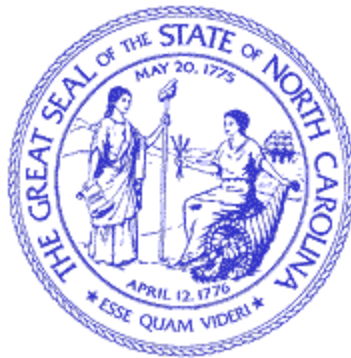


# State of North Carolina



## Debt Affordability Study

April 14, 2004

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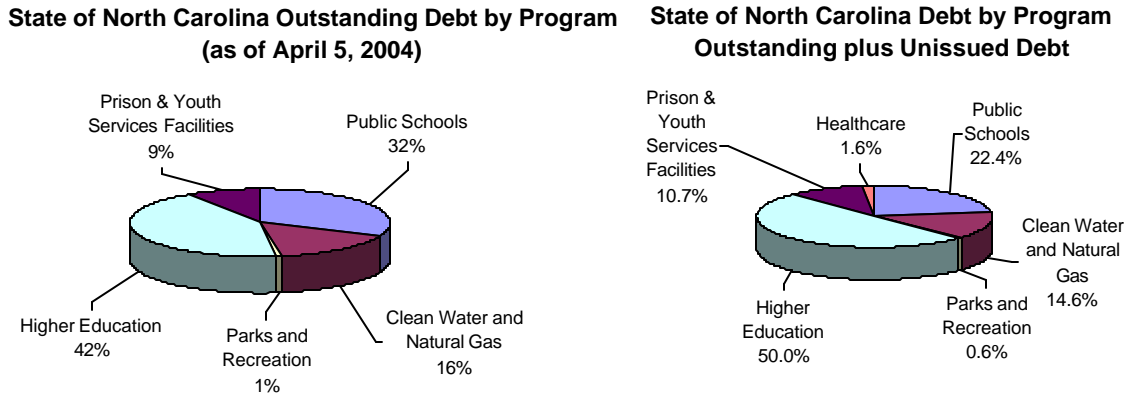
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## EXECUTIVE SUMMARY

The North Carolina Department of State Treasurer hereby presents the second State of North Carolina (the “State”) Debt Affordability Study. This Study has been prepared for the purpose of creating a management tool available to the people of North Carolina and their representatives for analyzing and managing debt capacity. The Study contains an evaluation of the State’s current and projected debt burden, using indicators such as tax-supported debt to personal income, debt per capita, debt service to tax revenue and rapidity of principal repayment ratios, and several recommendations based on the results of the Study.

Currently, all of the State’s debt ratios are below median levels both for all fifty states, as compiled by Moody’s Investors Service, and for a peer group of seven states rated triple -AAA by all three credit rating agencies. Thus, North Carolina’s debt is considered low and is manageable at the current level. Expected future debt issuances over the next three fiscal years total \$2.2 billion, with \$1.37 billion or 62% issued for Higher Education purposes. The chart below on the left depicts the State’s outstanding debt by programmatic use while the chart on the right shows the breakdown of the State’s outstanding debt plus expected issuances by programmatic use. Highway debt is excluded from these charts and the Study because the debt is self-supporting. Also excluded from this Study are the short-term Tax Anticipation Notes issued for unemployment tax benefits. These notes are due June 30, 2004 and will be paid from employer unemployment contributions.

**Figure 1**



Due to the projected issuance of \$2.2 billion of tax-supported debt over the next 3 years, all the State’s debt ratios are expected to increase over this period. The debt service to tax revenue ratio is projected to rise from 2.1% at the end of Fiscal Year 2003 to 3.9% at the end of Fiscal Year 2006 and the ratio of debt to personal income is projected to rise from 1.7% at the end of Fiscal Year 2003 to 2.5% by Fiscal Year 2006, while the debt per capita ratio is projected to rise from \$465 to \$726 by Fiscal Year 2006. The State’s debt ratios in Fiscal Year 2006 compare favorably to the current medians for its peer group of seven triple-AAA rated states, with the State’s debt to personal income and debt service ratios projected to be below, while the debt per capita ratio is projected to be above the current median for the peer group.

**Figure 2**

North Carolina Debt Ratios versus Ratios for Other Highly Rated States				
State	Ratings (Fitch/S&P/Moody's)	Debt to Personal Income*	Debt per Capita*	Debt Service as a % of Tax Revenue**
Delaware	AAA/AAA/Aaa	5.0%	\$1,599	5.0%
Georgia	AAA/AAA/Aaa	2.9	802	5.9
Maryland	AAA/AAA/Aaa	2.8	977	4.1
Missouri	AAA/AAA/Aaa	1.3	368	2.9
South Carolina	AAA/AAA/Aaa	2.4	587	4.1
Utah	AAA/AAA/Aaa	2.9	682	5.3
Virginia	AAA/AAA/Aaa	1.7	546	3.6
	Peer Group Median (as of 6/30/03)	2.8%	\$682	4.1%
North Carolina (as of 6/30/03)	<b>AAA/AAA/Aa1</b>	<b>1.7%</b>	<b>\$465</b>	<b>2.1%</b>
	Ratio to Median	0.61 x	0.68 x	0.51 x
North Carolina (as of 3/31/04)	<b>AAA/AAA/Aa1</b>	<b>2.1%</b>	<b>\$582</b>	<b>2.7%</b>
	Ratio to Median	0.75 x	0.85 x	0.66 x
North Carolina (Projections for 2006)	<b>AAA/AAA/Aa1</b>	<b>2.5%</b>	<b>\$726</b>	<b>3.9%</b>
	Ratio to Median	0.89 x	1.06 x	0.95 x

\* Ratios for peer group as calculated by Moody's in its "2003 State Debt Medians" report published July 2003.

\*\* Calculated from Fiscal Year 2002 CAFR for Georgia and Fiscal Year 2003 CAFRs for Delaware, Maryland, Missouri, South Carolina, Utah and Virginia

Establishing guidelines for future debt issuance is a critical part of prudent debt management and can keep the debt burden from becoming excessive. The following guidelines for the State's debt ratios are recommended.

- For net tax-supported debt to personal income, a target level of 2.5% with a ceiling of 3.0% is recommended
- For debt service to revenues, a target of 4.0% and a ceiling of 4.75% are recommended.
- For the ten-year payout ratio, a target of 55% and a floor of 50% are recommended.
- In addition, as the State rebuilds its reserve funds from their current levels, a target unreserved general fund balance of 8% is recommended, with a floor of 6%.
- The State should establish the upper limits of the debt to personal income level and the debt service ratio -- 3.0% and 4.75% respectively -- as levels that would be changed only in extraordinary circumstances.

Assuming a net tax-supported debt to personal income target of 2.5%, the State is projected to have no additional debt capacity in Fiscal Year 2006. Assuming the debt service to revenues target of 4.0%, the State is projected to have an additional \$150 million in debt capacity in Fiscal Year 2006. Both the debt to personal income ceiling of 3.0% and the debt service to revenue ceiling of 4.75% suggests that \$1.180 billion in debt capacity is available in Fiscal Year 2006. These projections are summarized in the table on the following page.

