

REDUCING THE STATE'S DEBT



A REPORT TO THE GOVERNOR

January 8, 2014

OVERVIEW

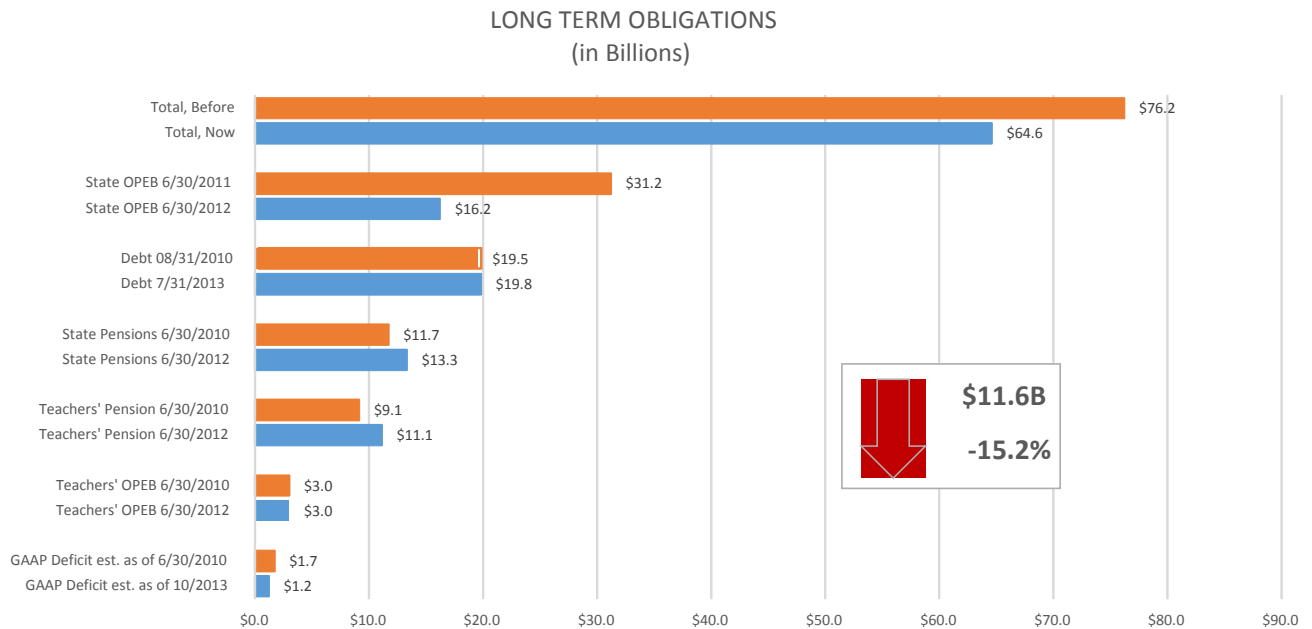
Since 2011 the administration and the legislature have begun to take aggressive steps to pay down the state's long term liabilities. Had action not been taken, by June 30, 2011, the total of the state's long-term obligations would have reached a high of \$76.2 billion. By 2013, the nominal total of long-term debt had been reduced by 15% to \$64.6 billion.

This progress has come during a period of significant fiscal stress. In the spring of 2011, the budget for the biennium that ended on June 30, 2013, was projected to face a shortfall of over \$3 billion each year. In past periods of fiscal stress, prior administrations and legislatures elected to balance the budget by reducing pension contributions, offering early retirement incentives, or borrowing money for operating expenses. For instance, the state used over \$645 million in surplus funds to lower the general fund contributions for teachers' pensions in fiscal years 2006 through 2009 and negotiated an agreement with the unions to defer \$314.5 million in payments for state employee pensions in fiscal years 2009 through 2011. In December 2009, economic recovery notes were issued, adding \$948 million to the State's bonded debt to address a budgetary shortfall.

Each of these approaches increased the state's long-term debts and continuing down that path would have added to that debt. Instead, since 2011 we have maintained a disciplined approach to funding all our long-term obligations; we have increased our payments in priority areas, particularly pensions and the GAAP deficit; and we have negotiated significant benefit changes and cost-sharing arrangements with our employees that have made our future pension and retiree benefit programs vastly more affordable.

