

AGENDA

JOINT MEETING OF THE COMMITTEES ON FINANCE AND CAMPUS PLANNING, BUILDINGS AND GROUNDS

Meeting: 3:05 p.m., Tuesday, May 20, 2014
Glenn S. Dumke Auditorium

Committee on Finance

Roberta Achtenberg, Chair

Adam Day

Rebecca D. Eisen

Douglas Faigin

Margaret Fortune

Steven M. Glazer

Lou Monville

**Committee on Capital Planning,
Buildings and Grounds**

Rebecca D. Eisen, Chair

J. Lawrence Norton, Vice Chair

Adam Day

Douglas Faigin

Margaret Fortune

Lillian Kimbell

Lou Monville

Cipriano Vargas

Consent Items

Approval of Minutes of Meeting of March 25, 2014

Discussion

1. Capital Financing and the 2014-2015 Governor's Budget Proposal , *Information*

**JOINT MEETING
COMMITTEES ON FINANCE AND
CAMPUS PLANNING, BUILDINGS AND GROUNDS**

Capital Financing and the 2014-2015 Governor's Budget Proposal

Presentation By

Elvyra F. San Juan
Assistant Vice Chancellor
Capital Planning, Design and Construction

Ryan Storm
Interim Assistant Vice Chancellor
Budget

Robert Eaton
Acting Deputy Assistant Vice Chancellor
Financing, Treasury, and Risk Management

Summary

This item responds to the California State University Board of Trustees' request at its March 2014 meeting to follow up with additional information and provide an assessment of risk on the capital financing changes proposed for the CSU in the 2014-2015 Governor's Budget (the "Proposal"). This item builds upon previous presentations to the board and provides: additional analysis on the initial funding level of the Proposal (i.e. the level of the permanent increase to the CSU general fund base); a summary of key debt policy considerations to implement the Proposal and the impacts of debt policy decisions; potential impacts that the Proposal may have on the CSU credit ratings and cost of capital; and a summary of possible State Public Works Board refinancing opportunities.

Staff will also provide appropriate updates regarding the Proposal stemming from the Governor's May Revise to the 2014-2015 Budget.

Summary of the Proposal

Under the Proposal, the budget burden for debt service (principal and interest) on State General Obligation (GO) bonds and State Public Works Board (SPWB) bonds that have been issued on behalf of the CSU will be shifted from the State to the CSU on a permanent basis. The Proposal also provides the CSU with new authorities to help the CSU address future capital financing needs. Key components of the Proposal include:

- Permanently increase the CSU general fund base budget by approximately \$297 million to accommodate the debt service shift (\$198 million for GO bond debt payments and \$99 million for SPWB bond debt payments).

In order to accommodate recent projects that have been approved by the legislature and have been funded with SPWB bonds, but which are not yet reflected in the debt service schedules for SPWB bonds, the Department of Finance (DOF) has agreed to a series of increases to the CSU general fund base budget in the near future. This would result in an \$18 million increase to the CSU base budget by 2017-2018, or an increase in the debt service shift from \$297 million to \$315 million. However, this potential increase would not be in statute and would be subject to approval by the legislature in future budgets.

No other adjustments would be made to the CSU general fund base budget in the future to accommodate changes in GO/SPWB debt service.

- Authorize the CSU to pledge, in addition to any of its other revenues the CSU may choose to pledge, its annual general fund support appropriation, less the amount of that appropriation required to meet GO and SPWB debt service, to secure CSU debt issued pursuant to the State University Revenue Bond Act of 1947¹ ('47 Bond Act). The Proposal also provides that the State will not restrict or impair the CSU's ability to pledge its annual general fund support appropriation, as long as any debt supported by the pledge remains outstanding.

Under this provision, no more than 12 percent of the annual general fund support appropriation may be used to: (a) fund academic buildings and infrastructure projects; and (b) refund, restructure, or retire SPWB bond debt.