**Figure 3**

	Current Ratio	Projected by the end of FY 2006	Projected Debt Ratio After Issuance of		
			Additional \$150 Million	Additional \$700 Million	Additional \$1.180 Billion
Debt to Personal Income	1.7%	2.5%*	2.6%	2.8%	3.0%**
Debt Service to Revenues	2.1%	3.9%	4.0%*	4.4%	4.75%**
		* Suggested Target Ratio		** Suggested Ceiling Ratio	

Our guidelines must strike the proper balance. Guidelines that are too low or restrictive do not provide enough debt capacity to finance needed infrastructure, while imposing no limit on debt issuance could reduce future budgetary flexibility by creating an excessive debt service burden and lead to a deteriorating credit position.

If tax revenues decline and new borrowing programs are added, debt ratios will further increase, both on an absolute and relative basis. If these ratios reach a level considered excessive, it could have an adverse effect on the State’s bond ratings. In these circumstances, the State may reduce or delay its capital program, increase the use of “pay-as-you-go” funding or raise revenues. On the other hand, should our revenue picture improve and North Carolina continues to experience rapid growth, we must have guidelines flexible enough to prudently service the needs of our people.

As we look to the future and the need to prioritize capital projects, the State may want to consider either of the approaches that the states of Minnesota and Nebraska have developed and implemented. Minnesota has developed criteria to prioritize capital projects on a statewide basis while Nebraska uses its criteria guidelines specifically for its higher education capital projects. Either approach can provide an additional tool to assist the State in the decision-making process for capital projects.

In 2003, the General Assembly considered legislation which would create a committee to oversee a formal capital project prioritization process. The Capital Projects Priority Committee would create a scoring system as a tool to assist the Governor and the General Assembly in evaluating priorities for capital projects supported by General Fund revenues. The General Assembly should again consider creating this entity.

The General Assembly also considered the creation of the Debt Affordability Advisory Committee, which would annually advise the Governor and the General Assembly on the estimated debt capacity of the State for future years. Legislators should again consider the creation of this entity, which would also recommend other debt management policies desirable and consistent with sound management of the State’s debt.

## **INTRODUCTION**

The North Carolina Department of State Treasurer has developed this Debt Affordability Study to provide a methodology for measuring, monitoring and managing the State's debt capacity. Debt capacity is a limited and scarce resource. It should be used only after evaluating the expected results and foregone opportunities. The Debt Affordability Study will enable the State to structure its future debt issuances within existing and future resource constraints by providing a comparison of its current debt position to relevant industry standards and by evaluating the impact of new debt issuances as well as changes in the economic climate on the State's debt position. The Debt Affordability Study thereby can be used to help develop and implement the State's capital budget. The study is premised on the concept that resources as well as needs should drive the State's debt issuance program.

A Debt Affordability Study can further serve as a vehicle to evaluate the effect of such debt issuances on its credit standing. The study, together with stated policy goals, can help the State protect its credit ratings of AAA/Aa1/AAA since debt is one of four main factors considered by rating agencies in assigning credit ratings. Other factors considered are the economy, administration/management and financial condition. A Debt Affordability Study is considered a positive factor by the rating agencies when they evaluate issuers and assign credit ratings. As evidence, Standard and Poor's stated in a June 2002 report, "Capital planning and, more recently, debt affordability models or guidelines that evaluate capital requirements and funding sources and assess the future impact of current bond programs are strong management tools."

The process of analyzing the State's debt position also helps integrate debt management practices (an Executive Branch function) with capital spending decisions (a Legislative Branch function). The information produced by the Debt Affordability Study and annual updates can be used by policymakers to evaluate the long-term impact of financing decisions and assist in prioritizing capital spending.

The results of the study can be used by the State to establish priorities during the capital planning process. State policymakers will have current information available when making critical decisions regarding borrowing. In addition, as the State considers new financing initiatives, the long-term financial impact of any proposal on debt capacity can be evaluated upon request. The information generated by this analysis is important for policymakers to consider because their decisions on additional borrowing can affect the fiscal health of the State.

The key debt ratios of net tax-supported debt to personal income and debt service to general fund revenues, along with reserve fund levels, have an impact on bond ratings, which in turn affect the cost of borrowing. In addition, the level of financial resources is a critical credit consideration. Establishing an acceptable range for the selected ratios will allow the State to monitor periodically its financial and debt positions and provide a framework for calculating theoretical debt capacity, assisting in the capital budgeting process, prioritizing capital spending and evaluating the impact of each debt issue. Thus, in conjunction with the Debt Affordability Study, the State should develop debt and financial policies that establish prudent financial ratios.

## **REVIEW OF CREDIT RATINGS**

Credit ratings are the rating agencies' assessment of a governmental entity's ability and willingness to repay debt on a timely basis. Credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay.

**Figure 4**

State of North Carolina Credit Ratings as of April 1, 2004		
	Rating	Outlook
Fitch Ratings	AAA	Not Applicable
Moody's Investors Service	Aa1	Stable
Standard & Poor's Ratings Services	AAA	Stable

The State's general obligation bonds are rated AAA by Fitch Ratings ("Fitch"), Aa1 with a "stable" outlook by Moody's Investors Service ("Moody's") and AAA with a "stable" outlook by Standard & Poor's Ratings Services ("S&P"). All three agencies base their prime ratings on the State's strong, diverse economic base, its sound financial management and low debt levels. They also place emphasis on consistently maintaining adequate fund balances and overcoming the fiscal challenge posed by the current national recession and local spending pressures. In particular, the rating agencies cited the State's effective management of and swift response to its budget stress. However, the State must continue to pay close attention to ensuring structural balance in the outlying years. Overall, the State with its conservative approach to its financial operations remains in a positive credit position as it faces the prospect of an expanding and diversifying economy.

## **STATE DEBT OUTSTANDING**

To calculate net tax-supported debt, credit analysts take into account all debt supported by general tax revenues. This debt position shows the amount of indebtedness serviced from an issuer's General Fund; that is, it reflects the debt service payments made directly from tax revenues and is known as net tax-supported debt. Although a consensus appears to exist among credit analysts as to the appropriateness of using net tax-supported debt as the standard for determining an issuer's debt position, there is less unanimity about the precise calculation. The inclusion of indirect obligations in a net tax-supported debt measure depends to some degree on the judgment of each credit analyst. The State's net tax-supported debt position as of June 30, 2003 is shown in the table on the following page.

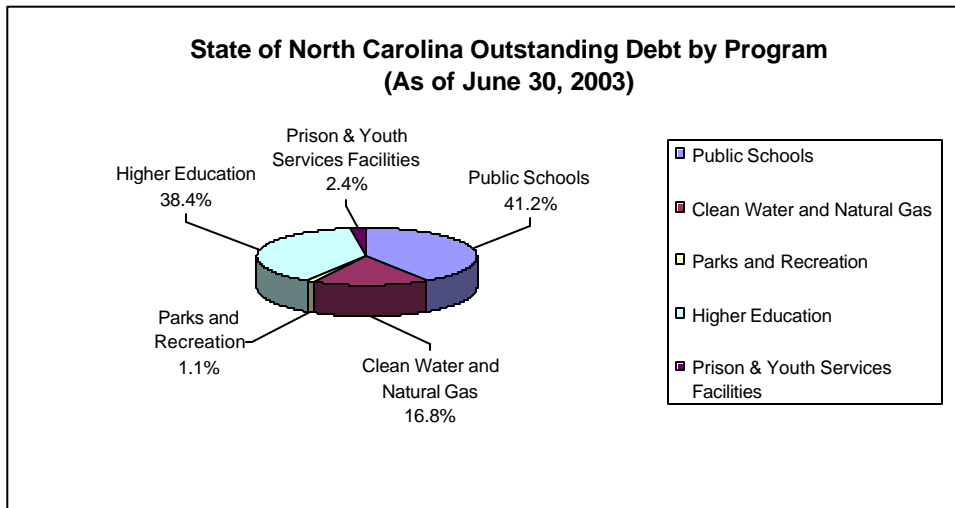
The State had total general obligation debt outstanding of approximately \$4.08 billion at June 30, 2003 including highway construction debt of \$166.6 million that is supported by separate taxes. Although S&P and Fitch include highway construction bonds in their calculation of the State's debt position, Moody's does not. We have followed Moody's approach because the debt is self-supporting.

