Remarks of Rick Harmon
Office of State Treasurer
South Carolina House of Representatives
Transportation Infrastructure & Management Ad-Hoc Committee
September 16, 2014

Mr. Chairman and members of the committee, my name is Rick Harmon and I work in the Office of State Treasurer Curtis Loftis. I am responsible for management of the State's debt, and in that role, I work closely with our State's investors, investment banking firms, and the rating services. I am here today to report information about the status of our state's debt and to share general comments about its potential as a resource for funding transportation needs. My comments will start with an overview of the state's current indebtedness and debt capacity, current budgetary requirements of debt service, and then I'll discuss the state's credit rating and the policy implications of additional state debt.

Debt Capacity

The first chart entitled "Comparison of Debt Service to Limitations" shows debt service requirements and limitations for all of the debt paid by the General Fund and reflects state capital improvement bonds, economic development bonds, research university infrastructure bonds, air carrier hub bonds issued in conjunction with the commitment the state made to Boeing in 2009, and the actual and pro forma debt service associated with the additional Boeing commitment made in 2013. We also include in this chart the general obligation bonds we have issued on behalf of the transportation infrastructure bank, although the bank reimburses the general fund for debt service.

This chart reflects that we remain comfortably within the 5% constitutional debt limitation. In fiscal year ending 2014, total debt service subject to the 5% limitation constituted roughly 2.0% of general fund revenue, and will likely remain around that level through fiscal year 2016. Beginning in 2017, we will begin to recover capacity as we pay off capital improvement and school facilities bonds. This category of debt is colored blue on the chart.

Our capacity for issuing economic development bonds under the additional ½ of 1% statutory limitation is more constrained. In fiscal year 2014, debt service constituted almost full capacity for bonds issued under that Act, and we will not likely have any capacity for issuance under this limitation any earlier than fiscal year ending 2021. This category is colored green on the chart. The same holds true for capacity to issue Research University Infrastructure Bonds, which are also limited to ½ of 1%.

The second chart shows current general obligation highway bond capacity and utilization. The constitutional constraint on this class of indebtedness is 15% of the revenues made applicable by the General Assembly for state highway purposes from taxes or licenses imposed for the privilege of using the public highways of the State – primary the gasoline tax, the fuel oil tax, and motor vehicle license fees; however, the majority of motor vehicle license fees are also pledged to the indebtedness of the Transportation Infrastructure Bank. While the Infrastructure Bank pledge is subordinate to the pledge of these revenues to general obligation highway bonds, we generally subtract those revenues from highway bond capacity analyses to avoid overcommitting those resources. The green line entitled "Observed Limit" reflects this adjustment.

This chart shows that, for several years, the various highway revenues and the associated capacity for debt have remained relatively flat. Accordingly, our capacity to issue new highway debt is limited through fiscal year 2019, when significant portions of existing indebtedness will be retired.

Debt Service Budget

While we have debt capacity for bond authorizations under the 5% constitutional limitation, our chief constraint is budgetary affordability. Our total budgetary commitment to debt service paid from the general fund has been in the $200 million range for several fiscal years, but as things stand today, debt service will decline to about $165 million in 2016 and $123 million in 2017. This debt service covers about $1 billion in state bonds issued for capital improvements, public schools, economic development and university research.

As debt service declines over the next few years, our comfortable capacity for a bond bill will be around $400 million, with associated debt service of $30 to 40 million in recurring general funds required to service that level of debt. On a budgetary basis, that capacity may be reduced to some extent by the effects of Act 98 of 2013, which redirected $50 million annually to the Infrastructure Bank, and which I will discuss shortly. The third chart shows the overlay of this redirection in red cross-hatching.

Before the state determines how best to utilize this eventual capacity and as we consider implications of utilizing capacity for transportation projects particularly, we will need to strengthen our capital planning process because it is an important management technique valued by the rating agencies, and is integral to our state credit rating. We are aware of and appreciate Chairman White's and the Ways and Means Committee's work to advance this important initiative.

