Impact of State Borrowing Activities on Louisiana's Future Financial Resources

State Bond Commission
Department of the Treasury

Performance Audit
Issued February 11, 2016

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LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

February 11, 2016

The Honorable John A. Alario, Jr.,
President of the Senate
The Honorable Taylor Barras,
Speaker of the House of Representatives

Dear Senator Alario and Representative Barras:

This report provides the results of our performance audit on how the borrowing activities of the State Bond Commission (Commission) have impacted Louisiana's future financial resources and to estimate the actual long-term costs of these activities.

The report contains our findings, conclusions, and recommendations. Appendix A contains the Department of the Treasury and the Commission's response to this report. I hope this report will benefit you in your legislative decision-making process.

We would like to express our appreciation to the management and staff of the Department of the Treasury and the Commission for their assistance during this audit.

Sincerely,

Daryl G. Purpera, CPA, CFE
Legislative Auditor

DGP/aa

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Louisiana Legislative Auditor

Daryl G. Purpera, CPA, CFE

State Bond Commission, Department of the Treasury
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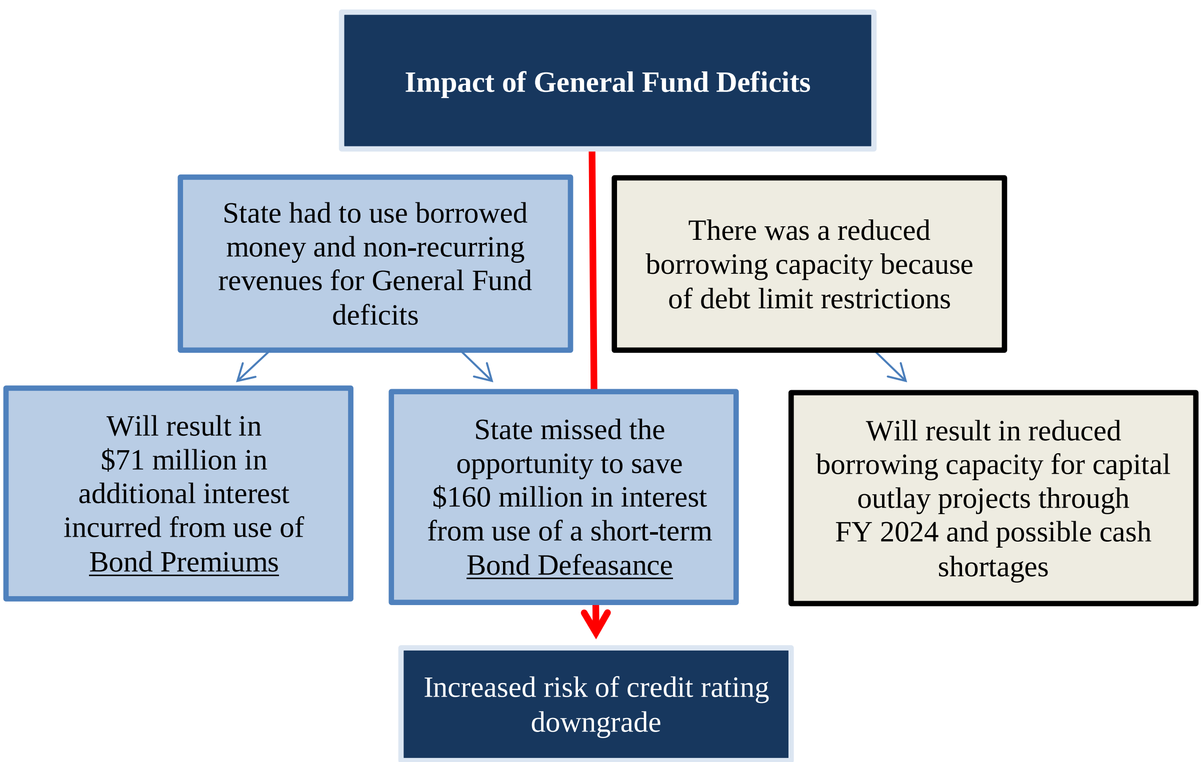
Audit Control # 40150012

Introduction

During fiscal years 2011 through 2016, Louisiana has faced projected General Fund deficits averaging $1.2 billion annually that the legislature has had to address to enact a balanced budget. The state has addressed these deficits, in part, by using borrowed money and non-recurring revenues to avoid cutting operating expenses or increasing revenues from taxes, licenses, or fees. Specifically, the State Bond Commission (Commission), in accordance with state law, has used costly short-term measures that will not only increase future deficits, but will push the state closer to its debt limit, which will limit the state's borrowing capacity for capital outlay projects through fiscal year 2024. Exhibit 1 shows the impact of General Fund deficits.

Exhibit 1



Source: Prepared by legislative auditor's staff using information obtained from the Department of the Treasury.

To help address these deficits, the Commission used bond premiums and executed bond defeasances. Ordinarily, the state makes debt payments from the Bond Security and Redemption Fund (BS&R); any remaining funds are transferred to the General Fund or statutorily-dedicated funds.[1] The state's use of bond premiums and defeasances reduced the amount needed for debt payments from BS&R, which made additional funds available for transfer into the General Fund and statutorily-dedicated funds.