**Figure 5**

State of North Carolina Net Tax-Supported Debt As of June 30, 2003 (\$ in thousands)	
General Obligation Bonds	
Payable from General Fund Revenues	\$3,882,813,828
Payable from Highway Trust Fund Revenues	166,625,000
Notes Payable	9,629,000
Certificates of Participation	<u>17,500,000</u>
Gross Tax-Supported Debt	<u>\$4,076,567,828</u>
Less: Self-Supporting Debt	(166,625,000)
Net Tax-Supported Debt	<u>\$3,909,942,828</u>

The chart below illustrates the State's outstanding debt broken down by use of proceeds. The largest investment financed with bonds is for higher education facilities with \$2.0 billion or approximately 40% of total debt outstanding devoted to higher education infrastructure.

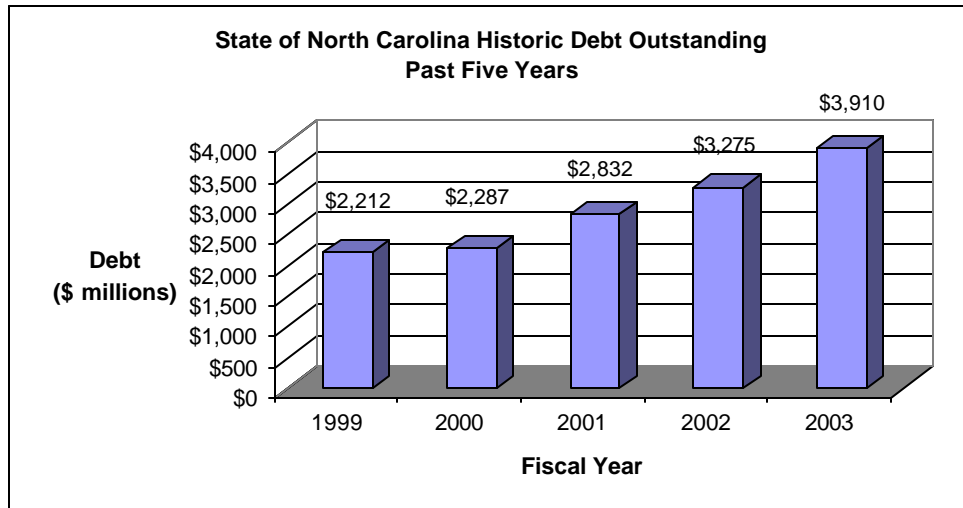
**Figure 6**



**GROWTH IN STATE DEBT**

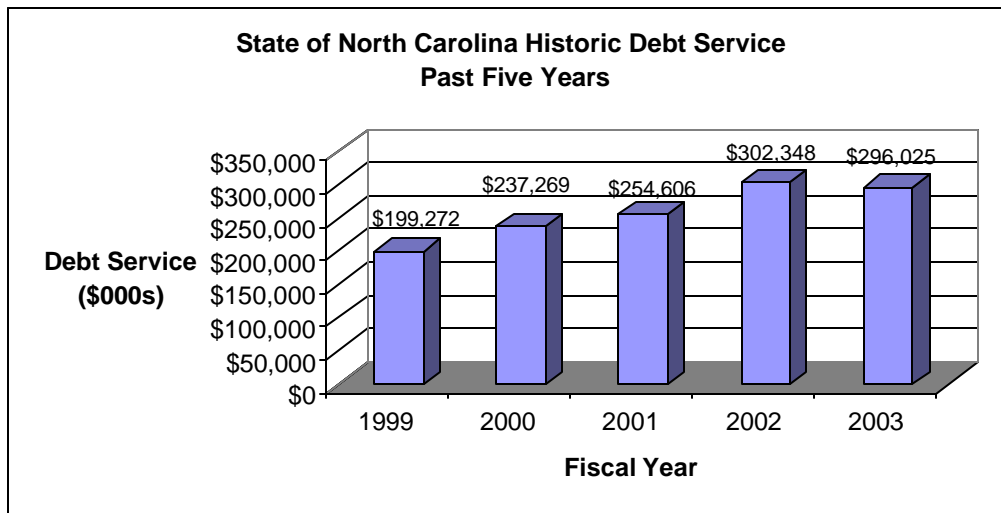
Trends in debt are an integral part of evaluating the State's debt levels. The State has made a substantial investment in infrastructure over the years, addressing the requirements of a growing population for education and other capital needs. Total general fund supported debt grew 76.9% during the last five years, increasing by \$1.7 billion from approximately \$2.21 billion on June 30, 1999 to approximately \$3.91 billion on June 30, 2003, at an average annual growth rate of 15.3%. The chart on the following page graphically illustrates the growth in total State net tax-supported debt outstanding over the last five years.

Figure 7



The State's debt has risen more than debt service because the State has actively taken advantage of low interest rates by completing refundings for present value savings. The chart below depicts the increase in annual debt service payments over the last five years.

Figure 8



The State's annual debt service payments have increased over the last five years, rising from \$199 million in 1999 to approximately \$296 million in 2003 at an average annual growth rate of 10.4%. This measure is important from a credit perspective because it indicates how much of the State's budget is devoted to the fixed burden of debt service and thus the degree of flexibility in the State's budget.

## STATE DEBT RATIOS

In addition to examining an issuer's total debt position, credit analysts review its debt ratios and their change over time. Credit analysts use the following key ratios to assess the financial burden of outstanding debt on a state: (i) debt as a percentage of personal income, (ii) debt per capita and (iii) debt service as a percentage of General Fund revenues. Debt to personal income indicates the burden a state's debt places on the income tax base, the main source of revenue for most state-level general obligation issuers. Debt per capita assesses the relative magnitude of an entity's debt position compared to other issuers. The level of debt service to General Fund revenues is an important ratio because it indicates the amount of flexibility that the issuer has in its budget. Rating analysts also consider the rapidity with which an entity repays its debt obligations. Payment of 25% in five years and 50% in 10 years is considered average for general obligation issuers.

Below is a presentation of the State's indebtedness and debt ratios as of June 30, 2003, compared to June 30, 1999. As can be seen, the State's net debt outstanding increased by \$1.7 billion or 76.8% from 1999 to 2003. The State's debt ratios also rose during this period as resources did not increase as rapidly as debt did. Debt to personal income increased 55% from 1.1% to 1.7%, while debt per capita increased by \$176, from \$289 to \$465, and debt service to revenues rose 31% from 1.6% to 2.1%.