Fiscal Policy and Rating Considerations

In general terms, the rating agencies consider our current debt levels in the low to moderate range. Their reports acknowledge our prudent debt practices and judicious use of debt historically, which together with our strong management practices and willingness to take prompt action in times of budgetary stress underlie our AAA rating.

Their more recent concerns have focused primarily on the state's continued economic recovery (as is the case with almost all states), a relatively low funded ratio for our pension plan (also a challenge for many of the states), as well as our wealth and employment levels (which they have regarded to some extent as outlying by comparison to our highly rated peers). As you know, we carefully manage our relationship with the major rating services with regular contact, and have an excellent rapport with all three.

At the national level, the rating services continue to be vigilant over the national debt and longer term fiscal challenges confronting the U.S., with an attendant focus on the effect of these factors on the states, which will continue to confront the state until the Congress returns to

regular budgetary protocols and makes progress toward longer-term resolution of the national debt.

Rating Considerations for Transportation Finance

More specific to the topic of transportation finance, as we testified to the Senate Finance Transportation Funding Special Subcommittee in its deliberations leading to the enactment of Act 98 of 2013, the rating services evaluate singular emphasis undertakings like highway funding carefully, particularly if it comes at the expense of competing general fund commitments and expenditures.

Over the last decade, debt capacity has been utilized for two relatively specific purposes; with $750 million in general obligations authorized for school facilities construction and more than $850 million for economic development and research initiatives. As a practical matter, however, these worthwhile and justifiable commitments, coupled with two economic recessions, have impacted our ability over the longer term to address other capital needs, not only transportation but also higher education infrastructure. Both of these areas have been described by rating agencies as among the challenges that confront states over the longer term.

Notwithstanding, we have committed substantial resources to transportation funding over the decade, primarily through the Infrastructure Bank. The fourth chart shows the components of tax-supported indebtedness at June 30, 2014, using the criteria that the rating agencies use in determining comparative measures among the states. While the Infrastructure Bank's indebtedness is not a general obligation, significant portions of its revenue structure include tax-based components, regardless of the governmental unit from which they arise. From this perspective, the state's debt complexion has been heavily weighted toward transportation finance.

These rating measures are also instructive with respect to debt affordability, because they incorporate such measures as debt -per capita, -as a percentage of personal income, and -as a percentage of state domestic product. As I noted earlier, the rating services generally view South

Carolina's tax supported debt in the low to moderate range, which is one of two primary components underlying our high credit rating. The last chart shows various South Carolina measures against state medians, where we rank from 26th to 35th among the states for key debt measures. These data suggest that to maintain our position at or below state debt medians, additional tax-supported indebtedness should not exceed $500 to $600 million.

While our population (as measured by debt per capita) on an exclusive basis would support capacity in the $1.3 billion range, we are constrained by the wealth of the constituency (as measured by debt as a percentage of personal income), and more severely by our state's economic activity (as measured by debt as a percentage of state domestic product). These are the areas on which the rating services focus as credit challenges for the state.

Regardless of the measure, our debt capacity is a finite resource and therefore must be carefully managed within the context of competing demands over the longer term. Accordingly, highly rated states are expected to make decisions that result from an ongoing and somewhat dynamic information gathering and priority setting process because these commitments will impact resources over an extended time horizon – generally 15 to 25 years – during which time both planned and unplanned events will surface and need to be addressed. To put this into practical perspective, our decision in 1999 to issue $750 million in school facilities bonds remains with us today at a cost to the General Fund of about $68 million a year, where it will remain until the year 2015. Likewise, our commitments to economic development will extend until the year 2026, and our commitments to transportation through the Infrastructure Bank will extend to the 2030's and beyond. Given this perspective, it is imperative that we take a broad look to discover our highest funding priorities before undertaking additional plans to commit debt capacity and budgetary resources over the long term, particularly if they are singularly focused.

The rating agencies are also sensitive to the issues of useful life and sustainability, so approaches to infrastructure maintenance need to include considerations not only for addressing backlog, but ensuring that a longer term solution addresses ongoing needs. Ideally, only the

backlog should be financed with debt; and ongoing needs should have a non-financed resource sufficient to cover the majority of routine maintenance on a current basis.