Taking this disciplined approach to long term debts has come at a price. We have had to reduce spending on government services, strictly limit the replacement of retiring state employees, and significantly reduce the value of our retirement plans for virtually all employees and especially new employees. It is nevertheless critical that the state maintain or improve its financial strength – and its credit rating – by sustaining these efforts over time and ultimately reducing the impact of long-term debts on the state's budget and economy. As we pay down these debts – especially the unfunded obligations to retired teachers and state employees which make up more than two-thirds of our debts – we will have more resources available for investments in our community or to reduce taxes in the future.

The following chart shows the components of state long-term debt, with current levels compared to levels on or around the start of the current gubernatorial term. Because each category of debt is measured at different times, and in different ways, the date of each measurement is provided as well.



This reduction does not tell the whole story, however. Some of the most significant steps that the state has taken to control its debts do not show up in this tally. This is because more conservative assumptions often increase the size of a projected liability while requiring more aggressive repayments, particularly in the area of pensions.

For instance, in 2012 the state made its largest ever annual contribution to the State Employee Retirement System (SERS). Nonetheless the valuation of the fund showed an increase in the unfunded liability of \$1.2 billion (11%), an increase that resulted from the state’s decision to use more conservative assumptions about interest earnings, inflation, and demographics. This, coupled with poor investment returns during that year, resulted in an increase in the reported liability despite the larger contribution and the pension payment restructuring that will save billions for state taxpayers between 2012 and 2032.

Furthermore, the total reduction in long-term debts, while a significant accomplishment, does not allow for consideration of the features and implications of the different types of long-term debts that the state faces.

Some state debt, like unfunded pensions or retiree health liability (called OPEB, for Other Post-Employment Benefits), are estimates of the future costs of obligations the state has already undertaken. This debt is largely related to work performed in the past by individuals who have already retired from state service. The value of these debts varies based not only on efforts to pay them down and control future benefit costs, but also based on the assumptions made and the investment results on the significant funds already in place.

Other debts, such as most of our bonded debt, are owed to individuals and institutions who loaned money to the state, and are generally related to capital projects that are still in service. This debt is more like a mortgage on a home, in that it requires repayment during the time a homeowner lives in the house. As with a mortgage, this type of debt can be a very useful way to acquire necessary but expensive things without saving for decades first. But, also like mortgages, it is essential that the borrower ensure that the debt service will be affordable in the future.

Lastly, the state has some debt that it owes to itself, or rather, to our children, in the form of the GAAP deficit. By not balancing its budget on a GAAP basis over many years, the state was left with over a billion dollars in accumulated shortfall. This number has been sharply reduced, and is on track to be eliminated within the next 14 years at the latest.

By reducing and eliminating this debt, the state's financial strength is significantly improved. By using this approach the state is committed to making annual payment towards the GAAP deficit, so that future decision-makers cannot defer payments for other purposes.

The following sections provide details on each of the major categories of the state's long-term debts:

State Retiree Health Benefits (Other Post-Employment Benefits, OPEB)

The state offers continuation of health benefits to retirees as a benefit of employment. Once retirees become eligible for Medicare, the state benefits become supplemental to that coverage. Funding to cover these benefits has historically been budgeted every year from current tax revenues, and that practice largely continues today. However, recent changes in accounting rules require that governments place a value on the total liability for retiree health benefits that have been earned by employees but not yet expended. In other words, the state is required to place a value on the future cost of retiree health benefits the same way that we place a value on future pension payments.

The state recently established a trust fund into which funds can be placed to pay for future retiree health benefits. That fund currently has about \$60 million, far short of the \$16 billion in total liabilities. However, the 2011 State Employee Bargaining Agent Coalition (SEBAC) agreement requires all employees and the state each deposit 3% of pay into this trust, which will reduce this liability.