**Figure 9**

State of North Carolina Fiscal Year 2003 versus Fiscal Year 1998 Debt Ratios				
	Debt Outstanding (000's)	Net Tax-Supported Debt to Personal Income	Net Tax-Supported Debt Per Capita	Debt Service to General Fund Tax Revenue
FY 1999	\$2,212,108	1.1%	\$289	1.6%
FY 2003	\$3,909,943	1.7%	\$465	2.1%

As previously mentioned, credit analysts also examine the rapidity of debt repayment ratio. At the end of FY 2003, the State's general obligation debt had a rapidity of repayment ratio of 28.2% in five years and 56.7% in ten years, indicating that debt is being paid more quickly than the general obligation issuer average of 50% in 10 years. The State's repayment ratio is above average and is also a positive consideration.

## COMPARISON OF DEBT RATIOS TO SELECTED MEDIANS

A comparison to national and peer group medians are helpful because absolute values are more useful with a basis for comparison. In July 2003, Moody's published the "2003 State Debt Medians" report with its annual analysis of state debt medians. As shown in the table on the following page, the State's net tax-supported debt to personal income ratio, the net tax-supported debt per capita ratio, the debt service to revenues ratio and the rapidity of repayment are all significantly better than the Moody's median levels.

**Figure 10**

Comparison with Moody's 2003 Median Ratios for States and Other Benchmarks State of North Carolina Ratios as of June 30, 2003					
Net Tax-Supported Debt to Personal Income			Debt Service as a % of Tax Revenues		
North Carolina	2003 Medians	Ratio of the State to Median	North Carolina	Median	Ratio of the State to Median
1.7%	2.2%	0.77x	2.1%	3.5%*	0.60x
Net Tax-Supported Debt Per Capita			Principal Payout Percentage in 10 Years		
North Carolina	2003 Medians	Ratio of the State to Median	North Carolina	Benchmark Average	Ratio of the State to Benchmark
\$465	\$606	0.77x	56.7%	50.0%**	1.13x

\* Last published in 1996

\*\* Rule of Thumb

The table below details the peer group comparison for the three debt ratios evaluated. The peer group, states rated triple-A by all three credit rating agencies, include the states of Delaware, Georgia, Maryland, Missouri, South Carolina, Utah and Virginia. The debt to personal income and debt per capita ratios are taken from Moody's "2003 State Debt Medians" report while the debt service ratio has been calculated from the most recent Comprehensive Annual Financial Report available for each state. As seen below, North Carolina has the lowest debt service ratio of any of the peer group and the second lowest debt per capita and debt to personal income ratios while all debt ratios are below the median levels. Thus, the State's debt ratios compare very favorably to the highest rated states.

**Figure 11**

Actual North Carolina Debt Ratios versus Actual Ratios for Other Highly Rated States				
State	Ratings (Fitch/S&P/Moody's)	Debt to Personal Income*	Debt per Capita*	Debt Service as a % of Tax Revenue **
Delaware	AAA/AAA/Aaa	5.0%	\$1,599	5.0%
Georgia	AAA/AAA/Aaa	2.9	802	5.9
Maryland	AAA/AAA/Aaa	2.8	977	4.1
Missouri	AAA/AAA/Aaa	1.3	368	2.9
South Carolina	AAA/AAA/Aaa	2.4	587	4.1
Utah	AAA/AAA/Aaa	2.9	682	5.3
Virginia	AAA/AAA/Aaa	1.7	546	3.6
	Peer Group Median	<u>2.8%</u>	<u>\$682</u>	<u>4.1%</u>
North Carolina (as of 6/30/03)	<b>AAA/AAA/Aa1</b>	1.7%	<b>\$465</b>	2.1%
	Ratio to Median	0.61 x	0.68 x	0.51 x
North Carolina (as of 3/31/04)	<b>AAA/AAA/Aa1</b>	2.1%	<b>\$582</b>	2.7%
	Ratio to Median	0.75 x	0.85 x	0.66 x

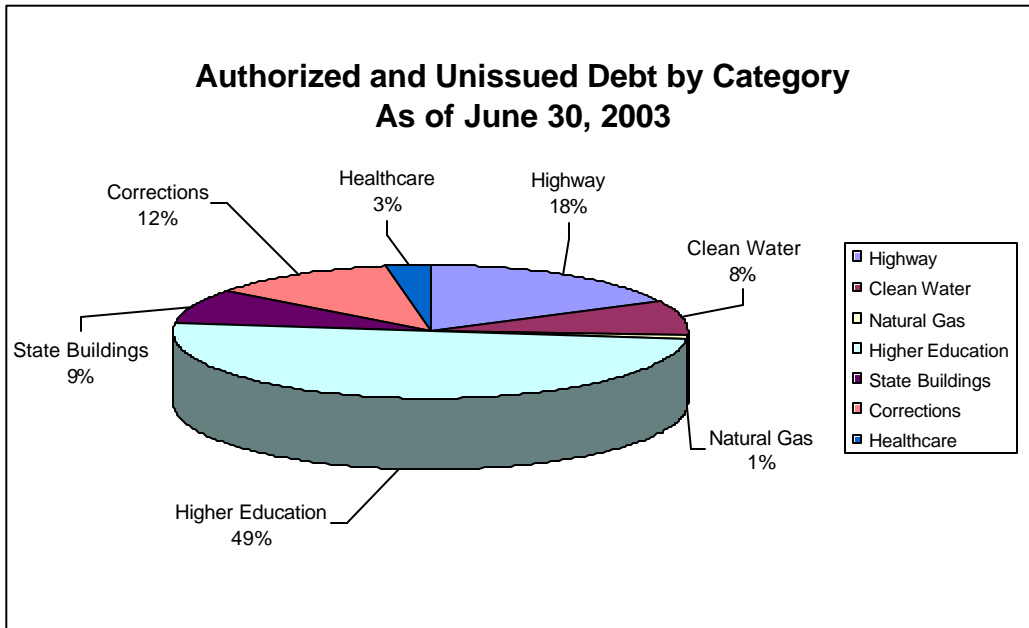
\* Ratios for peer group as calculated by Moody's in its "2003 State Debt Medians" report published July 2003.

\*\* Calculated from Fiscal Year 2002 CAFR for Georgia and Fiscal Year 2003 CAFRs for Delaware, Maryland, Missouri, South Carolina, Utah and Virginia

## PROJECTED DEBT ISSUANCE

As of the end of Fiscal Year 2003, the amount of authorized but unissued bonds totaled \$4.0 billion, including \$2.0 billion Higher Education Bonds, \$316 million Clean Water Bonds, \$52 million Natural Gas Bonds, \$700 million Highway Construction Bonds and \$921 million of certificates of participation to fund various other projects. The increase in projected debt issuance over the next three years is primarily due to higher education bonds, with \$1.99 billion, or approximately 50% of projected debt issuance, to be issued for these programs. The State plans to issue all of the authorized capacity by the end of Fiscal Year 2006.

Figure 12



The table below represents the projected debt issuance over the next three years for each of the State's currently authorized bonding programs backed by general fund revenues, excluding Highway debt.