Further to this point, the financial resources committed to the solution must be stable and recurring, with redirection of existing resources carefully considered. The rating agencies have observed that although South Carolina's revenues have stabilized and are trending higher in the last few fiscal years, budgetary general fund revenue is only recently approaching its pre recessionary level of about $6.7 billion that peaked in fiscal year 2006-07. General fund revenue declined significantly in the following 3 fiscal years, necessitating dramatic cuts in expenditures for general funded programs.

Recovery of general fund revenue to its pre-recessionary amount is not a threshold amount that we must reach before we undertake any new commitments, including whether or not we pass legislation to adopt a bond bill, or redirect funds, or commit anticipated surpluses for any priority set by the General Assembly; however, as a highly rated state whose credit reputation is rooted in its strong management characteristics, the expectation is that we can demonstrate that we have anticipated and considered our competing demands on general fund resources; and used an informed process to make our decisions. That process is all the more important because some programs previously funded at the pre-recessionary level have not yet been restored – but that doesn't mean that they necessarily should be.

Accordingly, the agencies will carefully evaluate highway funding against other state programs that only recently have been restored to pre-recessionary levels, with emphasis on how the state will address growth in other general fund expenditures, particularly healthcare expense, education, pensions, and other longer term liabilities, all in the face of pressure on states that will attend ultimately reduced federal funding necessary to address continuing federal deficits and growing national debt.

As general guidance, the greatest financing efficiencies arise from issuance of revenue bonds, followed by general obligation highway bonds, and then general obligation bonds subject

to the 5% constitutional limit, but as we noted earlier, tax revenues constrain capacity for both types of general obligation bonds.

We gain significantly more leverage and other practical benefits from the issuance of revenue bonds so it follows that, if additional debt is determined to become a part of the solution, ideally the revenue stream supporting it should be an appropriate non-tax revenue source. We caution that even with the issuance of revenue debt, the rating agencies include portions of revenue indebtedness in our state debt measures which could affect the state's credit rating without deliberate management. The point here is that while using portions of the state's debt issuing ability may be considered as a part of the overall solution, its use must be constrained, judicious, and appropriate, and the reality is that our capacity for issuance will not come close to addressing the longer term need.

Implications of Act 98 of 2013

As you know, among other things Act 98 of 2013 increased recurring transportation funding by committing $50 million in non-tax sources of the Department of Transportation to the State Infrastructure Bank to finance bridge replacement, rehabilitation projects and expansion and improvements to existing mainline interstates, with an offset of $50 million by appropriation. This provision of Act 98 was contemplated to be leveraged by the Infrastructure Bank to provide cash and secure indebtedness for about $550 million in projects. Moreover, Act 98 provided for redirection of 50% of the revenues of certain motor vehicle sales, use, and casual excise taxes to the State Non Federal Aid Highway Fund to be used exclusively for highway, road, and bridge maintenance, construction, and repair. Finally, Act 98 transferred $50 million in unobligated fiscal year 2012-13 general fund revenue to the Department of Transportation for bridge replacement and rehabilitation.

We covered the provisions of Act 98 with the rating services in conjunction with our December, 2013 state review. The rating services expressed interest in the plan and asked us to keep them informed of developments. While we take no current position on proposals to increase revenues for transportation infrastructure funding, we expect that, given the significance of

amounts reported by the media as needed for transportation over the longer term, the rating agencies will closely monitor continued utilization and redirection of existing resources, with particular interest in the inclusion of new or enhanced revenue as a part of the state's comprehensive funding plan.