- Fund projects on a pay-as-you-go basis within the same 12 percent annual general fund support appropriation limit.
- Streamline the project submittal process to the DOF and the legislature.
- Add flexibility under the '47 Bond Act to allow the CSU to utilize the new authorities through its existing Systemwide Revenue Bond (SRB) program.

KEY FINANCIAL CONSIDERATIONS

¹ The State University Revenue Bond Act of 1947 (Education Code Sections 90010-90082) is the authority under which the CSU's Systemwide Revenue Bond program has been created.

Initial Funding Level of the Proposal and the Ability to Address Future Capital Needs

At the March 2014 board meeting, staff presented analyses on the ability of the CSU to address future capital needs—in particular, to address the growing \$1.8 billion backlog in deferred maintenance—under the Proposal’s funding level of \$297 million, as well as two higher initial funding level scenarios: (a) \$337 million, or \$40 million higher than the Proposal; and (b) \$397 million, or \$100 million higher than the Proposal. Under the \$297 million and \$337 million initial funding scenarios, the Proposal would not provide the CSU with sufficient ability to adequately address its deferred maintenance backlog. In both cases, while opportunities to issue debt and meet some deferred maintenance needs arise at different points in the future, the backlog continues to grow into the indefinite future. However, under the \$397 million initial funding scenario, the CSU could make progress in addressing its deferred maintenance backlog. While the backlog would not be eliminated, the additional revenues support enough additional debt issuance to fund approximately \$1.6 billion of deferred maintenance need over the next twelve years, and in 2023, the backlog would be about \$1.3 billion less than under the Proposal’s \$297 million initial funding level.

Since the March 2014 board meeting, the CSU has worked with its financial advisor, KNN Public Finance, and investment banking teams at Barclays Capital and Bank of America Merrill Lynch, who have independently confirmed these conclusions under a number of interest rate, debt structuring, and debt policy assumptions.

Debt Program Structure and Debt Policy Considerations

Under the Proposal, the CSU could utilize its new authorities to structure a new capital financing program through the existing SRB program or create a new, stand-alone debt program. In working through the existing SRB program, legal documentation, the costs of developing the new program, including credit rating discussions, and program administration would be less compared to the creation of a new, stand-alone program. However, in working through the SRB program, state general fund appropriation risk would be directly introduced into the SRB program, as well the potential risk of debt service coverage dilution, which could impact credit ratings over time and increase the cost of capital. These two risks are manageable (e.g. through CSU debt policy) and overall, at this point, working through the existing SRB program would be recommended.

In terms of debt policy, there are a couple of key policy decisions that would need to be considered regarding the utilization of the new authorities and the development of a new capital financing program under the Proposal.

- **Allocation Methodologies**—The allocation of revenues and the resulting capital funding resource, as well as pay-as-you-go funds, available under the Proposal will need to be determined. Generally, this will be a choice between managing the resources centrally or allocating them down to individual campuses. This decision will have potential impacts

on a number of areas, including how efficiently the resources are utilized, how projects will be evaluated and presented to the board for financing approval, and how project expenses will be funded and incorporated into financing analysis.

- **Debt Service Coverage Ratios**—The choice of minimum debt service coverage ratios for projects financed under the Proposal’s new authorities will have a significant impact on the level of capital funding that will be available from a particular level of revenues, and will also have a potential impact on credit ratings. For example, under current market interest rates, debt service coverage ratios of 1.10, 1.25, or 1.50 would reduce the level of capital funding available from a particular level of revenues by nine percent, twenty percent, or one-third compared to the level of capital funding available at a 1.00 debt service coverage ratio (i.e. the revenues are leveraged to their maximum). Lower debt service coverage ratios make better use of the available revenues, but also introduce greater risk into the debt portfolio, with potential impact on the CSU’s ratings and cost of capital. In determining appropriate debt service coverage ratios, an additional consideration will be whether or not to include the revenues and GO/SPWB debt service that will come over to the CSU as part of the Proposal.

