RIPEC

Comments on Your Government

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Analysis of Rhode Island's Debt Including Pension and OPEB Obligations

Introduction

The current fiscal crisis has brought about renewed attention to the credit-worthiness of states and municipalities. As governments struggle to achieve balanced budgets, often relying on changes that do not structural improvements, economists have started to warn that they face a potentially larger issue – a credit squeeze brought on by investors reluctant to buy government-backed debt.

Another looming issue is the level of unstated debt in the form of long-term obligations such as pensions and other post-employment benefits (OPEB). Standard and Poor's, one of the country's three major credit rating agencies, notes that long-term liabilities differ from traditional debt in the sense that these liabilities are subject to variation based on a number of factors such as fund performance and the assumptions upon which the actuarial analysis is based. However, the long-term obligations represented by unfunded pension and OPEB liabilities pose significant risks to governments and, thus, taxpayers.

This RIPEC *Comments* provides an overview of the State's current debt position, including the estimated unfunded liability for pensions and OPEB. In addition, the *Comments*, using data from the American Enterprise Institute and Standard and Poor's, examines the state of stated debt plus outstanding long-term liabilities throughout the country in order to provide context for Rhode Island's current situation.

Stated Debt

Bond rating agencies consider a number of issues when analyzing the State's overall debt position, including the State's total net tax-supported debt. Net tax-supported debt refers to all debt in the State that requires an appropriation.

As of June 30, 2009, Rhode Island had a net tax supported debt of $1,846.2 million, representing a 5.8 percent increase from June 30, 2008 ($1,651.3 million). Net tax supported debt currently includes the following:

Direct debt: Direct debt is debt supported by the State's general fund for which the State has pledged its full faith and credit. It consists of general obligation bonds and notes issued in anticipation thereof. This type of debt requires approval by the voters. Rhode Island had $1,036.2 million in outstanding direct debt as of June 30, 2009 and $269.3 million authorized but unissued debt as of January 1, 2010. Direct debt increased by 9.2 percent between June 30, 2007 and June 30, 2008 and increased by 3.9 percent between June 30, 2008 and June 30, 2009.

Other Long-term debt: Other long-term debt includes State obligations related to revenue bonds from State agencies or commissions, third party financing arrangements and other contracts entered into by the State. Examples include capital leases with the Rhode Island Refunding Bond Authority (formally the Rhode Island Public Buildings Authority), master equipment lease agreements with financial institutions, revenue bonds issued by the Economic Development Corporation and certificates of participation.

Table 1
Rhode Island's Net Tax Supported Debt ($ thousands)

	2007	2008	2009
Direct Debt			
Various Purpose Bonds Outstanding	$ 897,119	$ 982,923	$ 1,036,189
Variable Rate General Obligations	16,365	14,165	-
Subtotal	$ 913,484	$ 997,088	$ 1,036,189
Guaranteed Debt			
Subtotal	$ -	$ -	$ -
Other Debt Subject to Annual Appropriation			
Convention Center Authority Outstanding	$ 279,935	$ 270,960	$ 263,800
Econ Dev. - Transportation (motor fuel)	76,290	72,560	81,125
Public Buildings Lease Rental Bonds	42,710	24,235	6,040
CP - Vehicle Leases	19,790	14,395	9,400
CP - Intake Center	8,160	5,535	2,775
CP - Attorney General	2,575	2,230	2,030
CP - Pastore Steam Plant	22,360	22,160	21,035
CP - DLT Howard Complex	15,970	13,375	12,630
CP - Shepards Building	22,135	20,980	19,155
CP - Training School	50,205	48,370	46,470
CP - Kent County Courthouse	54,405	52,075	49,690
CP - Tribunal Court Complex	20,765	19,940	19,090
CP - Information Technology	23,490	21,000	30,500
CP - School for the Deaf	-	-	30,425
CP - Energy Conservation*	12,735	12,735	23,920
Loan Agreement - HSTC Fund	-	-	150,000
Rhode Island Housing NOP	15,502	18,152	13,179
Econ. Dev. - URI Power Plant	12,194	11,494	10,759
Econ. Dev. - Masonic Temple	14,280	9,775	5,030
Econ. Dev. - McCoy Stadium	4,275	3,265	2,220
Subtotal	$ 697,776	$ 643,236	$ 799,273
Performance Based Agreements			
Econ. Dev. - Fleet	9,630	9,415	9,180
Econ. Dev. Fidelity Building	20,402	19,592	18,708
Econ. Dev. - Fidelity Building II	10,000	9,766	9,514
Subtotal	$ 40,032	$ 38,773	$ 37,402
Gross Debt	$ 1,651,292	$ 1,679,097	$ 1,872,864
Less: Adjustments for Agency Payments	(28,848)	(27,766)	(26,617)
Net Tax Supported Debt	$ 1,622,444	$ 1,651,331	$ 1,846,247