Finally, if I could summarize our general guidance and recommendations:

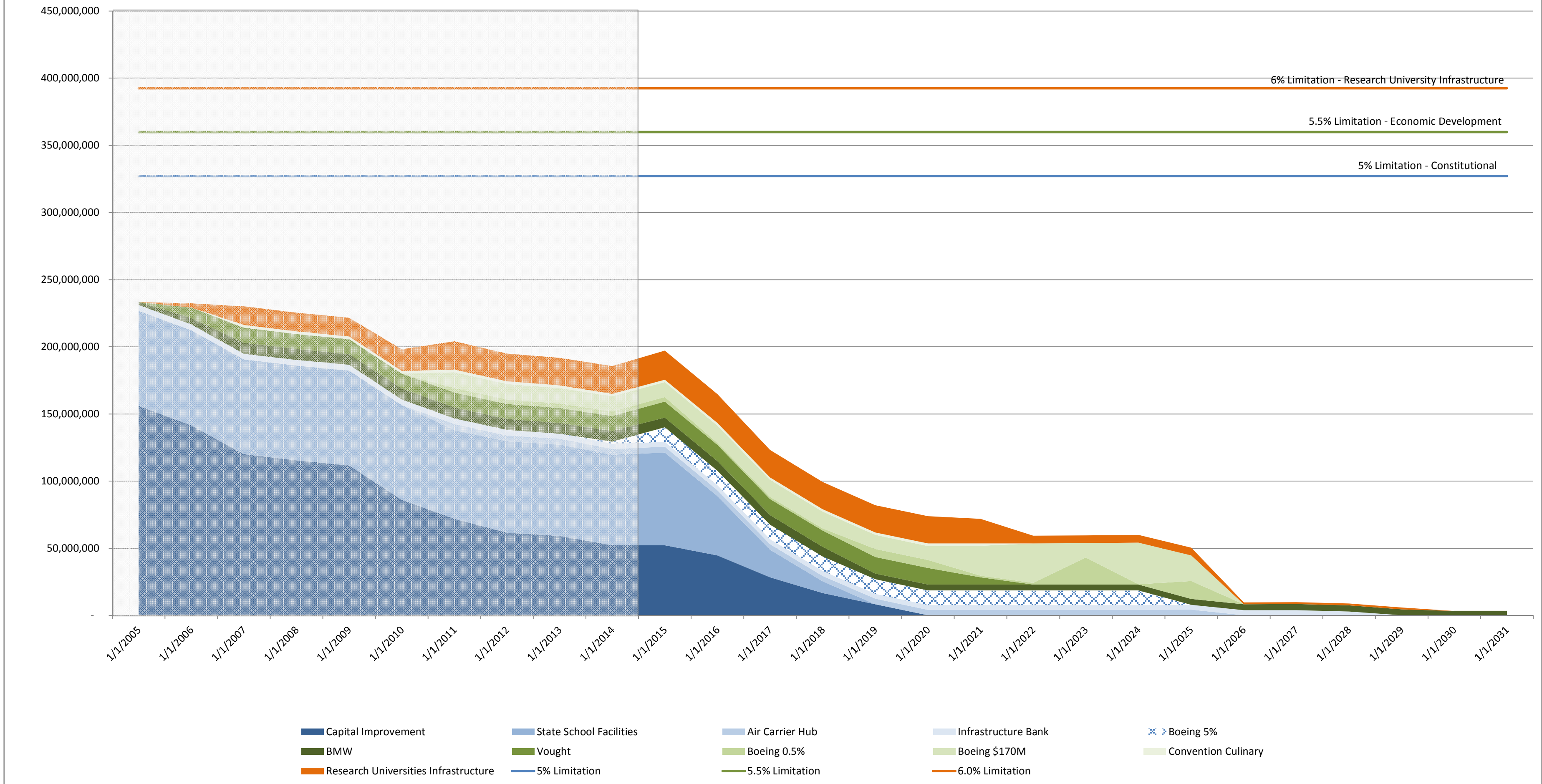
1. We recommend that the State continue the process of restoring its emphasis on the capital planning process, and consider transportation funding needs within the broader context of a statewide capital plan.
2. We recommend careful consideration anytime we utilize general obligation bonding capacity for targeted needs, and particularly, we recommend that we reserve any determination to issue general obligation debt for transportation until a statewide capital plan has been documented and vetted. We also recommend reserving an appropriate level of general obligation debt capacity to ensure that we have sufficient flexibility to deal with changes in priorities and circumstances over the time that the debt would be outstanding.
3. We recommend that the committee maintain a view toward funding that is sustainable over time, using debt to finance only highest priority backlog, and emphasizing funding that will support maintenance programs on a current basis. We also recommend selection of a non-tax revenue stream to support issuance of revenue rather than general obligation debt.
4. We recommend careful consideration of proposals that redirect funds, and particularly redirection of general funds, even if the redirection is made contingent on revenue growth.
5. Given the debt authorization already contemplated through enactment of Act 98 of 2013, we caution against reliance on further debt commitments until additional capacity is recovered over the next several fiscal years.