Louisiana Constitution Article VII § 8 requires the Commission to approve the selling of all state and local bonds, and state law[2] requires that it approve the execution of the bond defeasances. The Commission's membership is illustrated in Exhibit 2 and it meets monthly.

A **Bond*** acts as a loan where governments can borrow money by issuing bonds to investors (lenders) in exchange for cash. The state uses bonds primarily to pay for capital projects that will have long-lasting benefits, such as bridges, roads, sewer systems, buildings, etc.

A **Bond Premium** is extra money that the state receives up front in return for paying a higher interest rate over the life of the bond. The amount of the premium received is the discounted present value of these extra interest payments.

A **Bond Defeasance** is a way of setting aside money in the present to offset future debt payments. The state cannot get this money back after setting it aside.

*Appendix C summarizes the process for issuing a bond.

Exhibit 2: Membership of the State Bond Commission

Primary Executive Branch	Statewide Elected Officials	Legislative Branch

• Governor (or Executive Counsel)
• Commissioner of Administration
	• State Treasurer (Chairman)
	• Lieutenant Governor
	• Attorney General
	• Secretary of State
		• Presiding Officers
		  • Senate President
		  • House Speaker
		• Committee Chairmen
		  • Senate Revenue and Fiscal
		  • Senate Finance
		  • House Ways and Means
		  • House Appropriations
		• Members at large
		  • Senator
		  • Representative

Source: Prepared by legislative auditor's staff using information in Louisiana Revised Statute 39:1401.

[1] La. Const. Art. VII § 9.
[2] Act 55 of 2014 ($210 million) and Act 56 of 2015 ($125 million).

The objective of this audit was to determine how the Commission's borrowing activities have impacted the state's future financial resources and to estimate the actual long-term costs of these activities. Overall, we found the following:

- **The Commission, as authorized by the Capital Outlay Act, used $210 million in bond premiums from fiscal years 2011 through 2016 to make debt payments, which reduced General Fund deficits. As a result, the state will have to pay back this amount with an additional $71 million in interest over the next 20 years without the benefit of long-lasting capital improvements.** Ordinarily, bond proceeds are used to invest in capital outlay projects that have long-term benefits for the public such as roads and bridges.

- **The Commission, as required by legislation, approved the use of $335 million in non-recurring revenue to defease bonds. These defeasances allowed the state to reduce its required debt payments in fiscal years 2015 and 2016, which reduced General Fund deficits. However, the state could have saved $160 million in interest by directly allocating this revenue for capital outlay projects.** In addition, had the state enacted a long-term defeasance instead of a short-term defeasance, the state could have saved $95.3 million on future debt payments while still reducing budget deficits.

- **The Commission has approved new projects faster than it can sell bonds to pay for them.** Consequently, the new administration and legislature will face a $3.7 billion backlog of approved spending on capital outlay projects resulting in a reduced capacity for new projects until fiscal year 2024.

- **A downgrade in the state's credit rating would increase the state's borrowing costs and decrease the amount that the state can afford to borrow each year.** For bonds that the state sold in May 2015, a downgrade from Aa2 to Aa3 would have cost the state $7 million (2%) in foregone proceeds. The state's use of one-time solutions, including borrowed bond premiums and defeasances utilizing non-recurring revenues, to reduce General Fund deficits resulted in the state maintaining a structural budget deficit, which has drawn scrutiny from credit rating agencies.

Appendix A contains the Department of the Treasury and the Commission's response to this report, Appendix B contains our scope and methodology, Appendix C summarizes the process for issuing a bond, and Appendix D contains the credit ratings for all states.

Objective: How have the State Bond Commission's (Commission) borrowing activities impacted the state's future financial resources and what are the actual long-term costs of these activities?

During fiscal years 2011 through 2016, the Commission used bond premiums and executed bond defeasances to help address and reduce General Fund deficits by $545 million. As a result of these measures, the state will have to pay $231 million more in interest over the next 20 years. These practices have also pushed the state closer to its debt limit, which will limit the state's borrowing capacity for capital outlay projects in the near future and increases the risk that the state's credit rating will be downgraded by ratings agencies. Our analysis is summarized in the following sections.

The Commission, as authorized by the Capital Outlay Act, used $210 million in bond premiums from fiscal years 2011 through 2016 to make debt payments, which reduced General Fund deficits. As a result, the state will have to pay back this amount with an additional $71 million in interest over the next 20 years without the added benefit of long-lasting capital improvements.

Because of market conditions, the state received $210 million[3] in bond premiums during fiscal years 2011 through 2015 (these premiums were used through fiscal year 2016) from the $2.3 billion the state has received in new general obligation bond[4] proceeds. Appendix C summarizes the process for issuing a bond. Bond premiums are extra money that the state receives up front in return for paying a higher interest rate over the life of the bond. Because the state is receiving money up front but agreeing to repay this amount with interest at a later date, premiums are essentially borrowed funds.

Example of Bond Premiums

If the state issued a $1 million, 10-year bond paying annual interest of 3%, but market interest rates were only 1.5%, then the state would receive a total of $1,138,333 in proceeds, of which $1 million is principal, and $138,333 is premium. The state would receive an extra $138,333 up front because it agreed to pay an extra $150,000 in interest (3% instead of 1.5% interest) over the life of the bond.