Another cost control approach to OPEB that the administration has undertaken, with considerable success, is to change the terms of retirement to encourage more state employees to remain working until they are closer to Medicare eligibility, since the costs of supplemental retiree coverage are a

fraction of the costs to cover retirees who are not yet eligible for Medicare. The change adopted in 2011 requires three additional years of work before a normal retirement, and increases the penalty for early retirement, also benefit the pension plan.

The recent reforms to state employee OPEB are described below:

- New provisions in the 2011 SEBAC agreement
 - 3% contribution to Retiree Health Care Trust Fund for all health care eligible employees, with phased in implementation (SEBAC 2009 had required for a limited number of employees.)
 - State match of employee OPEB contributions beginning July 1, 2017, projected to be \$129.5 million.
 - Greater premium share for individuals who elect early retirement.
- In the valuation as of June 30, 2011 (issued in May of 2012) the OPEB actuaries reported that without the SEBAC 2011 agreement, the liability on June 30, 2011 would have been \$31.2 billion.
- The 2012 update to the OPEB valuation (issued in April of 2013) reflects anticipated savings due to the state’s new prescription drug contract that was implemented in June of 2013 and the conversion of the Medicare-age prescription drug program for state retirees to an Employer Group Waiver Program, and indicated a total liability of \$16.2 billion, a reduction of \$15 billion.
- Based on the most recent annual report from the Comptroller, the OPEB trust fund contained \$59.7 million in net assets as of June 30, 2012.
- Deposits to the OPEB Trust Fund:
 - State Contributions: \$10 million in FY 2008 and \$14.5 million in FY 2011.
 - Employee Contributions: \$1.4 million in FY 2010, \$21.6 million in FY 2011, \$25.0 million in FY 2012, and \$27.5 million in FY2013. Employee contributions are projected to be \$43.5 million in FY2014 and \$89.0 million in FY 2015.

State Employee Retirement System (SERS)

SERS is a defined-benefit pension plan administered by the state to serve most state employees. Employees who have worked enough years and are eligible to retire by age 65 (or 63 depending on years of service) receive an annual pension based on a portion of their compensation as an employee. That portion is determined by a formula based on the number of years of service of the employee. The average annual pension to retirees under the SERS plan is \$33,807, as of 06/30/2012.

Because the state only began to set aside funds to pay for future pensions in the 1970s and 1980s, and because the state has continually failed to set aside enough to satisfy the obligations, there is a significant unfunded liability in the SERS fund. Approximately three-quarters of the total liabilities of the fund are for workers who have already retired, so changes in benefits only impact the health of the fund gradually over time. Nevertheless, the state has continued to reduce the benefits offered to retirees by creating new "tiers" within the plan. Tier I employees, most of whom have already retired, have the most generous benefits. Tiers II and IIA, which cover most active state employees and many retirees, are less generous. A new Tier III was added by the administration in 2011 with benefits that are far less generous than Tier I.

The value of the benefits in the various tiers can be compared by looking at the "normal cost." This is the amount of money that the state and the employee must set aside and invest each year in order to be assured that there will be funds available to pay for any incremental pension earned by that year of service. The following table shows the normal cost for each tier as a percent of pay for the individuals in that tier, identified as the "Normal Rate". Note that the "hazardous duty" pensions are available to certain employees, like corrections officers and police officers, who are entitled to a more generous plan under their labor contracts. The large difference between the Normal Rate in Tier I and Tier III reflects the significant difference in the value of the benefits between the Tiers. For example, the normal rate for Tier I plan B is 12.54% vs. Tier III Others, with a normal rate of 2.18%.

