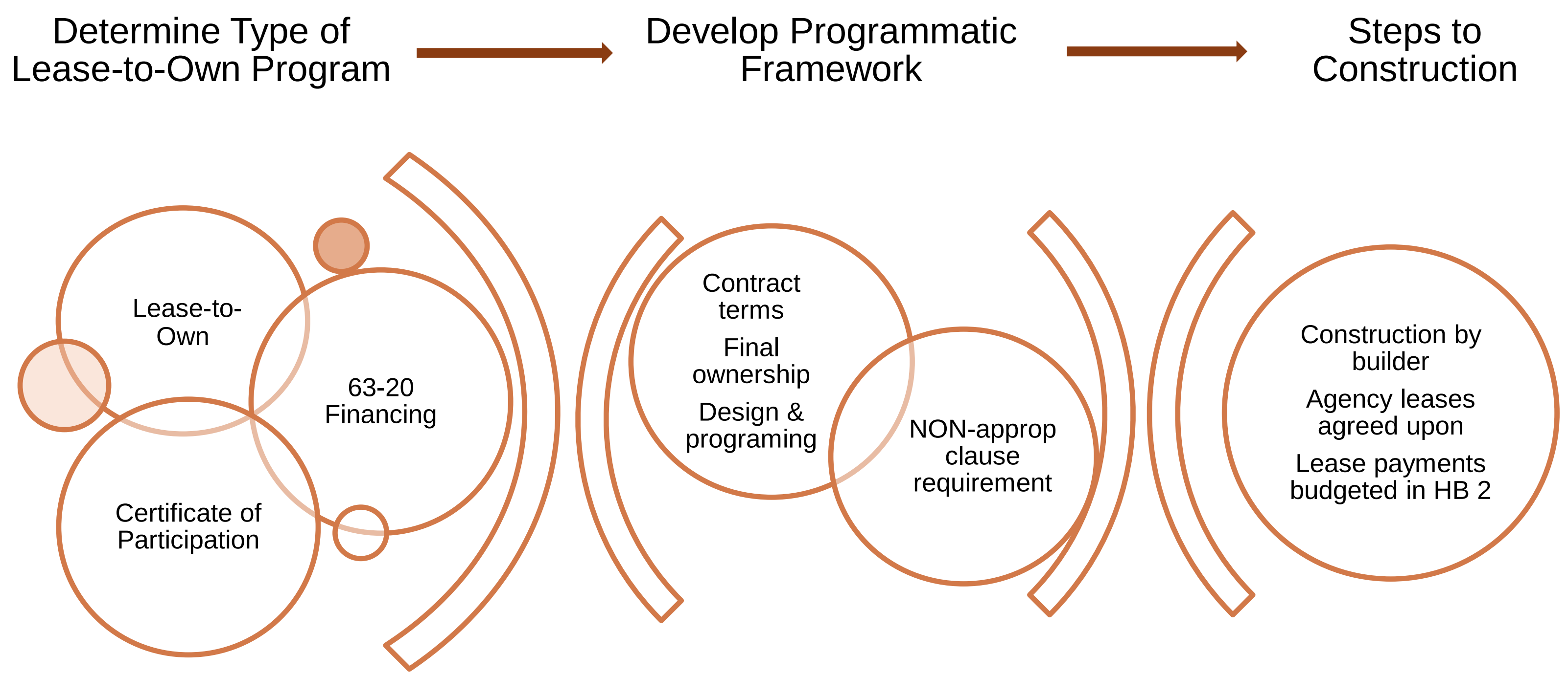
<u>Capture overflows and reversions</u> – This source could include redistribution of funds from programs that sunset, capturing general fund reversions, and overflows from reserve funds once the required fund balances are reached and directing those to the capital projects fund. Examples of legislation in Montana that have captured these types of revenue streams include the Fire Suppression Fund (HB 354, 2013 Session) and Budget Stabilization Reserve Fund (SB 261, 2017 Session).