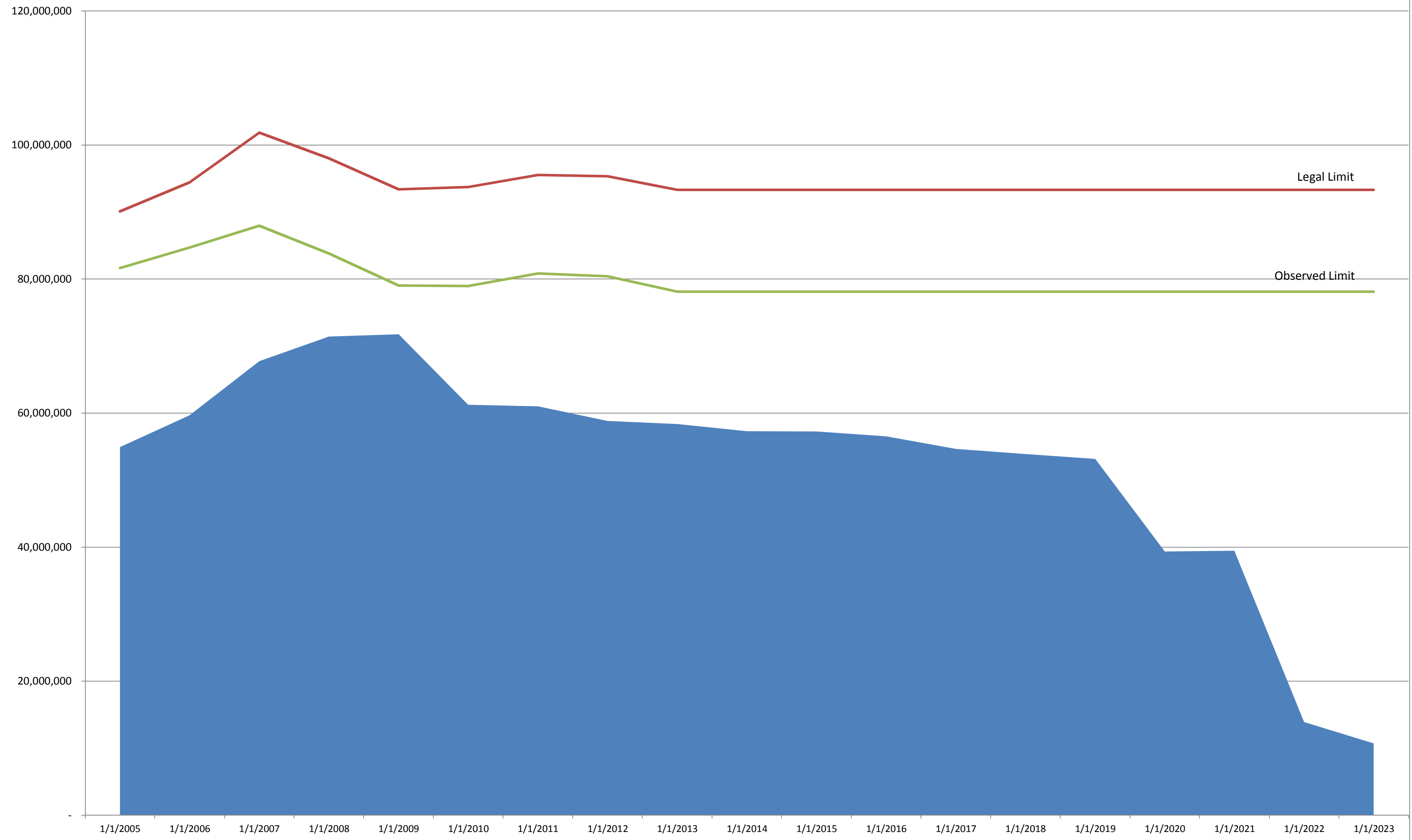
6. And finally, we support the committee's efforts to develop a comprehensive solution that includes considerations for diverse revenue resources, potential local participation, and any other alternative sources of funding.