Figure 13

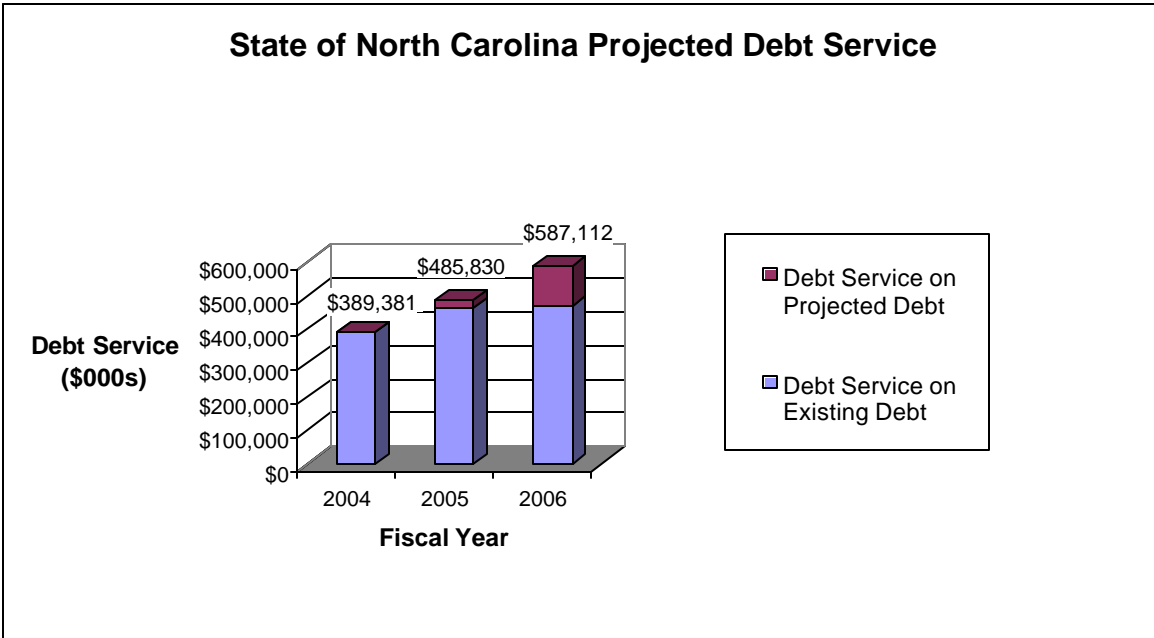
State of North Carolina Proposed Net Tax-Supported Debt Issuance Next Three Years				
	Fiscal Year 2004 (est)*	Fiscal Year 2005 (est)	Fiscal Year 2006 (est)	Total 2004-2006
Clean Water & Natural Gas Bonds	\$142,055,000	\$46,800,000	\$179,445,000	\$368,300,000
University & Community College Bonds	617,100,000	718,000,000	650,000,000	1,985,100,000
Certificates of Participation	<u>527,360,000</u>	<u>394,090,000</u>	-	<u>921,450,000</u>
	<u>\$1,286,515,000</u>	<u>\$1,158,890,000</u>	<u>\$829,445,000</u>	<u>\$3,274,850,000</u>

\* Includes \$1.1 billion debt already issued in Fiscal Year 2004.

## PROJECTED DEBT SERVICE

Annual debt service is estimated to grow to \$587.1 million by Fiscal Year 2006 assuming projected bond issuance of \$2.2 billion. The chart below shows projected debt service over the next three years, including debt service on outstanding and projected debt. This chart excludes Highway debt service and repayments of short-term unemployment Tax Anticipation Notes.

Figure 14



## RESOURCES EXPECTED TO BE AVAILABLE TO MEET FUTURE DEBT OBLIGATIONS

Capacity to support debt obligations is increased by demographic and economic growth to the extent that new resources can be captured through higher tax revenues. Because any projection is uncertain, it is important in planning for future debt capacity to make prudent assumptions about future growth in resources and to develop sensitivity analyses about other assumptions to ensure that an excessive level of obligations is not created.

Another source from which the State obtains debt capacity is the retirement of outstanding debt. As the State retires debt, this amount becomes a resource for new debt issuance without adding to the State's existing debt position. Shown in the table on the following page are scheduled retirements on the State's net direct tax-supported debt as of June 30, 2003, indicating that the State will free up \$776 million in debt capacity between FY 2004 and FY 2006 from retirements of existing obligations.

**Figure 15**

State of North Carolina Retirement of Net Tax-Supported Debt (\$ in thousands)	
Fiscal Year	General Obligation Bonds
2004	\$215,529
2005	257,833
2006	<u>303,020</u>
Total	<u>\$776,382</u>

Another consideration that affects future debt service capacity is the use of “pay-as-you-go” (“PAYGO”) funding of capital projects. By using current revenues to fund a portion of a capital plan, the State can reduce future debt service and retain debt capacity. For example, if the State funded a capital project with \$50 million as PAYGO rather than financing it through a \$50 million 20 year bond issue, the State would save approximately \$20.9 million in total interest payments over the life of the issue assuming current market conditions. Although rating agencies do not set specific guidelines for determining an acceptable level of PAYGO, the consensus is that the use of current revenues for capital projects reduces future debt obligations and is therefore a positive credit factor.

#### **EFFECT OF NEW DEBT - BASE SCENARIO**

In order to fund its capital needs, the State plans to issue \$2.2 billion net tax-supported debt from Fiscal Years 2004 to 2006, as indicated earlier. This level of issuance, after taking into account \$776 million of retirements of currently outstanding and of projected long-term net tax-supported debt, increases outstanding net tax-supported debt by \$2.5 billion, or 78%, at the end of 2006. The table on the following page reflects issuances and retirements for this period. The following assumptions were used in the Base Scenario:

- The estimated borrowing rate is 4.40% for the remaining fixed rate debt to be issued in Fiscal Year 2004, approximately 5.75% for debt to be issued by the end of Fiscal Year 2005 and approximately 6.10% for 2006.
- Interest rate of 4.0% for variable rate debt.
- 20-year amortization for all issues including Higher Education Bonds, except for Natural Gas Bonds (five year amortization), with overall level principal as projected by the State.
- Outstanding and projected Highway Debt not included.
- Outstanding short-term unemployment Tax Anticipation Notes not included.

**Figure 16**

State of North Carolina Projected Changes in Net Tax-Supported Debt As of June 30, 2003 (\$ in thousands)				
	FY 2004	FY 2005	FY 2006	Total Change in Debt FY 2004-2006
Debt at Beginning	\$3,909,943	\$4,980,929	\$5,881,986	
Planned Issuances	1,286,515*	1,158,890	829,445	\$3,274,850*
Retirements	(215,529)	(257,833)	(303,020)	(776,382)
Debt at End	<u>\$4,980,929</u>	<u>\$5,881,986</u>	<u>\$6,408,411</u>	<u>\$2,498,468</u>

\* Includes \$1.1 billion in Bonds issued so far in Fiscal Year 2004.

The effect on the State's debt ratios of issuing \$2.2 billion of new debt over the next three years has also been analyzed by reviewing the resources projected to be available, as shown below. In addition to the assumptions for future bond issuances outlined previously, the following assumptions were used in this Base Scenario:

- Projected annual tax revenue growth of 3.0%
- Projected annual personal income growth of 3.0%
- Annual population growth of 1.57%

Using the Base Scenario assumptions listed above, the table below outlines projected debt ratios from FY 2004 to FY 2006. The ratio of net tax-supported debt to personal income is projected to increase from 1.7% in FY 2003 to 2.5% in FY 2006. The ratio of net tax-supported debt per capita is projected to rise from \$465 in FY 2003 to \$726 in FY 2006. The ratio of debt service to revenues is projected to increase from 2.1% in FY 2003 to 3.9% in FY 2006 and the rate of principal payout falls from 56.7% to 51.7% by FY 2006.

