State Notes

TOPICS OF LEGISLATIVE INTEREST

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MDOT's Increased Reliance on Borrowing and Ballooning Debt Service Costs

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Introduction

Since 2001, the Michigan Department of Transportation (MDOT) has incurred almost $1.1 billion in new short- and long-term debt to supplement ongoing transportation revenue for its road and bridge infrastructure investment[1]. The majority of the borrowing was associated with former Governor Engler's Build Michigan II program ($600.0 million) and Build Michigan III program ($308.2 million). The remainder ($185.7 million) effectively provided funding for phases of a number of preservation and road capacity improvement projects previously deferred under Governor Granholm's Preserve First program. The use of borrowing to augment ongoing transportation revenue is not a new practice for the State of Michigan; however, the level of debt financing used in the last four years has not been seen recently. The result of the heightened level of borrowing, coupled with additional planned borrowing in 2006 through 2009, is a ballooning annual debt obligation that will peak in fiscal year (FY) 2008-09, measured both in nominal terms and as a percentage of the annual revenue available to MDOT to deliver its capital program.

Increased Use of Borrowing: 2001 Through 2004

In early 2001, the State Transportation Commission authorized MDOT to issue up to $900.0 million in long-term debt to finance the Build Michigan III program. In the summer of 2001, MDOT issued its first and only installment of Build Michigan III bonds, totaling $308.2 million. Under the original financing plan, yearly debt service payments would be covered by an annual $35.0 million transfer from the Countercyclical Budget and Economic Stabilization Fund (BSF) to the State Trunkline Fund (STF), beginning in fiscal year 2000-01. As a result of the challenges facing the State's General Fund/General Purpose budget, this transfer occurred in FY 2000-01 and FY 2001-02 only. Since that time, debt service on the outstanding Build Michigan III bonds is being paid by STF revenue directly and the BSF no longer provides revenue to the State's road and bridge capital program.

In July 2001, MDOT issued $400.0 million in short-term notes to advance and accelerate the delivery of its Build Michigan II program. Again in September 2002, MDOT issued another $200.0 million in notes for the same purpose. The Department used a unique financing method not previously employed called *grant anticipation notes* to borrow the $600.0 million[2]. Interest and principal payments on these notes are covered by the State's share of future annual Federal highway funds. The Department was able to take advantage of historically low interest rates when it issued these notes in 2001 and 2002, making their short-term nature more attractive than traditional 20- or 30-year bonds. It is argued that by advancing the Build Michigan program through the use of borrowing, the Department was able to avoid some of the inflationary cost increases that would occur if the projects were funded entirely

[1] This does not include refunding bonds issued since 2001.

[2] For a detail description of this borrowing, see "Build Michigan II and Grant Anticipation Revenue Vehicles", Senate Fiscal Agency, State Notes, July/August 2001. http://www.senate.michigan.gov/sfa/Publications/Notes/2001Notes/NotesJulAug01Thiel.PDF

on a pay-as-you-go basis, i.e., from current transportation revenue. In August 2004, MDOT also issued $185.7 million in long-term bonds to support its capital program, which subsequently allowed for the restoration of phases of 17 road and bridge preservation and capacity projects, many of which originally were included in the Build Michigan III program but deferred under the Preserve First program[3]. The estimated cost to complete the 17 restored projects is $1.0 billion.

Table 1 lists short- and long-term outstanding debt that is supported by State restricted transportation revenue or Federal highway funds. As of September 30, 2004, there was $1,655.7 million in outstanding debt supported by either State road and bridge revenue or Federal highway funds. Since FY 1999-2000, the amount of outstanding debt has increased 161.5%. The amount of outstanding debt is projected to peak in FY 2005-06 at $1,848.9 million, when the Department is expected to issue $260.0 million in long-term debt and before full repayment of the $600 million in short-term Build Michigan II notes (described below). An issue to be examined is the fiscal impact of the heightened reliance on borrowing over the past five years to deliver the State's annual road and bridge program.