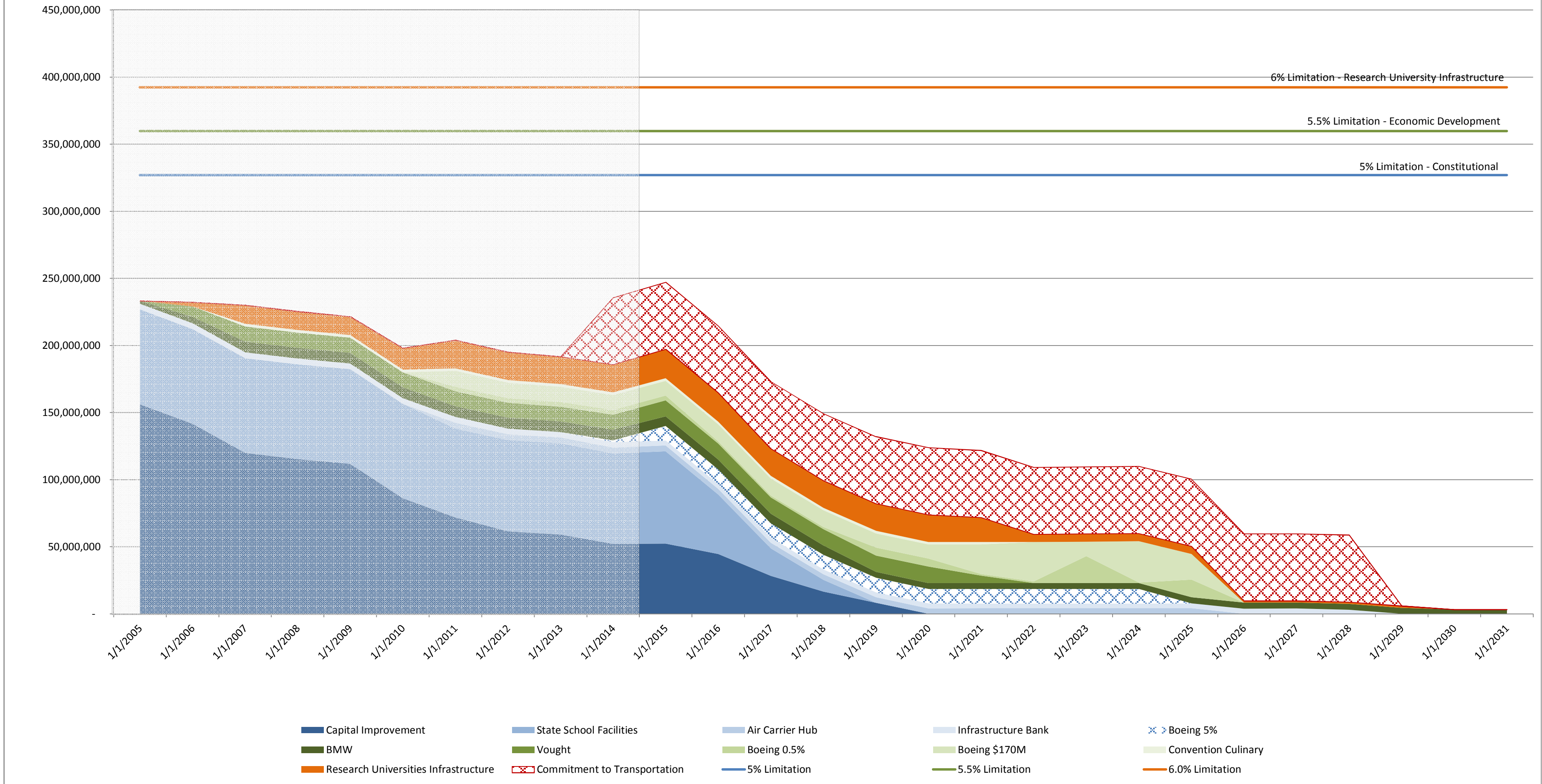
We believe that these considerations are integral to favorable views of the plan by the rating services.