<u>Redirect GF debt service</u> – GO bond payments for LRBP debt issues are declining as bond issues authorized in the past are paid off. This concept maintains the total amount of general fund payments at current levels and as bond issues are paid off, redirects the funding designated to retire the bond issues to the capital projects fund. 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 when considering only the currently issued debt. Currently issued general fund debt service is projected to decline and then be fully paid by FY 2032.

Creation of a new capital projects administrative framework would not be required, as the cash concept could be managed to large degree within the current LRBP programmatic structure. The legislature may want to create a second LRBP fund to accumulate the dedicated funding that would only be available for major capital building maintenance and construction. Additionally, the legislature may wish to strengthen some of the related laws and rules so funds are used in ways that are in agreement with legislative values. As an example, the state of Utah requires that a certain amount of funding is directed to the maintenance requirements of current state space before any new space projects are funded.

Concept 2. Lease-to-Own Alternatives

This figure outlines the process of developing a lease-to-own process for state building projects or capital construction.



Definitions:

Lease-to-Own – In a standard lease-purchase, or lease-to-own contract, the parties agree to a lease period during which rent is paid (that may include portions of the construction (principle) costs), and the terms of the sale at the end of the lease period including any unmet principle costs. Usually in the lease-to-own contract, any required option fees and accrued principle credits are both non-refundable should the tenant/buyer (the state) decide against purchase at the end of the lease. The state would generally be released from responsibility of final ownership and the landlord/seller (often the building contractor) is responsible for finding new/replacement tenants.

Note: Because Montana statute requires a non-appropriation clause (a contractual clause stating the lease contract is subject to legislative appropriation), a preliminary/tentative legal opinion by the legislative legal staff indicates that such a contract may not be viewed as a state debt and therefore would not require a two-thirds vote of the legislature as mandated in the Montana Constitution. More information is available in the corresponding legal memo.

Certificate of Participation (COP) – A COP is an instrument evidencing a pro-rata share in a specific pledged revenue stream (lease payments) by the issuer that are subject to annual appropriation. The certificate generally entitles the holder to receive a share, or participation, in the lease payments from a particular project. The lease payments are passed through the lessor to the certificate holders. The lessor typically assigns the lease and lease payments to a trustee, which then distributes the lease payments to the certificate holders.

63-20 Financing - A nonprofit corporation is created under the nonprofit corporation laws of a state and the corporation may issue tax-exempt obligations on behalf of a state or political subdivision for the purpose of financing governmental facilities as long as certain requirements are met. The nonprofit corporation must transfer title to the financed facility to a governmental entity when the debt is retired.

Discussion

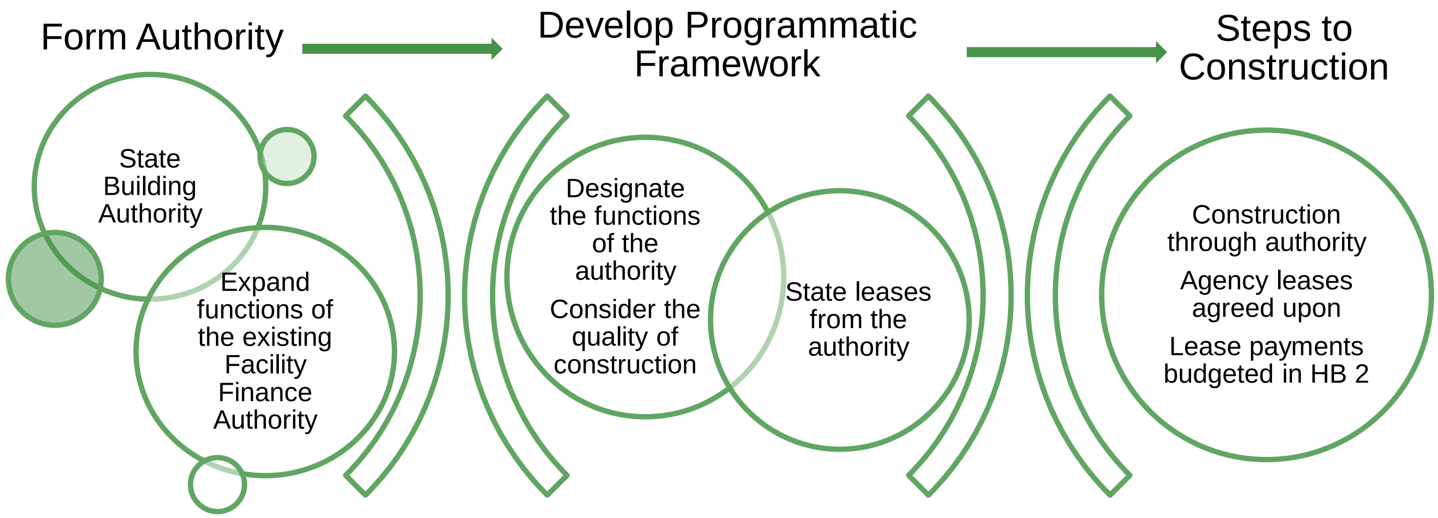
With any lease-to-own proposal, the state would not own the building until the contract is completed. To negate the requirement of a two-thirds vote of the legislature, the contract would require a non-appropriation clause, as is currently required in law. The contract would require that if the state did not make the contracted lease payments, the state would lose the potential of ownership.