Normal Cost of SERS by Tier

Group	Number Active Members	Average Age	Average Service (years)	Normal Cost	Normal Rate
Tier I - Hazardous	94	56.2	27.6	\$0	0.00%
Tier I - Plan B	2,942	56.1	30.2	\$32,992,790	12.54%
Tier I - Plan C	117	58.4	31.9	\$872,618	8.98%
Tier II - Hazardous	3,466	48.6	18.8	\$43,254,343	13.90%
Tier II - Others	13,809	52.3	21.2	\$88,086,530	8.01%
Tier IIA - Hazardous	6,311	40.6	8.2	\$34,979,603	7.80%
Tier IIA - Others	19,148	44.8	7.2	\$48,019,417	4.23%
Tier III - Hazardous	321	34.0	0.3	\$386,769	3.10%
Tier III - Hybrid Plan	57	37.7	0.6	\$0	0.00%
Tier III - Others	1,603	37.2	0.4	\$1,404,413	2.18%
TOTAL	47,868	47.1	13.5	\$249,996,483	7.45%

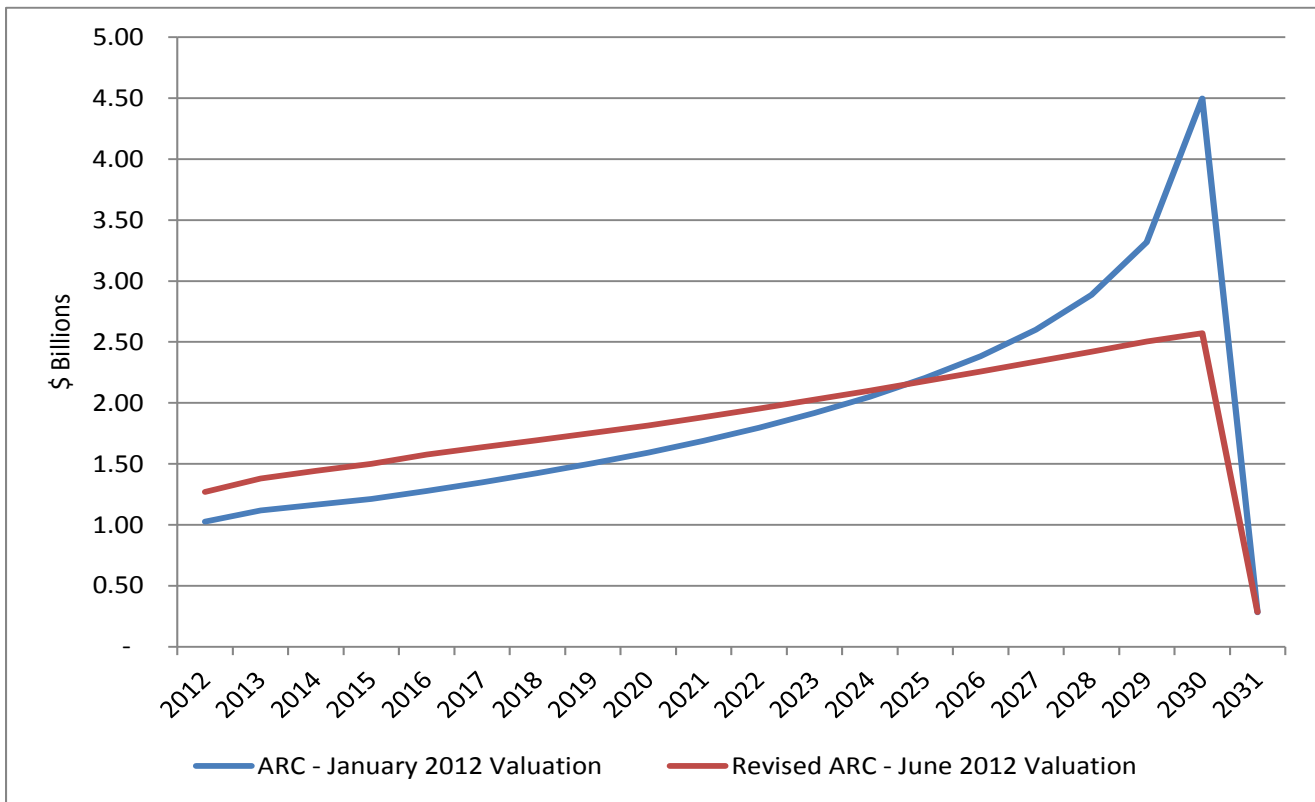
Recent reforms to the SERS system, enacted as part of the SEBAC agreement in 2011, are:

- New Tier III for individuals hired after 6/30/11
 - Normal Retirement eligibility age 63 and 25 years of service (YOS) or age 65 and 10 YOS and salary based on final five year average;
 - Hazardous Duty (HD) 20 Years of HD service and age 50 or 25 Years of HD Service regardless of age and salary based on final five year average pay;
 - Early Retirement age 60 and 15 YOS;
 - Ten year cliff vesting.
- For current employees who retire after 6/30/2022, Normal Retirement eligibility increase from age 60 and 25 YOS or age 62 and 10 YOS to age 63 and 25 YOS or age 65 and 10 YOS. By 7/1/13, present employees may elect to pay the actuarial pension costs of maintaining the normal retirement eligibility that exists in the present plan which is scheduled to change effective July 1, 2022.
- Change the minimum COLA for individuals who retire after 9/2/11 from 2.5% to 2.0%.
- Change the Early Retirement reduction factor from 3% to 6% for each year prior to normal retirement age.
- Pension savings due to 2 year wage freeze.

In addition to the benefit reductions just described, in 2012 the state made other changes that ensure that we pay down the debt of the fund more rapidly. Ironically, these changes will save the state's taxpayers billions over time, but in the short run they result in increased contribution requirements and a larger nominal value to the unfunded liability. These changes include:

- Elimination of two Rowland-era agreements, known as SEBAC IV and SEBAC V, which allowed the state to postpone payment of most of the pension debt until the late 2020s. These agreements allowed the state to avoid over \$100 million in annual payments, but would have required budget-busting balloon payments in the future. And, by paying the contributions later, the fund would not have benefited from years of investment earnings, making the total contributions higher than they need to be. The future pension payments before and after the elimination of these agreements are shown in the graph below. Note that the total savings to the state is over \$720 million.

Projected state contributions to SERS, based on elimination of SEBAC IV & V



- Reducing the interest assumption in the fund. Up until 2012, the actuaries who evaluated the SERS program assumed that invested funds would earn an average annual return of 8.25%. While the Treasurer has achieved yields close to this over time, the state elected to reduce this assumption to 8%. This change, and other more conservative actuarial assumptions, increased the debt of the fund by \$1.2 billion and increased the annual contribution by approximately \$100 million.

Overall, as a result of all these changes, the state is making record payments into the fund. Based on actuarial projections, the fund should be fully funded by the 2033, at which point the annual costs should drop from the \$1.2 billion we must pay this year down to the normal cost alone, or about \$300 million. At that point, the costs of providing pensions under SERS will be comparable to the costs paid by many private companies to provide 401K-type plans – about 7% or less of payroll split between employee and employer. The table below shows recent and projected payments into SERS, along with investment results.

SERS FUNDING HISTORY AND PROJECTIONS

Fiscal Year	Actuarial Required Employer Contribution (millions)	Actual/Est. Employer Contribution (millions)	Percent	Rate of Return Market Value Basis
2001-02	\$415	\$415	100%	-6.6%
2002-03	\$426	\$421	99%	1.9%
2003-04	\$474	\$470	99%	15.2%
2004-05	\$516	\$516	100%	10.5%
2005-06	\$623	\$623	100%	11.0%
2006-07	\$664	\$664	100%	17.1%
2007-08	\$717	\$712	99%	-4.8%
2008-09	\$754	\$700	93%	-18.3%
2009-10	\$897	\$721	80%	12.9%
2010-11	\$944	\$826	88%	21.2%
2011-12	\$926	\$926	100%	-0.9%
2012-13	\$1,060	\$1,059	100%	11.9%
2013-14 est.	\$1,269	\$1,269	100%	
2014-15 est.	\$1,379	\$1,379	100%	
2015-16 est.	\$1,443	\$1,443	100%	
2016-17 est.	\$1,501	\$1,501	100%	
2017-18 est.	\$1,575	\$1,575	100%	

- The deferral of the SERS contribution was \$50 million in FY 2009, \$164.5 million in FY 2010 and \$100 million in FY 2011.
- Starting in FY 2013, the SEBAC IV & V adjustments are eliminated.
- Starting in FY 2014, the assumed rate of return is lowered from 8.25% to 8%.