Potential Impacts on the CSU Credit Ratings and Cost of Capital

The potential impacts of the Proposal on the CSU’s credit ratings can be broken into two parts. First are the near term impacts resulting from the shifting of the GO and SPWB debt service. Because of the \$297 million permanent increase to the CSU general fund base budget to accommodate the debt service shift, the new authority to pledge annual general fund support appropriation, and the fact that both Moody’s Investors Service and Standard & Poor’s Ratings Services, the firms that presently rate CSU’s SRB program, already incorporate SPWB debt and/or CSU financial operating data into their rating analyses, no adverse impact on the CSU credit ratings would be expected in the near term. In fact, the ability to refinance SPWB debt for savings, along with the fact that the GO and SPWB debt service reduces over time, thereby freeing up cash flow in the future, could be seen as credit positives for the CSU, although likely not enough to result in an improvement in ratings.

Longer term, the potential impacts on the CSU’s credit ratings are primarily a function of how much, and how fast, debt might be issued by the CSU under the Proposal. Continued prudent management of debt, which has been the case throughout the history of the SRB program, will mitigate adverse impacts on ratings over the longer term and help preserve the CSU’s cost of capital. If the CSU were to be downgraded one level by each rating agency, the impact on the CSU’s cost of capital under today’s market conditions would be about 0.20% or twenty basis points.

Refinancing of SPWB Bonds

Under current market conditions, a small number of SPWB bonds that have been issued on behalf of the CSU could be refinanced by the CSU through its existing SRB program for net present value savings of about \$23 million, or 10.5%. This would result in annual cash flow savings of about \$1.5 million per annum that could generate about \$25 million in debt financing for capital needs.

Refinancing all SPWB bonds that have been issued on behalf of the CSU through the CSU's existing SRB program would result in significant net present value losses (ranging from \$91 million to \$135 million depending upon certain structuring assumptions). In adopting a structure similar to one utilized by the University of California in the fall of 2013, when it refinanced all of its SPWB bonds into its own debt program, the CSU could generate cash flow savings in the first ten years of an average of about \$38 million per annum and lower the net present value loss to about \$8 million, however, this would require the use of more sophisticated, and potentially riskier, financial products such as variable rate debt, swaps, shorter maturity put bonds, and taxable bonds.

Key Implications of the Proposal for the CSU

Under the Proposal, the CSU would be faced with notable challenges. The adequacy of the \$297 million funding level to meet new capital needs would be the primary challenge. Also, the \$297 million budget increase would not be sufficient to cover the GO/SPWB debt service in five of the seven years through 2020-2021, with the highest shortfall being \$40 million in 2016-2017. In such cases, the CSU would need to make use of its own resources to cover the deficit. In addition, there would be the ongoing risk that the GO/SPWB debt service would continue to be the responsibility of the CSU even in the face of future budget cuts due to economic downturns, thereby putting greater pressure on funds available to meet operating needs.

However, the Proposal also provides the CSU with new capital financing authorities, providing the CSU with a significantly improved ability to maintain and renovate its facilities. These authorities will last well into the future. Furthermore over time, the GO/SPWB debt payments decline, thereby freeing up cash flow for new capital purposes, including debt issuance, or other purposes.

**MINUTES OF THE JOINT MEETING OF THE
COMMITTEES ON FINANCE AND CAPITAL PLANNING,
BUILDINGS AND GROUNDS**

**Trustees of The California State University
Office of the Chancellor
Glenn S. Dumke Conference Center
401 Golden Shore
Long Beach, California**

March 25, 2014

Members Present

Finance Committee

Roberta Achtenberg, Vice Chair
Rebecca Eisen
Douglas Faigin
Margaret Fortune
Steven M. Glazer
Bob Linscheid, Chair of the Board
Lou Monville
Timothy P. White, Chancellor

Campus Planning, Buildings and Grounds Committee

Rebecca D. Eisen, Chair
J. Lawrence Norton, Vice Chair
Douglas Faigin
Margaret Fortune
Bob Linscheid, Chair of the Board
Lou Monville
Timothy P. White, Chancellor
Cipriano Vargas

Trustee Achtenberg called the meeting to order.