**Figure 17**

State of North Carolina Effect on the New Debt Issuance on Debt Ratios – Base Scenario						
	2003	Fiscal	Projected End of Fiscal Year			Ratio of the State to Median
	Medians	Year 2003	2004	2005	2006	
Net Tax-Supported Debt to Personal Income	2.2%	1.7%	2.1%	2.4%	2.5%	1.14x
Net Tax-Supported Debt Per Capita	\$606	\$465	\$582	\$677	\$726	1.20x
GO Debt Service to Revenues	3.5%	2.1%	2.7%	3.3%	3.9%	1.11x
Principal Payout in 10 Years	50.0%	56.7%	53.5%	51.7%	51.7%	1.03x

As can be seen, the Base Scenario results in ratios higher in Fiscal Year 2006 than in Fiscal Year 2003. In addition, as seen in the table on the following page, the State's debt service and debt to personal income are projected to be lower, while the debt per capita ratio is projected to higher than the current median for the peer group of triple-AAA rated states.

**Figure 18**

Projected North Carolina Debt Ratios versus Actual Ratios for Other Highly Rated States				
State	Ratings (Fitch/S&P/Moody's)	Debt to Personal Income*	Debt per Capita*	Debt Service as a % of Tax Revenue **
Delaware	AAA/AAA/Aaa	5.0%	\$1,599	5.0%
Georgia	AAA/AAA/Aaa	2.9	802	5.9
Maryland	AAA/AAA/Aaa	2.8	977	4.1
Missouri	AAA/AAA/Aaa	1.3	368	2.9
South Carolina	AAA/AAA/Aaa	2.4	587	4.1
Utah	AAA/AAA/Aaa	2.9	682	5.3
Virginia	AAA/AAA/Aaa	1.7	546	3.6
	Peer Group Median (as of 6/30/03)	2.8%	\$682	4.1%
North Carolina Projections for 2006	<b>AAA/AAA/Aa1</b>	<b>2.5%</b>	<b>\$726</b>	<b>3.9%</b>
	Ratio to Median	0.89 x	1.06 x	0.95 x

\* Ratios for peer group as calculated by Moody's in its "2003 State Debt Medians" report published July 2003.

\*\* Calculated from Fiscal Year 2002 CAFR for Georgia and Fiscal Year 2003 CAFRs for Delaware, Maryland, Missouri, South Carolina, Utah and Virginia

The projected ratios for the State, in our opinion, indicate that this level of debt issuance over the next three years is manageable and should not impair the State's high bond ratings, particularly since the debt to personal income ratio remains below the median. We do recommend, however, that the State continue to control its debt as in the past, annually publish a Debt Affordability Study and take corrective action by raising revenues or delaying debt issuance if an economic slowdown or some other outside factor causes the debt ratios to exceed the targeted levels.

## TARGET DEBT RATIOS

Although the State's currently contemplated level of issuance over the next three fiscal years is manageable, establishing guidelines for future debt issuance and financial performance is a critical part of prudent debt management and can keep the debt burden from becoming excessive. An excessive debt burden reduces the State's budget flexibility and impairs its credit position. Debt and financial management policies create a framework for ensuring that the issuance of additional debt will not harm the State's financial position. While the State currently has several legal constraints on the amount of debt that can be issued, it should consider establishing policy guidelines for debt issuance in terms of the effect of such issuance on debt ratios. Firm guidelines as to the issuance of future debt would help protect and perhaps enhance the State's credit ratings, particularly in view of recent revenue weakness. Care must be taken, however, to achieve a balance between fiscal flexibility and infrastructure investment. Guidelines that are too low or restrictive do not provide enough debt capacity to finance needed infrastructure while relaxing the constraints to impose no limit on debt issuance could reduce future budgetary flexibility by creating an excessive debt service burden and lead to a deteriorating credit position.

Debt policies could establish maximum debt ratios (ceilings or floors) and target debt ratios over a period of time to demonstrate that there is a limit above which the State does not expect to issue additional debt in order to control its debt service burden. By setting maximum debt ratios, the State will be committing to either decrease capital spending or to find other funding sources rather than create an excessive debt burden on future budgets. While these guidelines should be placed at a level that will enable North Carolina to fund vital capital

projects, they should be kept in place over a reasonable period of time to show stability of debt management. The debt and financial management policies should be developed for net overall tax-supported debt, as rating agencies compare states and calculate debt medians on the basis of overall debt. We must note, however, that debt is only one of four factors considered by rating analysts, others factors being financial condition, economic base and management factors. Debt ratios are a tool used to measure the debt factor and are applied as part of the overall analysis in arriving at an issuer's bond ratings.

The following ratios should be considered in establishing debt management policies:

- *Net Tax-Supported Debt to Personal Income*. This ratio is important because it measures debt levels against the taxpayer base that generates the tax revenues that are the main source of debt repayment. The State's debt to personal income ratio is projected to increase from 1.7% in Fiscal Year 2003 to 2.5% in Fiscal Year 2006. A target level of 2.5% is suggested, with a ceiling of 3.0%. There is no debt capacity available within the target of 2.5% debt to personal income ratio at the end of Fiscal Year 2006. The debt capacity available within the ceiling of 3.0% debt to personal income ratio at the end of Fiscal Year 2006 is projected to be \$1.180 billion.
- *Debt service to revenues ratio*. This is a ratio where policymakers control both variables affecting it. By measuring what portion of the State's resources is consumed by long-term fixed cost, this ratio reflects the State's budgetary flexibility to change spending and respond to economic downturns. Over time, the State can both change its tax levies to adjust its tax revenue and modify debt issuance plans in order to adjust debt service. The State's current ratio of 2.1% is projected to increase to 3.9% by FY 2006 as a result of expected debt issuances for capital improvement purposes.

A target level of 4.0% and a ceiling of 4.75% is recommended for this ratio so as to provide the State with adequate capital funding while maintaining budget stability. The debt capacity available at the end of Fiscal Year 2006 within the target of 4.0% is projected to be approximately \$150 million. The debt capacity available at the end of Fiscal Year 2006 within the 4.75% ceiling is projected to be approximately \$1.180 billion.

It would be considered a "best practice" for the State to maintain a balanced use of PAYGO funding and debt financing within the parameters discussed here. If the debt service ratio rises sharply as a result of an economic slowdown or other outside factor, the State should act to raise revenues or reduce debt issuance to ensure the debt service burden does not become excessive and threaten the State's high bond ratings.

- *Ten-year payout ratio*. A faster payout is considered to be a positive credit attribute. The State's level on June 30, 2003 was 56.7%. The State should maintain a floor for its ten-year payment of 50% and set a target of 55%.

We recommend taking into account two measures in setting debt guidelines -- debt to personal income and the ratio of debt service to revenues. With regard to the ratio of debt to personal income, we recommend a ceiling level of 3.0% that would not be breached without the approval of the Legislature. With regard to the debt service ratio, a ceiling of 4.75% is recommended that will not be exceeded without the approval of the Legislature. If either of the State's debt ratios approaches those levels, the State should take action to maintain the ratios under the ceiling. Specifically, the State should reduce its capital program, increase PAYGO funding, raise revenues or take a combination of these actions.

## LEVEL OF RESERVES

As previously mentioned, the State's credit ratings are based on a variety of factors, with indebtedness only one of the items examined by credit analysts. A very important consideration is stability of financial operations as measured by the unreserved General Fund balance since these funds serve as a source of flexibility in times of economic and fiscal stress. A contingency or "rainy day" fund plus undesignated fund balance comprising 5.0% of revenues was previously used by analysts as a standard for the appropriate minimum level of contingency, but many entities concluded that this level was inadequate to carry them through the recession of the early 1990s. Many issuers have therefore set a target to protect financial stability based on the levels needed to weather a severe economic downturn without completely depleting balances and thus incurring a deficit.