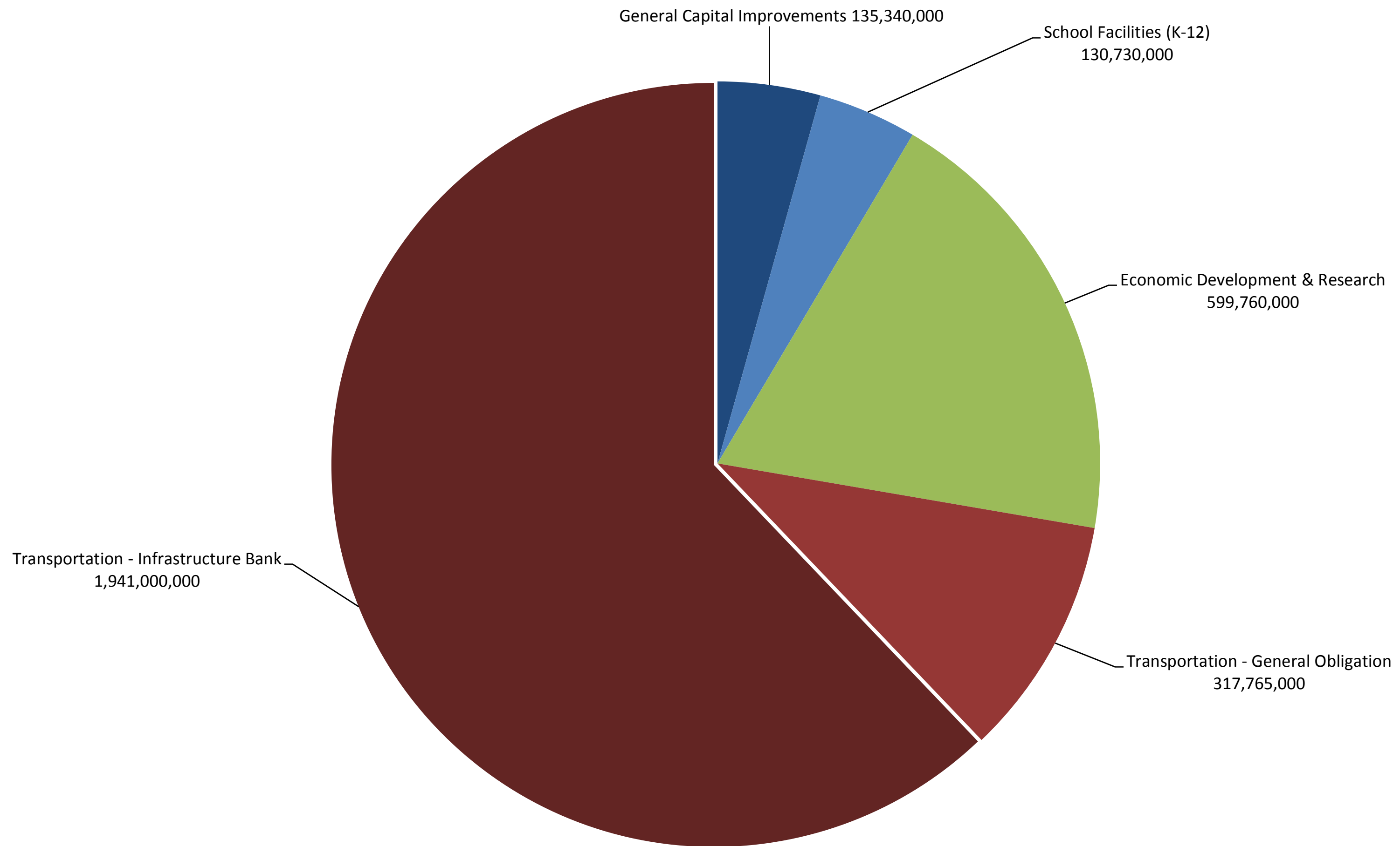
Mr. Chairman and members of the committee, thank you for your time and attention, and the opportunity to offer comments. Our office is available to assist and provide access to our financial and legal advisors in any way that would be helpful to you as you deliberate this important subject.