Capital Financing and the 2014-2015 Governor's Budget Proposal, *Information*

Ms. Elvyra San Juan, Assistant Vice Chancellor for Campus Planning, Design and Construction, stated that the use of long term bond financing is the primary method to fund both state and non-state funded capital outlay. The CSU has historically relied upon the state to fund academic buildings, science buildings, and instructional support buildings like libraries, and faculty offices. Typically the state funding has been from voter approved general obligation bond funds, with the legislature able to approve the use of State Public Works Board (PWB) bond funds. These are the two primary sources for state capital outlay, as there is very limited authority for

the CSU to use the operating budget for improvements. State capital outlay has historically been heavily reliant on voter approved general obligation bond funds. The last GO bond was approved in 2006 and the CSU received \$690 million to fund two years of its capital program.

The legislature approved use of PWB bonds in 2002 to help stimulate the economy, and did so again in 2008 as job stimulus funding. There has been occasional use of interest earnings or energy efficiency financing for capital projects.

Since 2007-2008 the amount of funding for capital outlay has significantly declined and changed to being heavily reliant upon PWB bonds. Due to the PWB bond financing structure, this has negatively impacted the CSU's ability to address deferred maintenance as such funds cannot be used for utility infrastructure projects, or partial building renovations. The decline in capital outlay funds and the decline in support budget funding for facility maintenance has put the CSU in crisis mode, as buildings continue to age with no ability or funding to remedy the growing problem.

There is significant pent up demand for capital improvements that represent a mix of renovations to existing buildings, replacement of existing buildings and new construction to address program academic growth. The total five-year plan exceeds \$7 billion and would be well served by annual funding levels of \$400 to \$500 million in capital expenditures per year to not just address replacement of electrical, ventilation and plumbing systems but address seismic and code deficiencies, and provide quality learning spaces. The board annually approves categories and criteria for priority setting of the capital outlay program that includes setting limitations on the number of projects that campuses can request. That is one reason the 2014-2015 request is less than \$500 million.

Interim Assistant Vice Chancellor Ryan Storm noted that, under the state budget capital funding proposal, the CSU would be statutorily equipped to self-determine the repair, renovation, and construction of any facility on its campuses. The Chancellor's Office team worked very closely with the Department of Finance to ensure the *statutory flexibilities and tools* needed by the CSU were included in the latest proposal. However, *not all funding concerns* have been resolved.

The proposal would require the CSU to use its operating budget for all infrastructure needs. This is a very big change from how the arrangement has worked historically. In the past, the state used cash or bonds to build or renovate our campus' academic facilities with CSU responsible for maintaining those assets. This proposal would end that partnership and would require the CSU to use its operating budget to maintain, renovate, and build academic facilities. The proposal provides for the use of up to 12 percent of the state appropriation for this purpose.

Next, the proposal would shift funding that is dedicated to paying off old bonds from other parts of the state budget into the CSU operating budget. That shift would be \$297 million to increase the CSU operating budget. The CSU would make payments on the bonds and bear the burden when bond costs exceed \$297 million in the near future and, conversely, the CSU will realize

savings when bond costs dip below \$297 million in the more distant future. The proposal would also allow the CSU to refund or restructure Public Works Board debt and would streamline the capital project approval process, which will take less time and fewer administrative approvals in Sacramento.

The proposal would fold in \$297 million in 2014-2015 and leave that money with the CSU indefinitely to pay for existing debt and any new debt the CSU may issue to meet its self-determined capital needs. There is a verbal commitment by the Department of Finance to increase CSU's funding over the next 3 years by \$18 million. The rationale for this is to honor commitments made by the state to fund yet-to-be-completed facilities.