[3] The state actually received $218 million, but $8 million was used to pay issuance costs and underwriter fees.
[4] General obligation bonds are bonds that the borrower promises to repay and pledges its full faith and credit toward repayment. These are in contrast to revenue bonds, which the borrower pledges to repay from a specific revenue source but not necessarily from general revenues.

The Commission, as authorized by the Capital Outlay Act each year,[5] used these premiums to make debt payments, which reduced General Fund deficits[6] from fiscal years 2011 through 2016. However, the state will have to repay the $210 million in premiums plus an additional $71 million in interest over the next 20 years.

According to the Department of the Treasury, while the Commission approved projects for expenditure reimbursement and approved bond issuances, it did not specifically vote for the utilization of bond premiums received from the sales. At the time projects obtained Commission approval for expenditure reimbursement, which is prior to the bond sale, the existence of a bond premium was unknown because the reimbursement approval is required 30 days prior to sale. Existing market conditions at the time of sale generated unexpected additional revenue referred to as bond premium. After the bond sale is finalized, the Department of the Treasury is made aware of the existence of bond premiums generated by the sale. As has been the practice since 2003, the use of these premiums has consistently been utilized for General Obligation debt service thereby freeing up general fund money.

Even though this has been the practice since 2003, in 2013, the Attorney General opined that bond premiums may be used for capital outlay projects, but the Commission has not adopted this practice. Instead, the Commission has continued to allow premiums to be used for debt payments that otherwise would have come out of the General Fund, thereby reducing General Fund deficits.

Ordinarily, bond proceeds are used to invest in capital outlay projects that have long-term benefits for the public such as roads and bridges. Thus, in future years when the state has to repay what it borrowed with interest, the citizens of Louisiana have the benefit of long-lasting capital improvements. In contrast, using bond premiums to reduce General Fund deficits burdens the state with paying back the premiums with interest without the added benefit of long-lasting capital improvements.

According to the Department of the Treasury, the Bond Commission staff has a potential solution that would modify the existing process of how premiums are utilized. This solution would entail utilizing premiums for project reimbursement instead of debt payments. This would result in a reduction of principal borrowed and would lower interest costs. It is the Bond Commission staff's intention to present this approach to the Commission for approval to use premiums in this way prior to the next bond sale.

[5] Since fiscal year 2005, the Capital Outlay Act has provided that, "Notwithstanding any provisions contained herein or other law to the contrary, any original issue premium or accrued interest proceeds received pursuant to the sale of general obligation bonds shall remain on deposit to the credit of the Bond Security and Redemption Fund until such time as they may be utilized in accordance with U.S. Department of Treasury Regulations promulgated pursuant to the Internal Revenue Code of 1986."

[6] These funds were used to pay interest due on other general obligation bonds. These payments would ordinarily be made from the state General Fund, so every dollar of bond premiums used for this purpose frees a dollar of state General Fund revenue, and reduces the General Fund deficit.

Summary of Management's Response: According to the Department of the Treasury/Commission, the Commission does not have anything to do with how a bond premium is used. The Commission does not vote on how a bond premium is used. Fiscal policy is set by the Legislature and implemented by the Governor, not the Commission. Utilization of bond premiums therefore is determined by the Legislature with significant influence from the Governor.

LLA Additional Comment: Although the Commission does not vote on how a bond premium is used, the Commission approves the sale of all General Obligation Bonds which sometimes results in a premium. A Tax Compliance and Use of Proceeds certificate is then signed by the Director of the Commission. This document outlines how the bond proceeds, including the premiums will be used. In addition, in 2013, the Attorney General opined that the Commission may allocate bond premiums for capital outlay projects, but the Commission has not adopted this practice. Instead, the Commission has continued to allow premiums to be used for debt payments that otherwise would have come out of the General Fund, thereby reducing General Fund deficits.

The Commission, as required by legislation, approved the use of $335 million in non-recurring revenue to defease bonds. These defeasances allowed the state to reduce its required debt payments in fiscal years 2015 and 2016, which reduced General Fund deficits. However, the state could have saved $160 million in interest by directly allocating this revenue for capital outlay projects.

During fiscal years 2014 and 2015, the state used $335 million in surplus funds in a manner that reduced General Fund deficits. The Revenue Estimating Conference designated these funds as "non-recurring" revenue because the state would not receive these funds year after year. La. Const. Art. VII § 10 allows for six uses for non-recurring revenue: retiring or defeasance of bonds, payments to reduce the unfunded accrued liability in state pension funds, funding for capital outlay projects, deposits into the Budget Stabilization Fund, deposits into the Coastal Protection and Restoration Fund, and funding for highway projects for which federal matching dollars are available.

Because the Constitution does not allow for non-recurring revenue to be used for general operating expenses, the Commission, as required by legislation passed during fiscal years 2014 and 2015,[7] enacted a short-term bond defeasance using these funds that helped reduce General Fund deficits in fiscal years 2015 and 2016. A bond defeasance is a way of setting aside money in the present to offset future debt payments. The state cannot get this money back after setting

[7] Act 55 of 2014 ($210 million) and Act 56 of 2015 ($125 million). Each defeasance, respectively, used non-recurring surpluses from fiscal years 2013 and 2014 to set money aside during fiscal years 2014 and 2015 to make debt payments due in fiscal years 2015 and 2016.

it aside because the funds are entrusted to an escrow agent (usually a bank) who will make required debt payments on the state's behalf as they come due. Specifically, the Commission set aside these surplus funds to make debt payments that would normally come from the General Fund budget, thereby reducing General Fund deficits by $335 million.