* Energy Conservation - URI and DOA

Source: Rhode Island State Budget Office - Capital Budget, various years

RBA - Refunding Bond Authority; CP - Certificates of Participation; HSTC - Historic Structures Tax Credit; NOP - Neighborhood Opportunities Program

As of June 30, 2009, Rhode Island had $799.3 million in other debt, an increase of 24.3 percent from June 30, 2008. The majority of this increase is related to the loan agreement for the Historic Structures Tax Credit of $150.0 million (18.8 percent of the total other long-term debt). The largest share of tax-supported debt is related to the Rhode Island Convention Center ($263.8 million, or 33.0 percent of the total).

Tax-supported debt is the most important category of debt with regard to the State's general credit. However, three additional categories of debt in Rhode Island are evaluated by credit analysts when determining a government's credit-worthiness: State-supported revenue debt, agency revenue debt and conduit debt. In the Public Finance Management Board's "2008 Report on Debt Management", these three categories of debt combined with tax-supported debt resulted in an overall debt level of $8,557.0 million as of June 30, 2008. Of this amount, tax-supported debt accounted for 19.3 percent.

Pension and OPEB Obligations

As noted earlier, other long-term obligations are categorically different from tax-supported debt in that the actual liability is subject to change due to the interaction of a number of variables including, but not limited to statutory changes. However, both pension and OPEB obligations represent a significant public commitment that, due to legal and constitutional protections, must be met by taxpayers unless statutory changes are made. Based on the most recent valuations, the total unfunded liability for both State and local government pensions and OPEB is $9.4 billion. The State's liability accounts for 36.4 percent of the total, whereas local government's liability accounts for 63.6 percent.

Pensions: The State of Rhode Island administers defined benefit plans for general state employees and teachers (ERS) judges (JRBT), state police (SPRBT), and participating municipal employees (MERS). Assets across all four plans are comingled for investment purposes, but are accounted for separately and are only used for the payment of benefits to members of that plan.

As of the most recent valuation, the funded ratio for all retirement plans except for judges increased over the year prior. Between FY 2007 and FY 2008, the funded ratio for state employees increased from 57.5 percent to 61.8 percent and the funded ratio for teachers increased from 55.4 percent to 60.3 percent. Funded ratios for state police increased to 79.6 percent, while the funded ratio for MERS increased to 92.8 percent.

The recent downturn in the market lowered the rates of return and has put additional pressures on state and local plans to meet the decreased asset values. The actuarial consultant for the State, Gabriel Roeder Smith and Company, notes that there was a net investment loss of $481.8 million in FY 2008 and a loss of $1,546.1 million in FY 2009. However, the most recent data indicate that, through the end of March the pension fund has recovered approximately half of the losses over the prior two years. Embedded in these losses is the negative cash flow the fund is experiencing as benefit distributions exceed contributions. The impact of the market fluctuations over the past two years will be phased in over the five valuations from June 30, 2009 through June 30, 2013.

OPEB: The Governmental Accounting Standards Board (GASB) Statement 45 requires disclosure of liabilities and costs of retiree medical benefits and other post-employment benefits (OPEB) in a manner similar to disclosure of pension liabilities. While GASB 45 does not require prefunding of OPEB liabilities, the standard creates strong incentives to fund; employers who fund OPEB liabilities will generally be able to use more favorable accounting methods and a higher discount rate, both of which will result in lower OPEB costs. In addition, state and municipal bond ratings may be affected by the results of OPEB valuations and related decisions on whether to fund the liabilities. The cost of borrowing may increase and bond ratings may be affected if liabilities are unfunded or strategies are not developed to manage costs.