The principal concern with this proposal as it now stands is a lack of sufficient resources to fund the CSU's capital program. Without the proper level of funding to meet deferred maintenance and other capital needs—let alone existing bond payments—this proposal will be very fiscally challenging.

Finally, and most importantly, the proposal leaves little to no resources to begin to address a backlog of \$1.8 billion of deferred maintenance and it certainly does not provide the fiscal resources to renovate existing facilities or plan for new ones. The CSU would have to spend several years managing these cash flow peaks and valleys to pay the existing debt and it would *not be until approximately 2022-2023 that the CSU could begin to make any significant investment in any of our capital needs*. If this proposal were to hold, the CSU will have gone from the end of 2008-2009 through 2022-2023 without a significant investment in critical infrastructure needs, a span of fourteen years.

Ms. San Juan demonstrated what impact an increase in proposed funding by \$40 million and \$100 million would have on the CSU's backlog of deferred maintenance. Mr. Storm stated that the CSU greatly values the statutory flexibilities and tools contained in the proposal. These are crucial to allowing us to operate our capital program in its entirety. Yet, the proposal does not include the resources necessary to address critical infrastructure deficiencies.

In an attempt to improve the proposal, the Chancellor met with the Governor's senior staff to discuss the proposal's deficiencies and to discuss ways to help bridge this significant funding gap. For the same reasons, Chancellor's Office staff also met with the Department of Finance to discuss the matter. Staff will return in May to provide an update on the proposal.

Trustee Achtenberg asked if the CSU were to receive \$100 million above the governor's proposal, if that would be enough to meet our capital needs going forward. Ms. Roush stated that it would provide the CSU with an adequate base, but the CSU would want to be cautious. In a future recession the capital debt must be paid and cannot be reduced. Trustee Monville suggested negotiating a maintenance of effort provision in the proposal language to protect against downside risk.

Trustee Day asked if an increase in the base includes covering deferred maintenance needs and what an investment could leverage. Ms. Roush stated that over time the CSU could leverage some savings but that would not occur until 2023, meaning that the CSU wouldn't be able to address the deferred maintenance backlog in a meaningful way until that point. Chancellor White stated that there is risk in this proposal and called on Acting Deputy Assistant Vice Chancellor Robert Eaton to discuss what \$1 million in debt service could leverage. Mr. Eaton stated that, conservatively, \$1 million in debt service could leverage \$10 million in capital project funding.

Trustee Faigin questioned the \$1.8 billion in deferred maintenance and if it was broken down by urgency. Ms. San Juan stated the CSU is currently looking at priorities across the system in order to look at a ranked order. The study will be done in a few months and this information will be shared with the board.

Trustee Achtenberg asked if we were in a rising interest rate environment and were this proposal to pass, would it affect our rating. Mr. Eaton stated that the general view is that rates will eventually increase. The impact on CSU's rating would depend on the flexibility and authorities the CSU receives.

Trustee Day questioned how the CSU would guarantee the state will continue to provide the CSU with the funds to cover the debt. Mr. Eaton stated there is no guarantee.

Governor Brown asked about the upside of this proposal. Mr. Eaton stated the authorities and flexibility gives the CSU greater tools to manage in the future. The upside is the broader authority to finance debt, however there are no near term benefits due to the insufficient resourcing to pay known debt service increases. Under the current proposal the CSU starts out well below its needs. Governor Brown stated he didn't fully understand the proposal and there probably needs to be more discussion to find the right starting point.

Chancellor White mentioned that the Governor in January had mentioned looking at the proposal and making sure it is right. Trustee Achtenberg inquired as to the correct starting point; something staff should bring back to the board. Chancellor White stated that staff will continue to analyze this proposal and bring back to the trustees a risk profile.

There being no further questions, Trustee Achtenberg adjourned the Joint Committee on Finance and Capital Planning, Buildings and Grounds.