Because of the importance of financial condition to the rating agencies, the study also includes an analysis of General Fund balances and reserves. Available reserves indicate financial stability, flexibility and the capacity to meet financial obligations, especially debt service payments, in a timely manner. The ratio commonly used to measure available reserves is unreserved General Fund balance as a percentage of General Fund revenues or expenditures. The State's unreserved General Fund balance at the end of FY 2003 was (\$333.1) million. Historic General Fund Balances and Unreserved Fund Balance as a percentage of tax revenues for the past five years are shown in the following two charts.

**Figure 19**

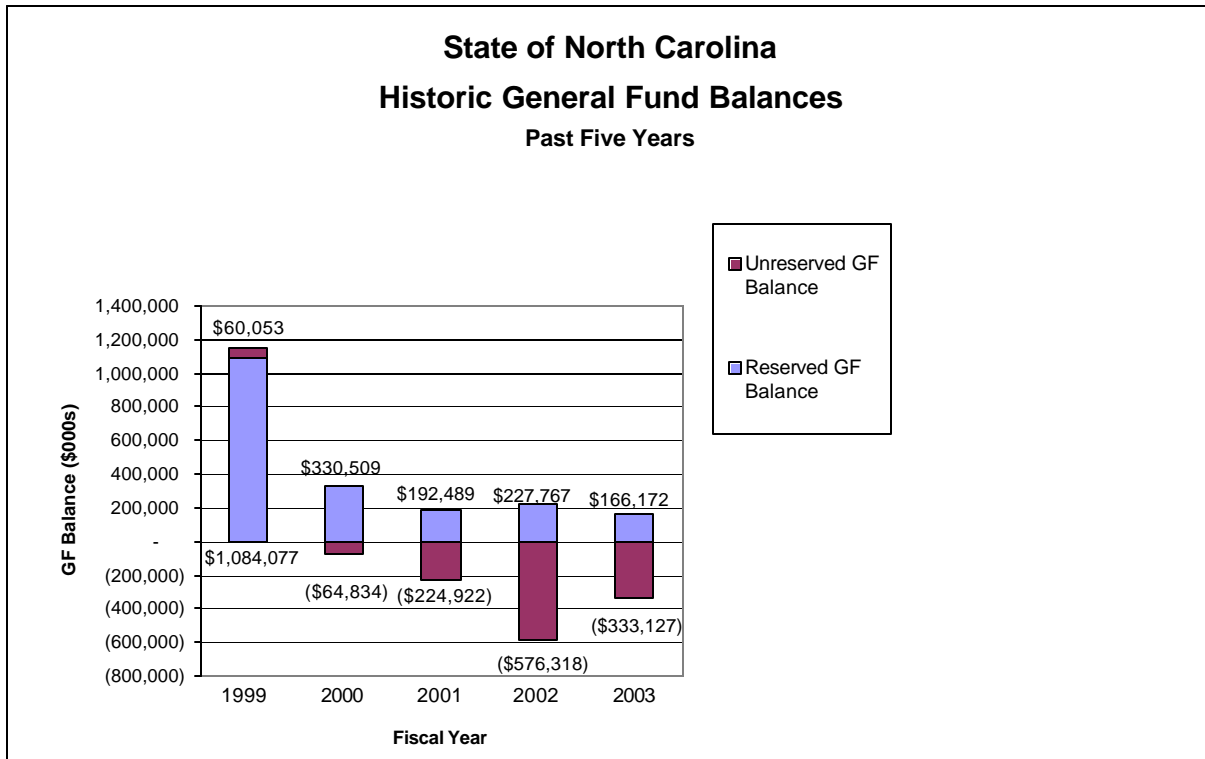
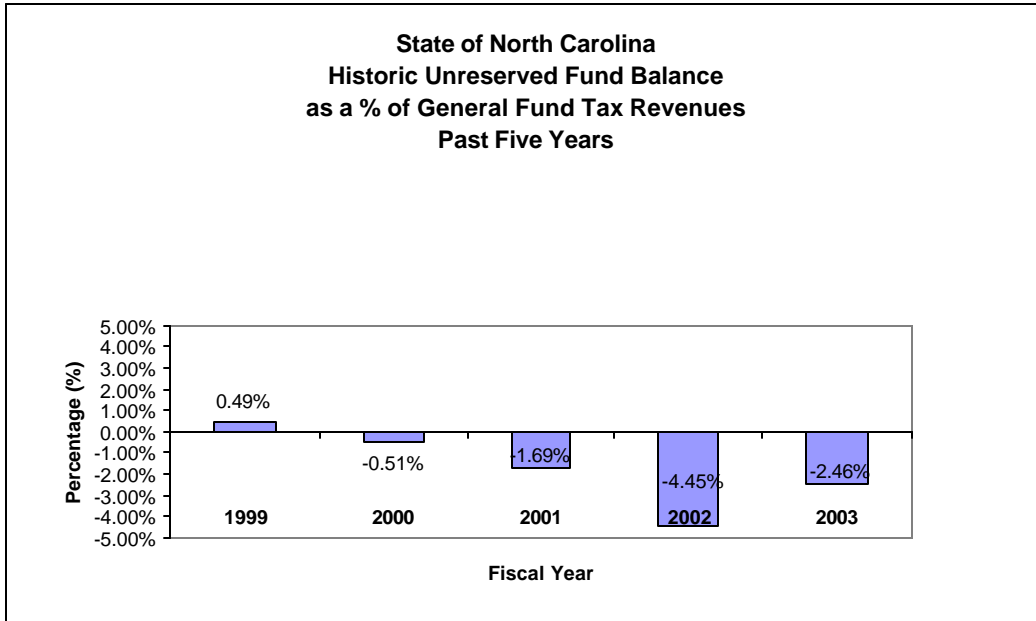


Figure 20



The Unreserved General Fund balance including the Rainy Day fund improved in fiscal year 2003 from (\$576.3 million) to (\$333.1 Million). In the fiscal year 2003-2004 budget the State continued to improve the financial condition of the General Fund by setting aside \$150 million to the Rainy Day fund.

- *Unreserved General Fund balance* – The suggested target level of Unreserved General Fund balance and the Rainy Day fund to the General Fund tax revenues is 8% with a floor of 6%. This target and floor level for Unreserved General Fund balance plus Rainy Day reserves is greater than the percentage reduction in those amounts that occurred during the two most recent recessions.

## CAPITAL PROJECT PRIORITIZATION

The process of prioritizing proposed capital projects varies widely among states. The states listed below have some method of prioritizing capital projects. Two of these two states, Minnesota and Nebraska, have developed detailed criteria and a point system to determine which capital projects will be funded. A summary of their approaches and criteria used can be found on the following pages.

**Figure 21**

States that Prioritize Capital Projects

- 
- |             |            |
|-------------|------------|
| ▪ Delaware  | ▪ Nebraska |
| ▪ Illinois  | ▪ Oklahoma |
| ▪ Michigan  | ▪ Texas    |
| ▪ Minnesota | ▪ Wyoming  |

**State of Minnesota:** Minnesota has developed a scoring system to assist the Governor and Legislature determine which capital projects will be funded. The capital projects are evaluated based on two criteria categories (described below): (i) *critical criteria*, with capital projects in this category evaluated based on their urgency in the current legislative session; and (ii) *strategic criteria*, with capital projects within this category evaluated based on their strategic need and value. A capital project could receive a maximum of 700 points each based on the two criteria categories. The criteria categories are described in more detail below.