There are a variety of types of lease-to-own programs to choose from. States using these financial instruments frequently use more than one type. Colorado makes use of COPs for major construction projects. The state of Colorado may not issue debt without a vote of the electorate. The contracts used by Colorado have a non-appropriation clause and the COPs have been tested in the Colorado courts due to the lack of a vote by the electorate. In each case the courts have found that COPs are not a long-term debt obligation of the state given the non-appropriation clause.

With any lease-to-own type, there are critical considerations for the legislature. Primary considerations include the terms of the contract and the ultimate ownership. The legislature may also want to establish a requirement that authorization for projects must be approved by the legislature, given that the subsequent appropriation for the lease payments are likely to increase agency budgets. Furthermore, the legislature may want to ensure the projects are overseen by the state’s Architecture & Engineering Division to ensure, to the extent possible, that the projects result in high quality buildings that are constructed to last and be operable/viable longer than the terms of the contract.

Concept 3. Public Authority Bonding

This figure outlines the processes of developing a public authority bonding process for state building projects, or capital construction.



Definition:

Public Authority – A public authority is a type of public-benefit corporation that takes on a somewhat bureaucratic role, such as the maintenance of public infrastructure, and often has broad powers to finance, create, regulate or maintain public property. One well known example of this type of entity is the New York Transit Authority.

