Remarks of Rick Harmon
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Joint Capital Bond Study Committee
November 9, 2015

Mr. Chairman and members of the joint committee, my name is Rick Harmon and I work in the Department of Administration, where my responsibilities are chiefly the development of the state's long-term capital plan. In that role, I am expected to evaluate the state's major assets, determine their expected useful lives and where we are within the asset life cycle, and develop an orderly plan that will lead to an informed implementation of matching available resources against liabilities attached to the acquisition, maintenance, replacement and, in some cases, disposal of those assets over time. This is an undertaking in which I have been interested for several years since the rating services place significant emphasis on long-term planning.

I also should hasten to say that I appreciate the invitation you've extended for me to give a historical perspective on the topic of state indebtedness within the scope of your study; however, much of my commentary will be based on history and prior experience: I would encourage the joint committee to seek input from the Treasurer's Office and other experts about certain specifics and future expectations, and as I go along, I will do my best to point out areas where the committee might consider seeking further information from others.

My remarks today will start with state's legal authority to incur indebtedness and briefly cover the types of general obligation debt authorized by the constitution; a summary of past bond bills and the areas of state government that benefitted from them; a general overview of debt capacity; and a historic perspective of the rating services' views of the state, their expectations about the planning process, and other rating considerations.

Constitutional Authority and Statutory Implementation. As you know, the state's ability to incur debt is rooted in the Constitution, which provides authorization for state indebtedness in two categories and no others: general obligations which are secured by the full faith and credit of the state, and revenue indebtedness payable only from a revenue-producing project or from a special source not involving the imposition of any tax.

The Constitution further provides for the issuance of three types of general obligation bonds:

- Highway bonds, provided that they are additionally secured by revenues made applicable by the General Assembly from taxes or licenses imposed on individuals or vehicles for the privilege of using the public highways, with a limitation on the maximum annual debt service not to exceed 15% of the applicable revenues collected in the prior fiscal year;
- State institution bonds, provided that they are additionally secured by a pledge of the tuition fees received by the institution, with a limitation on the maximum annual debt service not to exceed 90% of the tuition fees collected in the prior fiscal year; and
- General obligation bonds for any public purpose, with a limitation on the maximum annual debt service not to exceed 5% of the general revenues of the State collected in the prior fiscal year. This limitation may be reduced to 4 or increased to 7% by legislative enactment passed by a 2/3 vote of the total membership of the Senate and the House of Representatives. This limitation has been increased on two occasions in modern history – with a ½ of 1% limitation adopted to support issuance of economic development bonds, and another ½ of 1% limitation to support issuance of research university infrastructure bonds.

Proceeds from debt issued under the 5% general limitation historically have been used for statewide benefit, principally for capital improvements to facilities owned by the state and its institutions and, in the early 2000's, under a single statutory undertaking limited to $750 million that benefitted K-12 public schools. As I understand your charge, the focus of indebtedness under consideration by this joint study subcommittee would fall within this 5% debt-limited category since it is evaluating capital improvement plans, particularly those of the higher education institutions; long term capital bond needs; bond capacity and debt service requirements; the merits, necessities, projected costs and priority of the capital improvement plans, and other related subjects that will inform the governor and the General Assembly.

Your study is particularly timely as the state is expected to recover significant capacity over the next few years from the retirement and refinancing of capital improvement and school facilities bonds issued in the early 2000's, contrasted against a need to address deteriorating infrastructure – both state and institutional facilities and highway infrastructure – and a potential but currently unquantifiable need to address any appropriate relief that the state may determine to provide as a result of the recent floods.

Moreover, because the type of debt that can be issued for general purposes is limited by a percentage of general fund revenue collections, debt capacity is a finite resource that must be carefully utilized to address the state's most critical priorities, maintaining conformance with expectations of bond raters, investors, and the taxpaying constituency; ensuring budgetary affordability of debt service associated with any commitments undertaken; and reserving some capacity for future needs since under historical practice the resources committed will have a financial impact for 15 years or longer.

Historical Approvals and Application of Capital Improvement Proceeds. As many of the members will know, the state last approved a capital improvement bond bill in the year 2000 legislative year. According to the Annual Historical Analysis prepared by the Budget Development Division of the Revenue and Fiscal Affairs Office, the legislature approved 8 bond bills from 1986 through 2000, ranging from $60 million to $308 million, and totaling about $1.675 billion in bond authorizations subject to the 5% constitutional debt limitation. About $745 million or 45% of those authorizations were made to support higher education, followed by $375 million or 22% to support corrections agencies, 12% to support educational agencies other than higher education, with the remainder to support conservation, executive, and other agencies, each of which received less than 10% of the total authorizations made during that period.