**Critical Criteria:** The criteria Minnesota uses to determine if a capital project requires immediate funding are as follows:

*Critical Life Safety Emergency:* If a project requires immediate attention such as a roof has deteriorated to the point of collapse, it would qualify under this criterion and would receive 700 points.

*Critical Legal Liability:* If the project has an existing and documented legal liability, such as citations by building or fire inspectors, it would qualify under this criterion, with qualified projects receiving 700 points.

*Prior Binding Commitment:* If a project has no other funding alternative and a previous legislative action created a binding commitment, such as construction project that has already been partially funded and is under construction, the project would qualify under this criterion, with qualified projects receiving 700 points.

**Strategic Criteria:** The criteria Minnesota uses to evaluate each project's strategic need and value are set out below. Projects may receive from 0 to 700 points depending on how closely each capital project meets the following criteria.

*Strategic Linkage:* A project is evaluated using this criterion based on how closely the project is connected to a particular agencies strategic plan, state statutes or other identifiable state policy; projects are evaluated on a low, medium and high basis and may receive 0, 40, 80 or 120 points.

*Safety Concerns:* A project is evaluated using this criterion based on how safety issues are addressed. These safety issues are not necessarily as urgently needed as those discussed in the critical criteria category. An example would be clean up of a closed landfill or security improvements at a correctional facility. Projects are evaluated on a low, medium and high basis and may receive 0, 35, 70 or 105 points.

*Customer Services and Statewide Significance:* A project is evaluated based upon how it improves service for all citizens of the state. Projects with statewide impact and which provide customer service to the greatest number of people receive the most points. Projects with regional significance or which provide modest level of customer service receive medium points. Projects with local significance and modest customer service improvements receive the fewest. Projects will receive 0, 35, 70 or 105 points.

*Agency Priority:* This criterion measures how important a project is for a particular agency. Points are based on the ranking of the project on the agency's overall priority project list. The total number of requests for each agency are divided by four to establish agency quartiles in order to award the following points: 25, 50, 75 or 100.

*User or Non-State Financing:* 0 to 100 points are awarded to projects depending on the percentage of user financing, non-state funding, private contributions or matching funds that can be used to fund project costs.

*Asset Maintenance:* Requests for funding for the maintenance and repair of the state's land, facilities and equipment are evaluated on a low, medium or high basis and awarded 0, 20, 40 or 60 points.

*Operating Savings or Efficiencies:* 0, 20, 40 or 60 points are awarded to projects which produce operating savings or improve operating efficiencies.

*Projects Contained in Six-Year Plan:* If a project has been included either in a previous state agency six-year strategic plan or obtained previous state funding, it would receive 25 points. If both are applicable, the project may receive 50 points. Projects that have received past state funding but were not part of an agency's priority list may receive only 25 points.

**State of Nebraska:** Nebraska through its Coordinating Commission (the "Commission") for Post-Secondary Education is statutorily responsible for recommending to the Governor and Legislature a prioritized list of approved capital projects that should receive funding for higher education projects. The Commission's prioritization process involves the use of ten individual criteria, weighted using a 100-point system to assist it qualify capital projects and determine the order of funding and are described below.

*Statewide Facilities Category Ranking:* The Commission rank the type of facility based on overall statewide needs according to 11 different categories. For example, the Commission places a high priority on the safety of building occupants and maintaining the state's assets and, therefore, projects that are safety related receive a maximum of 30 points while a project such as land acquisition for future expansion of a project would receive a maximum of 3 points. Projects that combine two or more of the 11 categories are weighted to attain a point total.

*Sector Initiatives:* This criterion addresses how well the proposed capital project addresses a specific strategic or programmatic initiative with a maximum of 10 points awarded. An example of a sector initiative is the designation of a specific academic program or service offered by one or more institutions.

*Strategic and Long-Term Planning:* This criterion measures the degree to which a capital construction request addresses long-term planning efforts with a maximum of 10 points awarded.

*Immediacy of Needs:* This criterion measures the degree of urgency for the project. Projects intended to meet existing needs are given higher priority than long range needs. A maximum of 10 points are awarded depending on the degree of the need for the project.

*Quality of Facility:* This criterion measures how the capital project will improve an existing facility. A maximum of 5 points are awarded, depending on the facility condition.

*Avoid Unnecessary Duplication:* A maximum of 10 points is awarded for this criterion depending upon the degree to which the project minimizes unnecessary duplication.

*Appropriate Quality of Space:* This criterion measures the degree to which the project effectively uses space, a maximum of 5 points is awarded.

*Statewide Role and Mission:* The Commission considers the project from a statewide perspective based upon four subcategories: undergraduate instructional and student space; graduate or professional instructional and research space; public service and applied research space; and administrative or operational support space. Projects that include combinations of two or more of the four subcategories are weighted to attain a point total.

*Building Maintenance Expenditures:* This measures the cost of maintaining a facility based on dollars expended for maintenance per square foot compared to similar projects. A maximum of 5 points is awarded.

*Ongoing Costs:* This criterion measures the degree to which the project will reduce the incremental increase of state funding for its operation and maintenance. A maximum of five points are awarded.

**Summary:** Two different examples of the ways in which states use criteria for prioritizing capital projects have been presented. The state of Minnesota attempts to define basic evaluation criteria to be used statewide in order to address competing capital requests while the state of Nebraska has developed detailed criteria for a specific category of capital, its higher education projects. Our research indicates that the scores for Minnesota capital projects do not produce automatic funding decisions but rather are designed as a tool, much like a debt affordability study, to assist in the decision making process with regard to capital projects. The State may wish to consider the establishment of a board to develop and implement criteria to assist in prioritizing capital projects.

## CONCLUSION

Currently, all of the State's debt ratios are below median levels both for all fifty states and for a group of seven states with comparable credit standing. Thus, North Carolina's debt is considered low and is manageable at the current level. Expected future debt issuances over the next three years total \$2.2 billion, with \$1.37 billion, or 62%, issued for Higher Education purposes. Due to this projected issuance, all the State's debt ratios are expected to increase over the next three years. The debt service to tax revenue ratio is projected to rise from 2.1% at the end of Fiscal Year 2003 to 3.9% at the end of Fiscal Year 2006 and the ratio of debt to personal

income is projected to rise from 1.7% at the end of Fiscal Year 2003 to 2.5% by Fiscal Year 2006, while the debt per capita ratio is projected to rise from \$465 to \$726 by Fiscal Year 2006.

The State may want to consider developing and implementing a formal capital project prioritization process comparable to the procedures in place in the states of Minnesota and Nebraska. Furthermore, the State may want to consider the establishment of a board to develop and implement criteria to assist in prioritizing capital projects.

In 2003, the General Assembly considered legislation which would create a committee to oversee a formal capital project prioritization process. The Capital Projects Priority Committee would create a scoring system as a tool to assist the Governor and the General Assembly in evaluating priorities for capital projects supported by General Fund revenues. The General Assembly should again consider creating this entity.

The General Assembly also considered the creation of the Debt Affordability Advisory Committee, which would annually advise the Governor and the General Assembly on the estimated debt capacity of the State for future years. Legislators should again consider the creation of this entity, which would also recommend other debt management policies desirable and consistent with sound management of the State's debt.