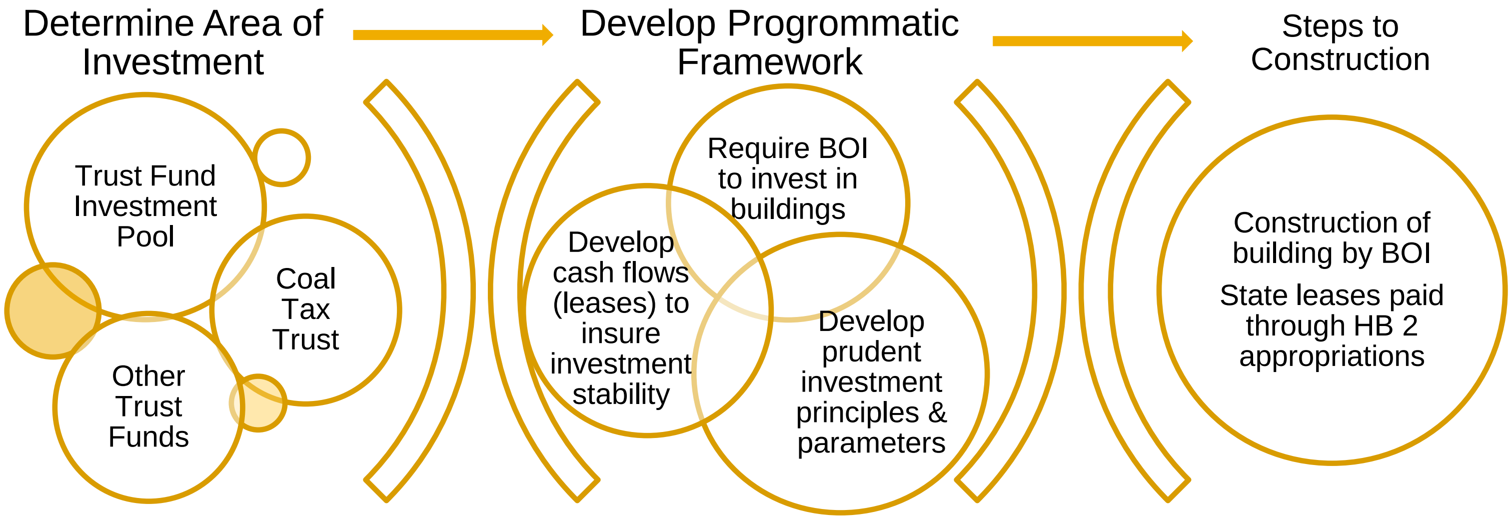
Discussion

The state of New York, which is constitutionally required to have the issuance of debt approved by the electorate, makes use of public authorities for financing many of its major capital needs. These authorities are not considered a direct state entity for the purposes of issuing debt. As of 2005, the New York authorities were responsible for 90% of the governmental debt. Montana has one authority, the Facility Finance Authority (FFA), that provides a mechanism for loans for medical-related capital investments. The FFA issues bonded debt backed by the Board of Investments that is reimbursed through the loan payments (including administrative fees).

The state could develop a new “State Building Authority” tasked with the provision of state space. However, the simplest approach may be to expand the existing FFA statutory framework to facilitate state and university system building projects. The expansion of the FFA would result in a significant change to the current program, in that the authority would not be making loans to the state, but instead would be building, owning, and operating state and university buildings. As in the case of the FFA, the Board of Investments would back the debt and the state would not be legally obligated for the debt. This concept could result in either a perpetual lease or a lease-to-own agreement for the occupying agency.

Concept 4. Buildings as Investments

This figure outlines the processes of treating new building construction as an investment.



Discussion

Buildings have become a component of investment portfolios for various Board of Investment (BOI) funds (particularly pension funds). In this case, the building becomes an asset of the trust and the lease payments from the buildings provide the return on investment. The legislature could require that a portion of the trust funds investments be dedicated to creating new buildings for state or university system purposes.

Prudent planning for such an endeavor would include limiting the total that might be invested in buildings and ensuring an acceptable rate-of-return (ROR) for the investments. In this case, the trust would own the building and the lease payments would be structured to cover the cost of creating the building plus the required ROR. If the legislature chose to pursue this option by adding state buildings to the coal tax trust portfolio, the action would not require a three-quarters vote of the legislature since the new asset (the building) would remain in the trust. However, it would be important to ensure an arms-length relationship between the trust and the state, to make sure the investment did not appear as a “raid” on the trust.

The Montana State Fund (MSF) recently constructed a building that was initially intended to be treated as an investment of the MSF trust and was planned exclusively for MSF use. Legislative Audit informed MSF that a building for the entity’s own use should not be accounted for as an investment, but instead a capital project. Ultimately, MSF did not include the building in its investment portfolio. Buildings in the pension portfolio are not exclusively occupied by BOI, but instead house several unrelated entities along with BOI. Similarly, if the state were to construct buildings for state purposes as an investment, the space may have to be shared by non-state entities.

Conclusion

There are a number of concepts available for construction of state buildings. Generally, to finance the construction of new or major maintenance/renovations to state buildings the state must either pay for the construction in cash, issue debt, or lease. Any concept that includes a lease may ultimately be more expensive than financing the project in cash or with bonds. However, in the absence of available cash or the legislative approval to issue bonds, some form of leasing may be the only option available for the state to reduce the backlog of major construction projects.