Teachers Retirement System (TRS) and Teachers' OPEB

The Teachers' Retirement System provides defined benefit pensions and retiree benefits for Connecticut public school teachers. The funds come from contributions made by teachers themselves as well as contributions made by the state. The individual school systems do not contribute to the fund. For many years, the state neglected to make adequate payments into the fund. Then, in 2008, the state elected to partially solve the funding problem in TRS by issuing bonds, called Pension Obligation Bonds, with the hope that the investment returns on the borrowed funds would be enough to pay the interest on the bonds plus leave additional earnings to pay for teachers' pensions. While the timing of that issue came shortly before a period of market turmoil and poor market performance, the approach did inject needed money into the fund, and commits the state to paying down the remaining debts of the fund over the life of the bonds. The state shares the obligations for retired teacher healthcare with active teachers and with retirees. Some local boards of education also provide retiree benefits.

There is a fund for retired teacher healthcare, but it is financed on pay-as-you-go basis from contributions by active teachers, retirees and the State. Because the teachers' retirement system requires more years of service before retirement, and because the state is liable for only a portion of retired teachers' healthcare costs, the liability for this system is smaller than that of state employees. Recent moves by the state to reduce costs through more competitive pricing for prescription drugs have reduced health costs to both the state and to the retired teachers by 17% effective January 1, 2014.

Prior to FY 2006 the Teachers' Retirement Pension System was chronically underfunded by the state. In FYs 2006 through 2009 the state relied on the use of surplus funds in order to contribute 100% of the required pension contribution.

TRS FUNDING HISTORY AND PROJECTION

Fiscal Year	Actuarial Required Contribution (millions)	Actual/Est. State GF Contribution (millions)	Contribution from Surplus Funds (millions)	Actual/Est. Total State Contribution (millions)	Percent
1989-90	\$349	\$322		\$322	92%
1990-91	\$304	\$157		\$157	51%
1991-92	\$309	\$133		\$133	43%
1992-93	\$300	\$112		\$112	37%
1993-94	\$146	\$124		\$124	85%
1994-95	\$154	\$133		\$133	86%
1995-96	\$165	\$140		\$140	85%
1996-97	\$174	\$148		\$148	85%
1997-98	\$211	\$179		\$179	85%
1998-99	\$222	\$188		\$188	85%
1999-00	\$241	\$204		\$204	85%
2000-01	\$253	\$215		\$215	85%
2001-02	\$211	\$205		\$205	97%
2002-03	\$221	\$180		\$180	81%
2003-04	\$271	\$185		\$185	69%
2004-05	\$281	\$185		\$185	66%
2005-06	\$396	\$226	\$170	\$396	100%
2006-07	\$412	\$237	\$176	\$412	100%
2007-08	\$519	\$429	\$90	\$519	100%
2008-09	\$539	\$329	\$210	\$539	100%
2009-10	\$559	\$559		\$559	100%
2010-11	\$582	\$582		\$582	100%
2011-12	\$757	\$757		\$757	100%
2012-13	\$788	\$788		\$788	100%
2013-14 est.	\$819	\$819		\$819	100%
2014-15 est.	\$852	\$852		\$852	100%

In April, 2008, a \$2.3 billion pension obligation bond (POB) was issued to immediately shore up the fund's finances. A bond covenant requires the state to fully fund the state's required pension contribution for as long as the POB's remain outstanding. By continuing a disciplined approach to paying the ARC and debt service on the POB's, the unfunded liability in the TRS will diminish over time.