Table 2
State/Local Pension and OPEB Liabilities
$ million

	ARC	**Payments**	**Unfunded Liability**
State			
Pensions			
State Employees	$127.1	$127.1	$1,671.5
Teachers-State Share	79.2	79.2	1,064.2
Subtotal Pensions	*$206.3*	*$206.3*	*$2,735.7*
OPEB*	$36.1	$35.5	$689.7
Total State	**$241.8**	**$241.8**	**$3,425.4**
Municipal Government			
Pensions			
MERS	$33.4	$33.4	$91.7
Locally-administered	161.5	132.4	1,894.6
Teachers-Local Share	105.2	105.2	1,596.3
Subtotal Pensions	*$300.1*	*$271.0*	*$3,582.6*
OPEB	$189.6	$100.8	$2,392.7
Total Municipal	**$489.7**	**$371.8**	**$5,975.3**
Total State and Local	**$731.5**	**$613.6**	**$9,400.7**

ARC= Annually required contribution
*Includes State employees and teachers

**The funding ratios for the State's pension system including MERS is as of June 30, 2008; for locally-administered pension plans as of the most recent information included in FY 2009 audits; the State's OPEB as of June 30, 2007;and local OPEB at June 30, 2009

Sources: ERS/MERS as of June 30, 2008; GRS OPEB Valuation February 2009, as of June 30, 2007; Auditor General report "Status on Pension and OPEB Plans Administered by RI Municipalities", March 2010

The most recent valuation shows that the State's annually required contribution (ARC) payments for state employees, teachers, judges, state police and legislators combined was $42.1 million for FY 2009. Actual payments were $37.9 million, or 90.0 percent of the ARC. The ARC for State general employees and the State share for teachers was $36.1 million in FY 2009; the OPEB payment for state employees and teachers was $35.5 million. The estimated total OPEB liability for all state employees (including judges, police and legislators) as of June 30, 2007 was $788.1 million. Of this amount, $689.7 million (87.5 percent) was for state employees and teachers.

Based on data from the Auditor General, annual required contributions for local OPEB liabilities were $189.6 million at June 30, 2009. Total ARC payments would have absorbed 5.9 percent of municipal budgets, or amounted to 9.6 percent of the tax levy, if municipalities had paid them in full. Actual contributions were $100.8 million, amounting to 3.2 percent of municipal budgets, or 5.1 percent of the tax levy. The estimated unfunded liability for municipal retiree health care benefits (including education) is almost $2.4 billion. This amount is 75.1 percent of the annual total combined budgets for local government in FY 2009.

Total Long-Term Obligations

While pension and OBEP obligations are not the same as explicit government debt (both long- and short-term), the sum of the three provides a picture of a state's overall indebtedness. Using data from the Census Bureau, total debt outstanding in Rhode Island (State and local governments) was $10.5 billion in FY 2007. The majority of this debt (80.2 percent) was on the State side (NOTE: the Census Bureau tabulates total debt outstanding, which is a broader category than tax-supported debt as noted on page 2 of this analysis).

Although the State has made improvements in debt management, total outstanding obligations in Rhode Island are significant. The Ocean State's total outstanding obligations for FY 2007 (the most recent year for which national data is available) are the highest in the country when measured as a share of State GDP, and 6th and 5th highest when measured as a share of personal income and per capita, respectively.

Based on State and local actuarial valuations and the Auditor General report "Status on Pension and OPEB plans administered by RI Municipalities", total State and local pension obligations are estimated to be $6,318.2 million and total OPEB liabilities are $3,082.4 million.

Combined, estimated debt and other long-term obligations total $19.9 billion across the State. Of this amount, $11.8 billion is the responsibility of the State, while total local obligations are $8.1 billion. Total outstanding obligations are 48.2 percent of 2008 private-sector state gross domestic product (GDP).

Table 3
Estimated State and Local Liability
Explicit Debt and other Long-Term Obligations
($ millions)

State	
Debt Outstanding*	$8,418.7
Net Pension Unfunded Liability**	2,735.7
Net OPEB Unfunded Liability**	689.7
Subtotal Long-Term Obligations - State	*$11,844.1*
Municipal	
Debt Outstanding*	$2,079.4
Net Pension Unfunded Liability	3,582.6
Net Stated OPEB Unfunded Liability	2,392.7
Subtotal Long-Term Obligations - Municipal	*$8,054.7*
Total State and Municipal Long-Term Obligations	**$19,898.8**
% of 2008 State GDP (Private Sector)	**48.2%**