While these concepts could be implemented on an individual basis, the LFC might consider deploying some combination of the concepts for financing the state's capital construction or building needs. Creating a program that includes several methods for financing buildings including bonding, cash, and various types of lease-to-own that could provide the legislature more flexibility as any variety of needs are presented.

The concepts included in this report are all more complex than a simple reading of this report may indicate. Consequently, having the assistance of the experts in the fields and legal staff would help to ensure that any program(s) meets the needs of the legislature and is organized in agreement with all constitutional and legal principles.

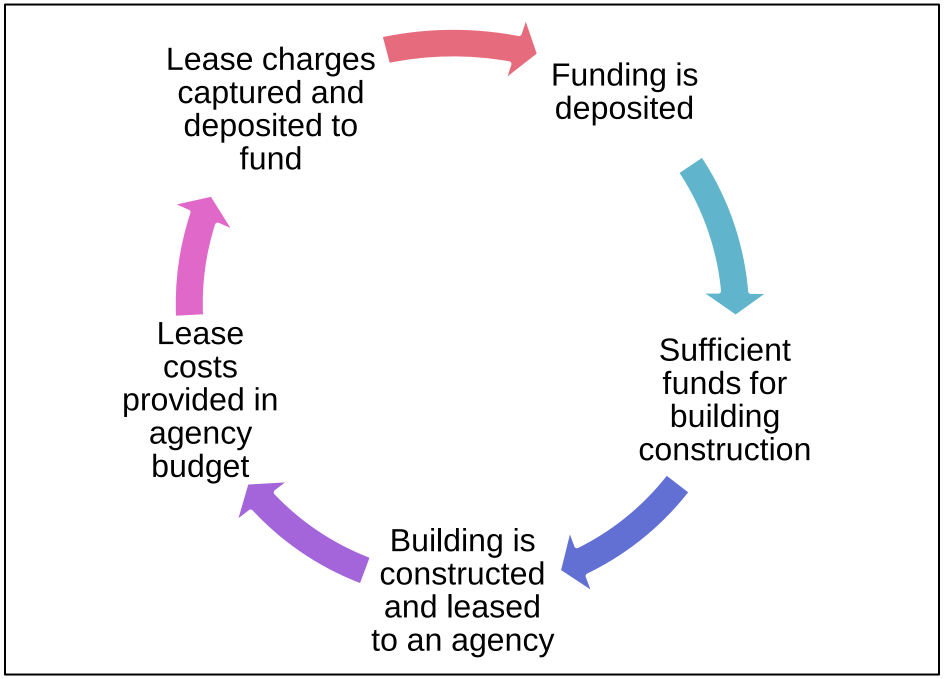
Finally, this report includes two addendums that provide concepts to 1) create a revolving capital projects fund and 2) take actions to potentially make the issuance of bonds more acceptable to the legislature. These items are outside of the scope of this report, in that they are not in and of themselves new concepts for financing state buildings, but instead provide methods that may improve current processes to work more efficiently.

If the LFC wants to start the process of developing alternative/additional financing for state building projects, the starting point would be to direct staff to further refine concepts and draft legislation that outlines the desired program(s). To that end, the committee might want to consider taking action on one of the following options:

1. Develop concept 1 – cash financing
2. Develop concept 2 – lease-to-own financing
3. Develop concept 3 – public authority financing
4. Develop concept 4 – buildings as investments
5. Develop concepts included in the addendums
6. Develop a combination of any/all of the above concepts
7. Take no action at this time

ADDENDUM 1: REVOLVING CAPITAL PROJECTS FUND (PAY-AS-YOU-GO AND LEASE)

This concept builds on the pay-as-you-go (cash) and lease-to-own concepts and combines them with the concept of a revolving loan program. The following figure outlines the processes needed to develop a revolving capital projects fund.