Table 1
Outstanding Michigan Transportation Debt
(Millions of Dollars)

	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04
Long-Term Bonds*	$633.2	$928.1	$911.9	$891.9	$1,055.7
Short-Term Notes	$0.0	$400.0	$600.0	$600.0	$600.0
Total	**$633.2**	**$1,328.1**	**$1,511.9**	**$1,491.9**	**$1,655.7**

* All State Trunkline Fund debt, including refunding bonds.

Source: Michigan Department of Transportation

Rising Debt Costs

Table 2 lists the total projected revenue from all sources available to MDOT for its road and bridge capital program and the estimated debt service requirements for the seven-year period, FY 2003-04 through FY 2009-10. The data reflect the revenue assumptions included

3 On Thursday, April 3, 2003, MDOT announced the Preserve First program as a "new program that increases emphasis on the preservation of our transportation system rather than on expanding it." This program consisted of three components: planned preservation projects, new preservation projects, and deferred capacity improvement projects. On Friday, April 4, 2003, MDOT announced the deferral of 34 projects. During the FY 2003-04 budget negotiations in the summer of 2003, legislators, and administrative officials agreed to provide approximately $250.0 million in new road and bridge funding to reinstate phases of 17 of the 34 previously deferred projects. During the negotiations, it was decided that $200.0 million of the total funding would come from long-term borrowing.

in the current Five Year Transportation Program[4]. The revenue data include both ongoing revenue (State and Federal) and borrowing proceeds. Annual debt service totaled $75.0 million last year (FY 2003-04); however, it is expected to increase to $334.0 million by FY 2008-09, a 345.3% increase. Similarly, debt service as a percentage of the revenue available will increase nearly four fold, from 5.3% in FY 2003-04 to 20.9% in FY 2008-09[5]. This increase is directly related to the repayment schedule of the $600.0 million in short-term notes issued in 2001 and 2002 for the Build Michigan II program.

Table 2
State Road and Bridge Capital Program[6]
(Millions of Dollars)

	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
Revenue	$1,423.0	$1,317.0	$1,641.0	$1,456.0	$1,514.0	$1,595.0	$1,439.0
Debt cost*	$75.0	$112.0	$197.0	$263.0	$287.0	$334.0	$129.0
Investment (revenue after debt)	$1,348.0	$1,205.0	$1,444.0	$1,193.0	$1,227.0	$1,261.0	$1,310.0
Debt as % of revenue	5.3%	8.5%	12.0%	18.1%	19.0%	20.9%	9.0%

* Does not include debt service for Economic Development Fund, Critical Bridge, and Blue Water Bridge

Source: Michigan Department of Transportation; SFA calculations

As noted above, MDOT used short-term grant anticipation notes for Build Michigan II, which requires the Department to make principal and interest payments with Federal highway funds. Although the bond proceeds have been exhausted, annual debt payments will continue through FY 2008-09. As of October 1, 2004, the Department had not made any principal payments on these notes; however, it had made interest payments totaling $20.3 million. The first principal payment of $20.0 million will be made this year, followed by $80.0 million in FY 2005-06, $140.0 million in FY 2006-07, $160.0 million in FY 2007-08, and $200.0 million in FY 2008-09. At the time the Build Michigan II notes were issued, it was believed that a new Federal highway program would provide sufficient new resources to satisfy these scheduled principal payments without substantially affecting the annual road and bridge investment level. At this time, the level of Federal highway funding that Michigan will receive this year and in the future is unknown.

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[4] MDOT's annual Five Year Transportation Program is a financially constrained plan for transportation investment. In other words, this document is not a "wish list" of projects, but a realistic estimate of projects or project phases to be undertaken based on the amount of resources that will be available during a given period of time. The cost of the various transportation projects, regardless of mode, included in the Program cannot exceed the revenue available during the specified period. A new Program (volume 5), covering 2005 to 2009, was issued on January 31, 2005. With respect to the State road and bridge component of the new program, total revenue available to MDOT during the five-year period is estimated at $7.5 billion in State and Federal resources. The total projected investment level (after required debt service) during the period is $6.3 billion.