Because two of these six uses, defeasances and funding for capital outlay projects, are similar in that they allow the state to reduce its future debt payments without reducing its overall spending on capital outlay projects, we focused our analysis on these two options. Even though this use of a short-term bond defeasance provided immediate relief from General Fund deficits, if the state had used the surplus funds to enact a different type of defeasance or to fund capital outlay projects, the state could have reduced its required debt payments in future years, which would have reduced future General Fund deficits by a greater amount over multiple years.[8]

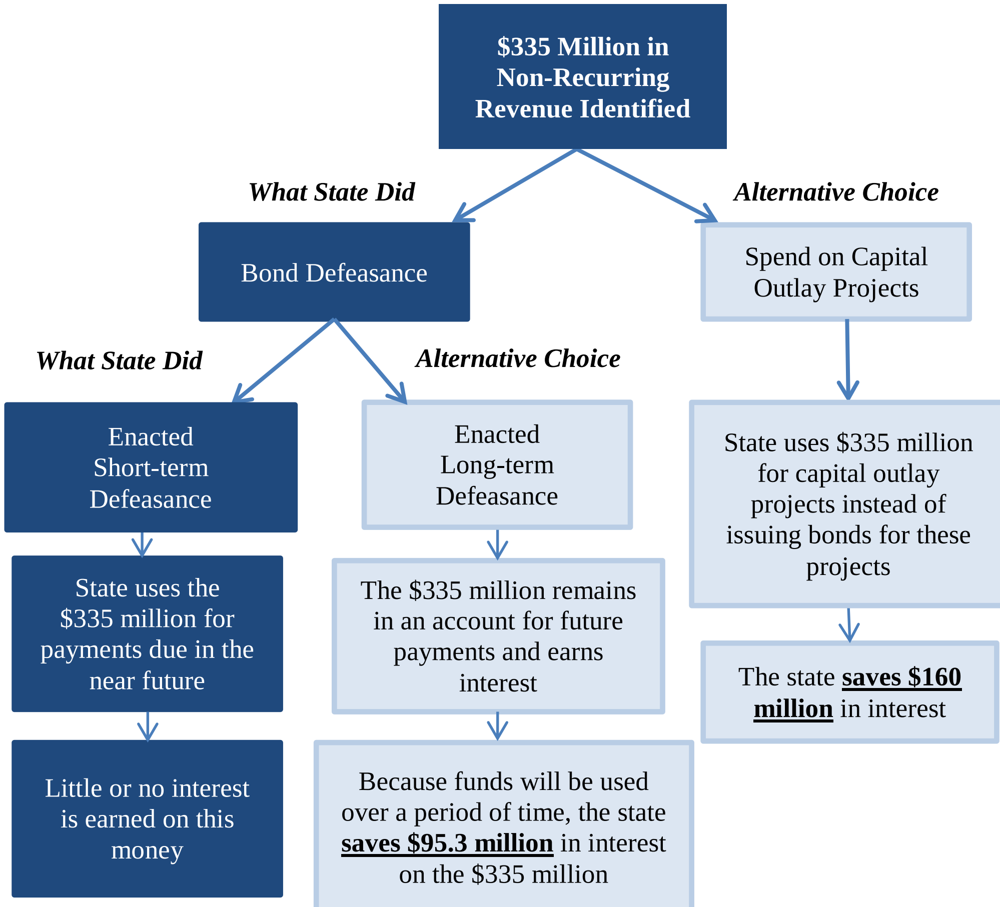
If the state had used the $335 million to enact a long-term defeasance instead of a short-term defeasance, it could have saved $95.3 million in future debt payments. In a defeasance, a borrower sets aside sufficient funds to satisfy a debt before it comes due. We considered two types of defeasances: long-term and short-term. The difference between these types of defeasances is how far into the future the state sets aside funds to pay down debt. If the funds are set aside to pay debts due over 20 years in a long-term defeasance, the money earns interest. A long-term defeasance also reduces General Fund deficits because it reduces required future debt payments. If the funds are set aside to pay debts due next year[9] in a short-term defeasance, the money earns little interest and just reduces the General Fund deficit for the next fiscal year.

Instead of enacting either type of defeasance, the state could have saved $160 million in interest by directly allocating surplus funds for capital outlay projects. Because the state pays a higher interest rate on its bonds than it can earn on funds set aside in a long-term defeasance, the state would save more money by choosing to invest these funds directly for capital outlay. Using surplus cash instead of bonds to pay for capital outlay projects enables the state to avoid paying interest on borrowed money. Furthermore, bond issuances and defeasances require the state to hire outside professionals, such as bond counsel, financial advisors, accountants, and escrow agents. During fiscal years 2014 and 2015, the state spent more than $77,000 for outside professionals to enact the bond defeasances. Direct appropriation toward capital outlay would have allowed the state to avoid these costs.

Exhibit 3 shows the impact of the different options the state had with using the surplus funds.

[8] Our analysis used a 20-year long-term defeasance.
[9] The state enacted a short-term bond defeasance to pay debt that was due during the subsequent fiscal year. For example, the state defeased $210 million during fiscal year 2014 to pay down fiscal year 2015 debt.