I think several factors influenced the suspension of bond bill enactments subsequent to the 2000 legislative year, particularly consumption of capacity for the school facilities bonds, the budgetary effects of economic recessions in the early and mid-2000's, rating agency warnings and actions, and shifts in focus from infrastructure support to economic development.

As a result, some needs that might otherwise have been funded through enactment of a bond bill have been addressed in other ways like fee increases and other revenue enhancements; increases in borrowing at the institutional level; supplemental, capital reserve or other one-time appropriations; and deferrals in capital improvements that might otherwise have been undertaken. The latter is potentially problematic because as deferral continues over time, costs grow as a result of inflation and exacerbation of underlying defects and deterioration. Bond raters and their assessment criteria are sensitive to growing but unaddressed capital needs because they represent future liabilities that potentially affect the rated entity's financial flexibility.

This is particularly true for higher education, which as a sector had its outlook revised to negative by Moody's in early 2013. In its release accompanying the revision, Moody's stated that the sector had hit a critical juncture in the evolution of its business model, and that most universities would have to lower their cost structures to achieve long-term financial sustainability and fund future initiatives. Among other things, the report cited strained non-tuition revenue sources as operating revenues from state appropriations continue to stagnate or decline, and research funding, already flat, being vulnerable to federal budget cuts. More specific to South Carolina, in 6 Moody's rating determinations of South Carolina institutions from December, 2010 to May, 2013, each cited "reduced, "declining", "significant", or "dramatic" cuts in state appropriations, and high dependence or increased reliance on student charges as rating challenges, while generally crediting the institutions with successfully managing declining appropriations over successive fiscal years. The Treasurer's Office may have more recent information available that would provide the committee with a more current perspective.

Anticipated Debt Capacity. As I noted previously, the latest information available to me indicated that our budgetary requirements for debt service are anticipated to decrease significantly over the next few years, from about $200 million in last fiscal year with steady declines to just over $100 million by fiscal year ending 2018. The Treasurer's Office may have more refined information available, and you might consider asking them for the debt service forecast for the next several years to confirm.

Rating Service View. In addition to the state's current debt service requirement being well-situated within the constitutional constraint, Moody's latest publication of state debt medians made in May, 2015 indicates that South Carolina is positioned favorably among other states within Moody's measures of debt affordability:

- South Carolina's net tax-supported debt per capita is $672 vs. a national median of $1,012, ranking the state at 35th where 1st is highest and worst;
- Our net tax-supported debt as a percentage of 2013 personal income is 1.9% vs. a national median of 2.5%, ranking the state at 34th where 1st is highest and worst;
- The state's gross tax-supported debt is $3.6 billion vs. a national median of $6.5 billion, ranking the state at 34th where 1st is highest and worst; and
- South Carolina's net tax-supported debt in dollars is $3.2 billion vs. a national median of $3.8 billion, ranking the state at 27th where 1st is highest and worst.

The committee may wish to consider these comparative statistics and indicators of debt affordability in conjunction with the state's constitutional debt capacity to confirm the reasonableness of any potential bond authorization.

Capital Planning. The rating services emphasize long term planning as an important indicator of strong management for highly rated credits because the process helps to quantify intermediate to longer term liabilities for comparison with revenue needs and expectations, thereby giving management advance notice of potential resource challenges. Standard and Poor's states in its rating criteria that a track record of aligning revenues and expenditures over time is an important element of fiscal performance, despite times where periods of imbalance between revenues and expenditures are common and expected. Moody's rating criteria provide that highly rated states tend to use certain fiscal management practices that produce strongest results, including among others credible multi-year financial plans and debt affordability analyses.

Fitch's rating criteria seek to identify actual and potential future obligations and exposures, taking the view that future capital projects may significantly increase debt ratios, thereby weakening the debt profile. Accordingly, Fitch views favorably a comprehensive and realistic approach to capital planning, and further favors strong management practices that include multiyear revenue and expenditure forecasts, and sound capital planning.

Other Rating Considerations. The rating services consistently recognize South Carolina's strengths as a comparatively low debt profile with rapid amortization; swift response to changing economic conditions; adequate reserves; and constitutional limits on indebtedness. They also acknowledge the state's prudent debt practices and judicious use of debt. They view the state's challenges as our persistently lower than average employment by comparison with national and regional averages and comparatively lower wealth and income levels across the constituency. Nevertheless, the state's strong style of management and conservative approach to finance are the hallmarks that underlie our high ratings. South Carolina is 1 of 11 states in its highly rated peer group.

Mr. Chairman, thank you again for the opportunity to appear before the committee. I can respond to any questions you or your members might have at this time.

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