I'd be happy to respond to any questions.


Comparison of Debt Service to Limitations
September 16, 2014
450,000,000
400,000,000
350,000,000
300,000,000
250,000,000
200,000,000
150,000,000
100,000,000
50,000,000
-
6% Limitation - Research University Infrastructure
5.5% Limitation - Economic Development
5% Limitation - Constitutional
1/1/2005
1/1/2006
1/1/2007
1/1/2008
1/1/2009
1/1/2010
1/1/2011
1/1/2012
1/1/2013
1/1/2014
1/1/2015
1/1/2016
1/1/2017
1/1/2018
1/1/2019
1/1/2020
1/1/2021
1/1/2022
1/1/2023
1/1/2024
1/1/2025
1/1/2026
1/1/2027
1/1/2028
1/1/2029
1/1/2030
1/1/2031
Capital Improvement
State School Facilities
Air Carrier Hub
Infrastructure Bank
Boeing 5%
BMW
Vought
Boeing 0.5%
Boeing $170M
Convention Culinary
Research Universities Infrastructure
5% Limitation
5.5% Limitation
6.0% Limitation


General Obligation State Highway Bonds
Existing Debt Service Compared to Limitations
120,000,000
100,000,000
80,000,000
60,000,000
40,000,000
20,000,000
-
Legal Limit
Observed Limit
1/1/2005
1/1/2006
1/1/2007
1/1/2008
1/1/2009
1/1/2010
1/1/2011
1/1/2012
1/1/2013
1/1/2014
1/1/2015
1/1/2016
1/1/2017
1/1/2018
1/1/2019
1/1/2020
1/1/2021
1/1/2022
1/1/2023


Overlay of Transportation Commitment
September 16, 2014
450,000,000
400,000,000
350,000,000
300,000,000
250,000,000
200,000,000
150,000,000
100,000,000
50,000,000
-
6% Limitation - Research University Infrastructure
5.5% Limitation - Economic Development
5% Limitation - Constitutional
1/1/2005
1/1/2006
1/1/2007
1/1/2008
1/1/2009
1/1/2010
1/1/2011
1/1/2012
1/1/2013
1/1/2014
1/1/2015
1/1/2016
1/1/2017
1/1/2018
1/1/2019
1/1/2020
1/1/2021
1/1/2022
1/1/2023
1/1/2024
1/1/2025
1/1/2026
1/1/2027
1/1/2028
1/1/2029
1/1/2030
1/1/2031
Capital Improvement
State School Facilities
Air Carrier Hub
Infrastructure Bank
Boeing 5%
BMW
Vought
Boeing 0.5%
Boeing $170M
Convention Culinary
Research Universities Infrastructure
Commitment to Transportation
5% Limitation
5.5% Limitation
6.0% Limitation



Office of State Treasurer Curtis M. Loftis, Jr.

Debt Affordability
Benchmarked by Moody's State Debt Medians

	South Carolina	Median	Rank	Implied Capacity at Median	
				at 100%	at 90%
Net Tax Supported Debt	$ 3,574,555,000	$ 4,135,598,000	27	$ 561,043,000	$ 504,938,700
Per Capita	749	1,054	35	1,455,593,158	1,310,033,842
as % of Personal Income	2.2%	2.6%	31	649,919,091	584,927,182
as % of Gross State Domestic Product	2.4%	2.4%	26	-	-