Exhibit 3
Different Options for Surplus Funds



Source: Prepared by legislative auditor's staff using information obtained from the Department of the Treasury.

The Commission has approved new projects faster than it can sell bonds to pay for them. Consequently, the new administration and legislature will face a $3.7 billion backlog of approved spending on capital outlay projects resulting in a reduced capacity for new projects until fiscal year 2024.

Between fiscal years 2016 and 2024, we project that the state will have the capacity to borrow an average of approximately $410 million each year without exceeding the state's borrowing limit.[10] However, based on recommendations by the Division of Administration, the Commission has approved $3.7 billion in spending on capital outlay projects as of December 2015. This will result in a reduced capacity for new projects until fiscal year 2024. The state's use of bond premiums and non-recurring revenues has reduced the state's borrowing capacity and made it harder for the state to pay for the backlog of approved capital outlay projects. If the state had used bond premiums and non-recurring revenues to pay for capital outlay projects, the backlog would be lower.

According to the Department of the Treasury, as set forth in statute, the Legislature votes to approve the Capital Outlay budget and the Governor signs the bill for enactment into law each year. Subsequently, the Commissioner of Administration, by law, exercises supervision and enforces the provisions of the Capital Outlay budget, including submitting the list of projects for lines of credit for approval by the Commission and submitting the list of projects to be reimbursed by a bond sale for approval by the Commission. While the Commission serves as the final approver of projects for reimbursement and bond sales, it is neither the initiator nor the sole participant in the approval process. As shown in Exhibit 2 on page 2 of this report, the membership of the Commission is comprised of members from the Executive and Legislative branches of government and statewide elected officials.

Without an increase in the state's revenue forecast, which would increase the debt limit and the amount the state can borrow each year, the state will need until fiscal year 2024 to raise enough bond proceeds to fund these approved projects without exceeding the state's borrowing limit. If the Commission wants to approve new projects so that project managers can begin work without waiting for all approved projects to be completed, projects that have already been approved must be postponed or canceled. Consequently, because the Commission has approved new projects faster than it can sell bonds to pay for them, there is an increased risk that the state will run out of cash, exhaust its borrowing capacity, or have less flexibility in approving and starting work on new projects as described below.

[10] La. Const. Art. VII, § 6(F) and R.S. 39:1367 prohibit the state from borrowing if the state would have to spend more than 6% of forecast revenues to make debt payments on new and outstanding debt in any current or future fiscal year. Act 419 of 2013 effectively increased the state's debt limit by directing the Revenue Estimating Conference to include additional revenues in its forecast, but the Commission adopted a resolution on August 21, 2014, reversing the effect of Act 419 to alleviate concerns that the state would incur more debt without the benefit of additional revenues to repay it.

- **Availability of Cash.** The state must have sufficient cash from bond sales to ensure that capital outlay projects progress on schedule and invoices can be paid, or else the state could face penalties for delays. As more projects are approved, the state may not be able to sell the bonds necessary to pay for the projects without exceeding the state's borrowing limit.[11]

- **Borrowing Capacity.** For capital outlay projects financed using general obligation bonds,[12] the state needs to have sufficient borrowing capacity to reimburse these project expenditures within the time limits imposed by the U.S. Treasury Regulations governing tax-exempt bonds, or else the state could be forced to exceed its borrowing limit (which requires a two-thirds vote of the legislature), issue more costly taxable bonds, or reimburse the expenditures without borrowing more money in order to meet its obligations. For example, the state currently has the capacity to borrow $410 million each year without exceeding the state's borrowing limit. At this rate, the state would need until fiscal year 2024 to provide funds for the $3.7 billion in approved projects.

- **Flexibility.** The state gives up flexibility by approving projects and committing to use general obligation bond proceeds without having the borrowing capacity to pay for these projects. Making too many commitments would limit the state's ability to fulfill new requests for capital outlay projects. Specifically, the state will have less flexibility to start new projects until existing projects have been completed, postponed, or canceled.

One way the legislature could mitigate these risks is by changing the law to base the line of credit limit (i.e. how much the Commission can approve in project spending) on the state's actual borrowing capacity and by setting a limit for non-cash lines of credit. This would make it harder for the Commission to approve new projects faster than it can raise bonds to pay for them. In addition, in order to reduce the current $3.7 billion backlog in approved spending on capital outlay projects, the state could increase revenues, or decrease the amount authorized to be spent on new bond-financed capital outlay projects until the current backlog is reduced. These options are discussed below.

Changing the law to base the line of credit limit on the state's actual borrowing capacity and setting a limit for non-cash lines of credit could prevent the Commission from approving new projects faster than it can raise bonds to pay for them. Even though R.S. 39:112(F) limits lines of credit[13] the Commission can approve for new projects, this law does not consider the

The Commission approves funding for general obligation bond financed projects by granting a **line of credit**. A **cash line of credit** is how much can be spent in the current year, and a **non-cash line of credit** is how much can be spent in future years.

[11] Unexpected weakening in the state's revenue forecast or in bond markets would reduce the amount that the state can raise through bond sales.

[12] General obligation bonds are bonds that the borrower promises to repay and pledges its full faith and credit toward repayment. These are in contrast to revenue bonds, which the borrower pledges to repay from a specific revenue source but not necessarily from general revenues.