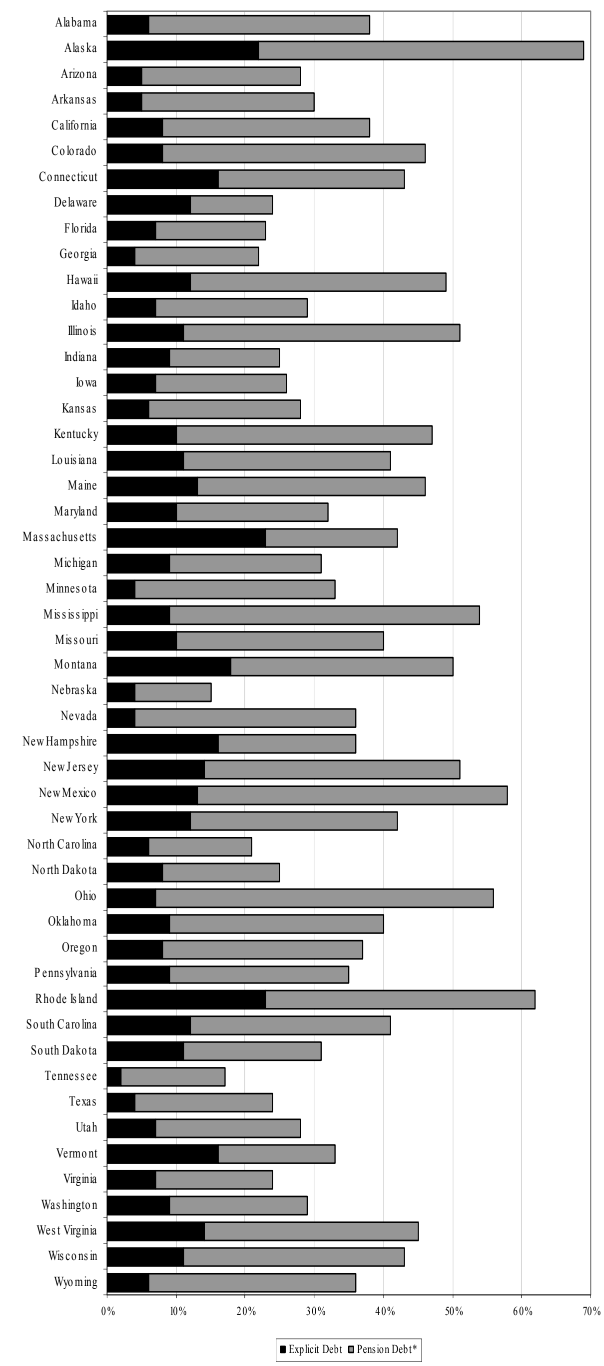
* FY 2007 Census estimates; outstanding short- and long-term debt
** Excludes State judges, police and legislators

Sources: ERS/MERS as of June 30, 2008; GRS OPEB Valuation February 2009, as of June 30, 2007; Auditor General report "Status on Pension and OPEB Plans Administered by RI Municipalities", March 2010; US Census Bureau, State and Local Government Finances, FY 2007; Bureau of Economic Analysis; RIPEC calculations.

A recent analysis by the American Enterprise Institute, "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities", examines the status of public debt and pension obligations across the 50 states. The study relies on a different method of accounting for pension debt – an options pricing approach instead of the traditional actuarial method of accounting, arguing that current actuarial methods understate the value of pension liabilities.

Based on this method, Rhode Island's outstanding pension liability is estimated at 39 percent of State GDP, the 6th highest liability in the country. This is almost double the State's total outstanding debt which represented 23 percent of State GDP. When the two categories are combined, Rhode Island's total outstanding obligations represented 62 percent of State GDP, the second highest in the country (behind Alaska at 69 percent of State GDP). As a recent New York Times article noted, this level of debt would push the two states outside the maximum permitted by the euro zone.

Chart 1
Explicit State Debt and Unfunded Public Pension Liabilities as a Percent of State GDP



Notably, these estimates do not include OPEB liabilities. Although quantifying and ranking OPEB liabilities is more challenging given the even-more variable set of factors used in determining the liability, as well as the fact that only recently have OPEB costs been disclosed broadly, rapidly escalating health care costs coupled with the general practice of pay-as-you-go funding mean that OPEB liabilities are sizable. In November, 2007, Standard & Poor's reported that the national State liability was $357.5 - $394.2 billion. Other estimates suggest that OPEB liabilities may be as much as five to ten times greater than current outlays for retiree health care.

The most recent estimates for OPEB liabilities for Rhode Island State and local government represent 1.7 and 5.8 percent of State GDP, respectively. If this total were added to the total debt and options-pricing valuation of pensions, the Ocean State's outstanding long-term obligations represent almost 80 percent of all private economic activity in the State.