Discussion

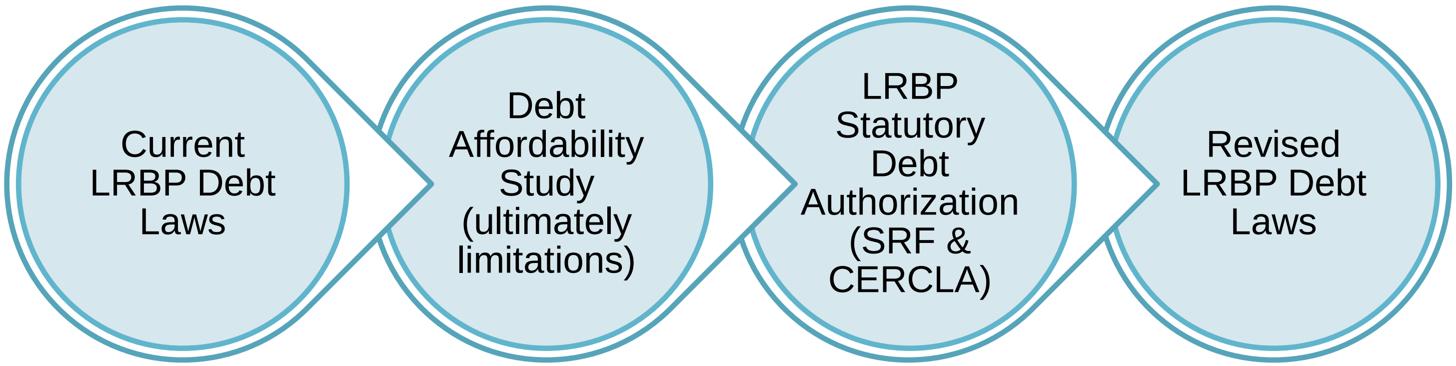
The state uses revolving funds for several state programs, including the State Revolving Fund (SRF) drinking and wastewater programs and the State Building Energy Conservation Program (SBECP). While the initial costs of constructing a building are significantly greater than those of SBECP, the concept and benefit of revolving the dollars for future uses would be the same. This concept may be more applicable to lower cost projects such as additions and renovations of buildings, which has/will become a greater need as the state's building inventory ages.

Both of the SRF and SBECP have been highly successful state programs, and in this concept the state would revolve funding for capital building and maintenance projects. The initial consideration for such a program would be the same as discussed in the pay-as-you-go concept, finding a revenue stream. More akin to the lease-to-own concept, the revolving program would lease the buildings to recapture the dollars expended. In SBECP, the fee charged to agencies for energy improvement projects is based on the cost of the projects divided by the years of savings expected in energy savings plus a 3% administration fee. In the case of a revolving building fund, a lease might be charged over the useful life of the building. Whether or not to charge an administration fee would be at the digression of the legislature.

This concept could take a substantial period of time to collect sufficient funds for projects (dependent on the revenue source), but once it is fully functional the need for new funding would decline.

ADDENDUM 2: DEVELOP DEBT AFFORDABILITY PARAMETERS

This concept is intended to improve the process of issuing state debt, which could lead to a greater likelihood in achieving the two-thirds vote required to approve debt. The following figure outlines some of the actions that the legislature may find sensible when considering debt financing.



Discussion

Although approval of debt financing for state buildings has become rare, there may be methods to make the endeavor more acceptable for the legislature. A study from Pew Charitable Trusts[1] recommends that best practices for debt financing include a debt affordability study, which would lay out the level of debt that the state could afford along with a long-term view on the potential for debt financing in future years. The ultimate conclusion would be the acceptable level of debt in the current and future years. A well-defined and investigated study may ultimately lead to limitations of debt, making the authorization process more amenable for the Montana Legislature.

Following such an analysis, the legislature may be comfortable in providing statutory authority for the issuance of LRBP debt. Programs like the state revolving funds (SRF) and Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) have an allowable level of debt provided in statute. While the initial statutes required a two-thirds vote, issuing debt within the limits do not require additional legislative authorization.

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[1] Strategies for Managing State Debt, Affordability studies can help states decide how much to borrow. June 06, 2017. "Twenty-seven states conduct debt affordability studies. Of these, nine -… - lead the way by producing studies that give policymakers a clear understanding of their states' debt levels through, among other things, careful projections, smart benchmarking comparisons, multiple descriptive metrics, and analysis."