[13] The limit is calculated by taking the previous year's limit, adding $200 million, and subtracting general obligation bond sales. The $200 million is adjusted each year for construction inflation and is cumulative over time.

state's actual borrowing capacity in calculating the limit. In addition, this law does not apply to non-cash lines of credit. As a result, $2.2 billion of the $3.7 billion that the Commission has approved is for non-cash lines of credit and thus not subject to this limit.

We focused on the impact of changing the law limiting lines of credit because this is an action the legislature can take to prevent the Commission from approving new projects faster than it can raise bonds to pay for them. The Capital Outlay Act (i.e. House Bill 2) authorizes more general obligation bond-financed project spending than the state can pay for in one year, so not all projects in the Act can move forward. Whether such a project moves forward depends on whether the project is approved by the Commission and receives a line of credit. If the Commission were limited to approving projects based on the state's actual borrowing capacity, and if the limit applied to both cash and non-cash lines of credit, this would decrease the risk that the state would run out of cash, exhaust its borrowing capacity, or have less flexibility in choosing projects.

In order to reduce the current $3.7 billion backlog in approved spending on capital outlay projects, the state can increase revenues, or the Commission could decrease the amount authorized to be spent on new bond-financed capital outlay projects until the current backlog is reduced. If the state's revenues increase (e.g. increases in taxes, licenses, fees, etc.), the state could borrow more without exceeding its borrowing limit, use the proceeds for capital outlay projects, and reduce the current backlog. Exhibit 4 shows how much borrowing capacity the state could gain by increasing revenues. As the exhibit shows, a permanent increase in revenues increases the state's borrowing capacity for one fiscal year.

Exhibit 4
Effect of Increase in Revenue Forecast on Borrowing Capacity
(for one fiscal year)

Revenue Increase	Borrowing Capacity*
No increase (current revenues)	$617 million
$500 million increase	$1,021 million
$1 billion increase	$1,425 million
$1.5 billion increase	$1,830 million

*The increased borrowing capacity would be a one-time gain. If the state borrows against the increased revenues, the state will owe debt payments on the new bonds for 20 years, so the increased revenues will not be available to support subsequent bond issuances.
Source: Prepared by legislative auditor's staff using information from the Department of the Treasury, the Congressional Budget Office, the United States' Treasury, and net state tax supported debt outstanding as of June 30, 2015.

In addition, if the Commission wanted to approve new projects without adding to the backlog, the legislature could directly appropriate General Fund cash for these projects. The Commission could also borrow in excess of the debt limit if approved by the legislature, but this would burden the state with additional debt payments that would add to the state's structural deficit and be viewed negatively by credit rating agencies.

Matter for Legislative Consideration: The legislature may wish to consider requiring that the line of credit limitation be based on the state's borrowing capacity and setting a limit for non-cash lines of credit.

Summary of Management's Response: According to the Department of the Treasury/Commission, the Division of Administration, not the Commission, controls the timing and flow of capital outlay projects. The Commission's sole involvement is to approve or disapprove lines of credit sent to the Commission by the Division of Administration. By statute, the Commission cannot consider a line of credit unless the Division of Administration forwards it to the Commission. By custom, the Division of Administration and the Governor's office decide, with input from their allies on the Commission and others, which lines of credit are sent to the Commission.

A downgrade in the state's credit rating would increase the state's borrowing costs and decrease the amount that the state can afford to borrow each year. For bonds that the state sold in May 2015, a downgrade from Aa2 to Aa3 would have cost the state $7 million (2%) in foregone proceeds.

The state's use of one-time solutions, including borrowed bond premiums and defeasances utilizing non-recurring revenues, to reduce General Fund deficits has resulted in the state maintaining a structural budget deficit, which has drawn scrutiny from credit rating agencies. Louisiana currently holds an AA rating from Standard & Poor's and Fitch and an Aa2 rating from Moody's.[14] In February 2015, Standard & Poor's and Moody's placed Louisiana on a negative outlook from a previously stable outlook, which indicates that the agencies may downgrade the state's rating. These two rating agencies placed the state on a negative outlook because of the state's persistent General Fund deficits. According to Moody's, "The negative outlook reflects the state's growing structural budget imbalance, projected at $1.6 billion for fiscal year 2016."

Maintaining a high rating is important because states with high credit ratings can generally borrow money at lower interest rates than states with low credit ratings. Of the 48 states that issue general obligation bonds, Moody's assigned 31 states a higher rating than Louisiana, 11 states the same rating, and six states lower ratings. Of the 11 states with the same rating, Louisiana is the only one with a negative outlook. Appendix D summarizes the rating for each state. The advantage of a higher credit rating is that the state experiences a lower cost of borrowing; therefore, the state can receive more money in bond proceeds without increasing its debt payments each year and can spend more on capital projects.

[14] The state hires ratings agencies, such as Moody's Investors Service, Standard & Poor's Ratings Services, or Fitch Ratings, to give investors an independent assessment of the state's creditworthiness.

We found that a decrease to an Aa3 rating by Moody's would have cost the state $7 million in proceeds for bonds issued in May 2015 because of higher interest rates, assuming that the amount of debt payments on these bonds remained constant. In contrast, we found that the state could have received an additional $13 million if it had issued the bonds with an Aaa rating, or $9 million more with an Aa1 rating, the next step up from Aa2 for just this one bond sale. Exhibit 5 shows the impact on the bond proceeds for each credit rating category.