Comments

As the General Assembly considers the 2010S and budgets for FY 2011 and beyond there is a need to be mindful of the impact all long-term obligations will have on the State's ability to respond to the challenges ahead. Since FY 2001, the fastest-growing component of the State's personnel budget has been pension costs (excluding the State's share of teacher retirement). These costs accounted for 5.1 percent of the FY 2001 State personnel budget; by FY 2011 they are projected to account for 8.1 percent. Although retiree health costs were not broken out in FY 2001, these costs increased $27.5 million between FY 2010 and FY 2011. Together, retirement and retiree health payments account for 11.2 percent of the State's proposed FY 2011 personnel budget of $1,678.4 million.

The status of the state and local pension plans and OPEB liabilities will not only affect the share of the budget dedicated to paying these costs, significant outstanding obligations in both will weaken the State's credit rating and increase the costs of future borrowing.

Investment losses over the past few years have weakened state pension funds around the country. The Center for State and Local Government Excellence, which examined 109 state plans and 17 locally-administered plans estimates that the surveyed plans had an aggregate funding ratio of 78 percent in 2009, down from 84 percent the year prior. The study estimates that the funded ratio for Rhode Island ERS was 58.0 percent (compared to 60.9 the year prior) and the funded ratio for MERS was 87.2 (down from 92.8 percent in 2008). While the funding ratio for MERS remains above the generally-accepted 80 percent benchmark, the funded status of ERS will likely be cause for concern in terms of the State's credit rating.

While OPEB were likely negligibly affected by the recent market fluctuations, this is primarily due to the fact that most states lack significant OPEB assets. However, ratings agencies such as Moody's note that "OPEB liabilities nevertheless may assume increased importance in state credit positions as plan valuations are factored in." In effect, the ratio of the ARC payment for OPEB as a percentage of revenues is an important part of Moody's assessment of credit-worthiness; the further out a state pushes payment of their long-term obligations for OPEB, the larger the liability and the larger the ARC payment becomes.

In addition, all three primary credit ratings agencies have noted that how Rhode Island addresses its current budgetary issues will have an impact on whether they downgrade the State's credit rating. Currently, all three have given Rhode Island a negative outlook, citing the weak economy and budget gaps. The three agencies noted that the past practice of relying on one-time revenues will likely result in a lowering of the credit rating and urge the State to consider long-term changes that will result in a structurally-balanced budget.

The reamortization of the State's pension fund contained in the House's FY 2010 supplemental budget proposal is projected to increase future costs by $2.2 billion according to House Fiscal Staff estimates. This would increase the estimated total outstanding obligations in the State by approximately 11 percent over the current $19.9 billion liability. Similarly, delays in addressing OPEB liability will serve to increase future costs. These two factors, combined with persistent budget gaps, and without significant structural change, may result in higher borrowing costs. Ultimately, the total value of the State's outstanding debt and long-term obligations, if unaddressed, will result in higher taxpayer burdens in the future.

Table 4
Moody's General Obligation Bond Ratings

State	Rating	State	Rating
Delaware	Aaa	Nevada	Aa2
Georgia	Aaa	New Hampshire	Aa2
Maryland	Aaa	North Dakota	Aa2
Missouri	Aaa	Ohio	Aa2
North Carolina	Aaa	Oregon	Aa2
South Carolina	Aaa	Pennsylvania	Aa2
Utah	Aaa		
Vermont	Aaa	Connecticut	Aa3
Virginia	Aaa	Maine	Aa3
		Michigan	Aa3
Florida	Aa1	Mississippi	Aa3
Indiana	Aa1	Nebraska	Aa3
Iowa	Aa1	New Jersey	Aa3
Kansas	Aa1	New York	Aa3
Minnesota	Aa1	Oklahoma	Aa3
New Mexico	Aa1	**Rhode Island**	**Aa3**
Tennessee	Aa1	West Virginia	Aa3
Texas	Aa1	Wisconsin	Aa3
Washington	Aa1		
		Arizona	A1
Alabama	Aa2	Louisiana	A1
Alaska	Aa2	South Dakota	A1
Arkansas	Aa2		
Colorado	Aa2	Illinois	A2
Hawaii	Aa2		
Idaho	Aa2	California	Baa1
Kentucky	Aa2		
Massachusetts	Aa2	Wyoming	NA
Montana	Aa2		

Ratings in Order of Highest to Lowest = Aaa, Aa1, Aa, Aa2, Aa3, A1,A2, A3, Baa1 (NA=No GO Debt)
Source: FirstSouthwest as of 04/07/10