[5] Despite the heightened use of borrowing in recent years, MDOT will remain below the debt service limits established in Public Act 51 of 1951 and by the State Transportation Commission.

[6] Includes revenue for "routine maintenance", which averages $269.0 million per year for the period.

The current Federal program expired on October 1, 2003; however, it has been extended through May 31, 2005. For the most part, this means that Michigan continues to receive Federal funding under the previous Federal highway program formulas. Continued delays in the reauthorization of the Federal highway program, coupled with the generally small funding increases received to date, mean that proportionately more Federal resources must be designated for the debt service on Build Michigan II notes. Furthermore, and more significantly, less-than-anticipated Federal highway revenue will force the Department to convert the entire $600.0 million in Build Michigan II notes to State-supported long-term bonds beginning in FY 2005-06. This will require the issuance of new, additional debt. Committing future Federal revenue to the repayment of notes without additional revenue, either from Federal or state sources, would have a negative impact on the projected road and bridge capital investment level during the next five years.

Fiscal Impact on the Road and Bridge Program

In order to pay off the short-term notes on schedule, MDOT plans to issue $600 million in new State-supported debt over the next four years ($100.0 million in FY 2005-06, $140.0 million in FY 2006-07, $160.0 million in FY 2007-08, and $200.0 million in FY 2008-09). This additional borrowing will add to MDOT's annual debt service schedule and prolong the repayment of the initial $600.0 million from five years to 20 years. It is estimated that the new borrowing will add $37.0 million to the annual debt service schedule, after the last issuance in FY 2008-09. The projected annual debt service costs will fall in FY 2009-10, after conversion of the short-term debt, to $129.0 million or about 9.0% of available revenue.

The existing financial plan for the State road and bridge capital program also assumes a second round of borrowing to supplement current ongoing revenue. The Department plans to issue $260.0 million in FY 2005-06. The estimated annual cost of this debt will be $20.0 million, assuming repayment over 30 years. The bond proceeds will cause a spike in the annual road and bridge investment level in FY 2005-06 at $1,444.0 million (shown in Table 2).

Further borrowing, beginning next fiscal year, will provide the Department with the additional resources needed to meet the scheduled principal payments of the Build Michigan II notes without severely affecting the level of annual investment in the State road and bridge capital program. Table 2 lists the revenue available for road and bridge investment on an annual basis, after debt costs have been deducted. Based on the current financing plan, the average annual investment level for the next five years will be approximately $1,266.0 million. Without the additional borrowing associated with the conversion of the Build Michigan II notes to long-term bonds ($600.0 million) and the FY 2005-06 issuance ($260.0 million), the average annual investment would be about $1,062.0 million, a reduction of 16.1% to the Department's capital program. Although the decision to repay the short-term notes with the proceeds from long-term bonds will increase annual debt costs and extend the term of indebtedness, it will allow MDOT to maintain an average annual investment of almost $1.3 billion.

Conclusion

It appears that without a significant increase in the ongoing revenue streams available to MDOT before FY 2005-06, additional long-term borrowing will be the only way to satisfy the ballooning debt service associated with the Build Michigan II program without significantly reducing the annual road and bridge capital investment level. The Department's increased reliance on short- and long-term debt over the past four years suggests that borrowing will continue as a financing strategy to support the State's road and bridge capital program. Although the proceeds from debt-financing can provide the resources needed in the near-term for programs such as Build Michigan and Preserve First, they do very little to address long-term revenue needs. Ultimately, the State must weigh the costs and benefits of additional borrowing as it attempts to find the appropriate balance of ongoing revenue and debt-financing to support road and bridge infrastructure investment.