Exhibit 5
Example of Effect of Credit Rating on Bond Proceeds
Bond Sale May 2015

Rating	Proceeds	Change in Proceeds from Actual	Percent Change
Aaa	$388 million	$13 million	3.4%
Aa1	$384 million	$9 million	2.5%
Aa2 (actual)	**$375 million**	**$0**	**0.0%**
Aa3	$368 million	($7 million)	(1.9%)

Source: Prepared by legislative auditor's staff using information from the Municipal Securities Rulemaking Board and Moody's Investors Service.

A credit rating is a rating agency's opinion on the likelihood that a borrower will be able to make debt payments as they come due. For example, according to Standard & Poor's, to obtain an AAA rating, a state must be projected to survive a prolonged economic downturn on the scale of the Great Depression without defaulting on their debt. Lower ratings go to issuers with low cash reserves, "structural deficits" in which expenditures persistently exceed revenues, undiversified or volatile tax bases, excessive outstanding debt, or other indicators of financial stress. In recent years the state has addressed General Fund deficits by using borrowed money and non-recurring revenues instead of implementing structural budget reform. Exhibit 6 summarizes Louisiana's financial strengths and weaknesses, as identified by the three major ratings agencies.

Exhibit 6
Louisiana's Financial Strengths and Weaknesses Identified by Ratings Agencies

Strengths	Weaknesses
• Timely responses to downward revenue projections • Trend of low unemployment relative to the nation • Debt policies that have lowered the state's debt ratios over time • Constitutional balanced budget requirements	• Continued structural budget deficits due to underperforming revenues • Below average reserves for an energy-reliant state • Large Medicaid caseloads • Unfunded pension and Other Postemployment Benefits liabilities

Source: Prepared by legislative auditor's staff using information from Standard & Poor's, Moody's, and Fitch.

APPENDIX A: MANAGEMENT'S RESPONSE

TREASURER OF THE STATE OF LOUISIANA

JOHN NEELY KENNEDY
TREASURER

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February 8, 2016

Mr. Daryl G. Purpera, CPA, CFE
Louisiana Legislative Auditor
P.O. Box 94397
Baton Rouge, LA 70804-9397

RE: State Bond Commission Performance Audit Report

Dear Mr. Purpera:

The Department of Treasury and State Bond Commission thanks you and your staff for conducting the performance audit regarding the impact of state borrowing activities on Louisiana's future financial resources.

In general we concur with the information contained in the report. However, there are two areas in which additional clarification is warranted. Please indicate these in your report.

(1) In the report, it was stated *"The Commission, as authorized by the Capital Outlay Act, used $210 million in bond premiums from fiscal years 2011 through 2016 to make debt payments, which reduced general fund deficits."*

The Commission does not have anything to do with how a bond premium is used. The Commission does not vote on how a bond premium is used. Fiscal policy is set by the Legislature and implemented by the Governor, not the Commission. Utilization of bond premiums therefore is determined by the Legislature with significant influence from the Governor.

(2) In the report, it was stated *"The Commission has approved new projects faster than it can sell bonds to pay for them"*.

The Division of Administration, not the Commission, controls the timing and flow of capital outlay projects. The Commission's sole involvement is to approve or disapprove lines of credit sent to the Commission by the Division of Administration. By statute, the Commission cannot consider a line of credit unless the Division of Administration forwards it to the Commission. By custom, the Division of Administration and the Governor's office decide, with input from their allies on the Commission and others, which lines of credit are sent to the Commission.

Attached you will find suggested language which has been submitted to the performance audit manager, Ms. Gina V. Brown, MPA, CIA, CGAP, CRMA. Thank you again for the efforts associated with conducting the recent performance audit.

Sincerely,

John Kennedy
State Treasurer

JNK/lmf/dtm

Enclosure

APPENDIX B: SCOPE AND METHODOLOGY

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. Our audit focused on the State Bond Commission (Commission) and how its borrowing activities from fiscal years 2011 through 2016 have impacted the state's future financial resources and the actual long-term costs of these activities.

We conducted this audit in accordance with generally-accepted *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. To answer our objective, we reviewed internal controls relevant to the audit objective and performed the following audit steps:

(1) Met with officials from the Department of the Treasury, House Fiscal Services, Senate Fiscal Services, Legislative Fiscal Office, Office of Facility Planning and Control, Office of the Commissioner of Administration, Interim Emergency Board, Lamont Financial Services, and the Sisung Group to gain an understanding of stakeholder concerns with the Commission's activities and bond markets and capital outlay.

(2) Researched state laws pertaining to bond issuance, uses for non-recurring revenue, and capital outlay procedures.

(3) Analyzed the state's use of new-money general obligation bond premiums by obtaining data from the Integrated Statewide Information System and Electronic Municipal Market Access system of the Municipal Securities Rulemaking Board. Calculated the portion of interest attributable to bond premiums on each issue.

(4) Analyzed the bond defeasances called for in Act 55 of 2014 and Act 56 of 2015. Estimated savings from a long-term defeasance by using yields from the U.S. Treasury's State and Local Government Securities window. Analyzed savings from direct appropriation to capital outlay by using total interest paid per dollar of proceeds on the state's Series 2014 D1 and D2 and Series 2015 A and B general obligation bonds.

(5) Analyzed the cash position in the capital outlay escrow fund by using information in the Integrated Statewide Information System. Interviewed staff at the Office of Statewide Reporting and Accounting Policy, Office of Facility Planning and Control, and Department of the Treasury to gain an understanding of accounting policies. Obtained calculations of limits on lines of credit and bond issuances

from the Office of Facility Planning and Control and State Bond Commission staff.

(6) Forecasted the state's future receipts from bond proceeds by using revenue forecasts from the Revenue Estimating Conference, future debt service from Commission staff, and future U.S. Treasury yields from the Congressional Budget Office's *Long-Term Budget Outlook*.

(7) Estimated the effect of a downgrade to the state's credit rating by one of the rating agencies by researching bonds issued during May and June of 2015, approximately the same time as the state issued the Series 2015 A&B general obligation bonds. Obtained a sample of twenty tax-exempt general obligation bonds issued by states during this period with Moody's ratings at time of issuance ranging from Aaa to Aa3. Used average yields for each rating and for each maturity to calculate credit spreads for higher-risk issues. Recalculated the amount of proceeds that the state would have received from the Series 2015 A&B with yields adjusted by the spread corresponding to each rating upgrade or downgrade, without changing debt service.

(8) Obtained five-year General Fund baseline budget projections from the Legislative Fiscal Office for fiscal years 2012 through 2016 and calculated the average projected General Fund deficit as measured at the beginning of each year's legislative session.

APPENDIX C: PROCESS FOR ISSUING BONDS

Bonds can be issued by either a competitive or negotiated bond sale. After a bond is issued by the state, the lender transfers the funds to the Department of the Treasury. From here, the State Treasurer deposits the money into the Capital Outlay Escrow Account. From the account, the state pays the capital outlay projects for which the bonds were issued and invoices presented.

How the State Issues Bonds to Pay for Projects

Choosing and Prioritizing Projects

- State agencies and legislators submit project requests to the Office of Facility Planning and Control (OFPC) for a feasibility analysis.
- OFPC makes recommendations to the Legislature for what projects should be included in the Capital Outlay Budget (HB2).
- Legislature enacts, Governor signs HB2.

Bond Commission Approval

- Bond Commission formally approves bond funded projects from HB2. The projects that are actually funded from HB2 are selected by the Division of Administration.
- OFPC, Department of Transportation and Development, and Coastal Protection and Recovery Authority will spend bond money and oversee project work.

Actual Bond Issuance

- Legislature enacts, Governor signs Bond Authorization Act (HB3).
- HB3 provides funding for selected capital outlay projects from HB2.
- Bond Commission works with financial advisor, bond counsel, to sell bonds to investors to pay for projects.
- Bond funds deposited into capital outlay escrow fund.
- State pays back bonds in accordance with the agreed upon terms.

APPENDIX D: STATE RATINGS

Number of States for Each Credit Rating	
Ratings	**Number of States**
Aaa	15
Aa1	16
Aa2	11
Aa3	3
A1	0
A2	1
A3	1
Caa3	1
No General Obligation	3
Total	51

*List of States includes Puerto Rico
Source: Prepared by legislative auditor's staff using information from Moody's Investors Services.

Breakdown of States, by Credit Rating and Outlook		
State	**Rating**	**Outlook**
Alaska	Aaa	Negative
Delaware	Aaa	Stable
Georgia	Aaa	Stable
Indiana	Aaa	Stable
Iowa	Aaa	Stable
Maryland	Aaa	Stable
Missouri	Aaa	Stable
New Mexico	Aaa	Stable
North Carolina	Aaa	Stable
South Carolina	Aaa	Stable
Tennessee	Aaa	Stable
Texas	Aaa	Stable
Utah	Aaa	Stable
Vermont	Aaa	Stable
Virginia	Aaa	Stable
Alabama	Aa1	Stable
Arkansas	Aa1	Stable
Colorado	Aa1	Stable
Florida	Aa1	Stable

Breakdown of States, by Credit Rating and Outlook		
State	**Rating**	**Outlook**
Idaho	Aa1	Stable
Massachusetts	Aa1	Stable
Michigan	Aa1	Stable
Minnesota	Aa1	Stable
Montana	Aa1	Stable
New Hampshire	Aa1	Stable
New York	Aa1	Stable
North Dakota	Aa1	Stable
Ohio	Aa1	Stable
Oregon	Aa1	Stable
Washington	Aa1	Stable
West Virginia	Aa1	Negative
Arizona	Aa2	Stable
Hawaii	Aa2	Positive
Kansas	Aa2	Stable
Kentucky	Aa2	Stable
Louisiana	Aa2	Negative
Maine	Aa2	Stable
Mississippi	Aa2	Stable
Nevada	Aa2	Stable
Oklahoma	Aa2	Stable
Rhode Island	Aa2	Stable
Wisconsin	Aa2	Positive
California	Aa3	Stable
Connecticut	Aa3	Stable
Pennsylvania	Aa3	Negative
New Jersey	A2	Negative
Illinois	A3	Negative
Puerto Rico	Caa3	Negative
Nebraska	No General Obligation Bonds	Stable
South Dakota	No General Obligation Bonds	Stable
Wyoming	No General Obligation Bonds	N/A
Source: Prepared by legislative auditor's staff using information from Moody's Investors Services.		