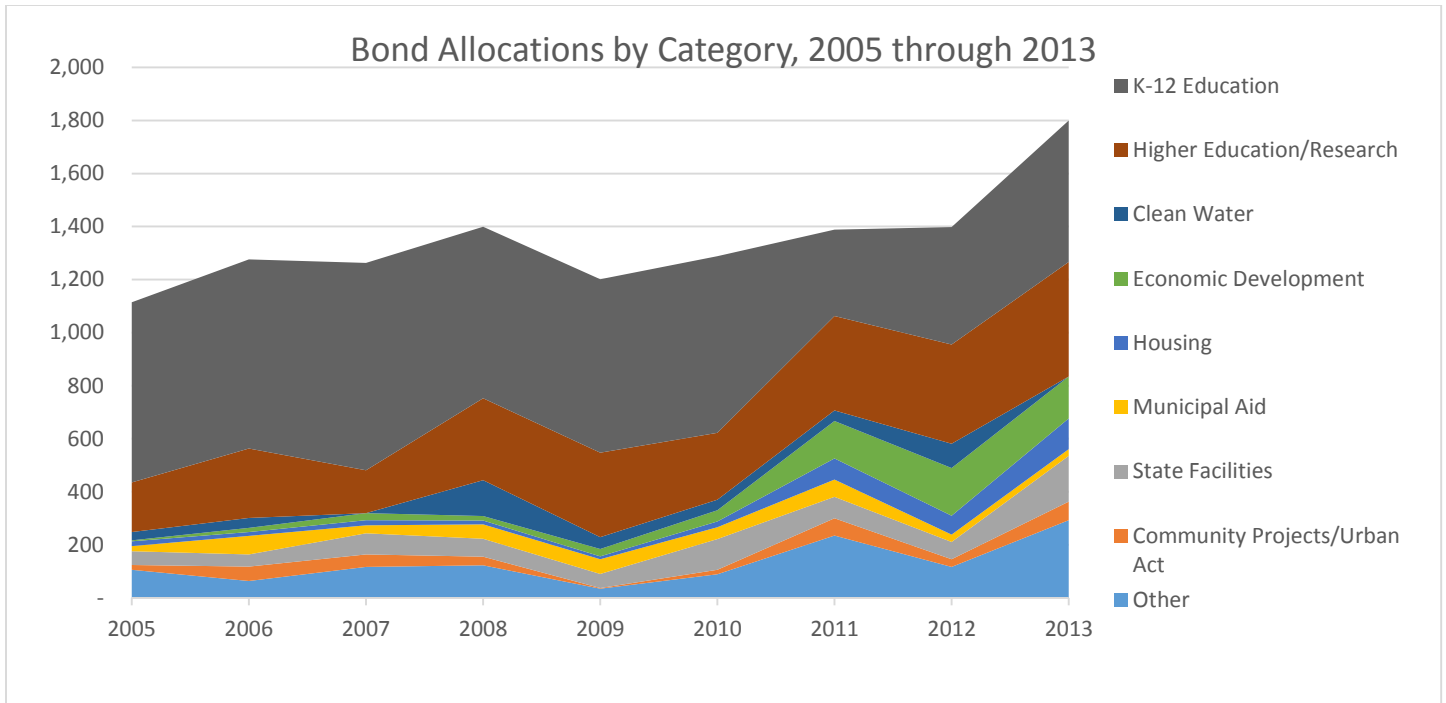
State Bonded Debt

The state issues bonds to fund capital projects. These bonds are loans from individuals and institutions, typically payable over 10 to 30 years. Most often they are tax-exempt bonds, meaning that the lenders do not have to pay tax on the interest earnings, allowing them to charge lower interest rates. The average cost of borrowing by the state is around 4%. Some of the bonds issued by the state are so-called revenue bonds, which have a dedicated stream of revenue for repayment. This is the case with transportation bonds, which are backed with gas tax revenue, or for bonds issued to fund student loan programs, CHFA mortgages and the like. Other bonds, called General Obligation or GO bonds are repaid with taxes and represent a promise by the state to repay.

The use of bonding to fund capital projects is a well-established feature of government finance around the world. It allows the state to invest in projects that benefit our residents in various ways without first having to set aside money over many years. It also allows taxpayers to pay for public improvements at the same time that they enjoy them. Consider, for instance, the Moses Wheeler Bridge project over the Housatonic River between Stratford and Milford on I-95. This project is well underway and will be completed in the next year or two. However, the bonds issued to pay for the state share of this project will be paid off over the next 20 years. This means that the cost of the bridge will be paid by the gas taxes from drivers who are using the new bridge.

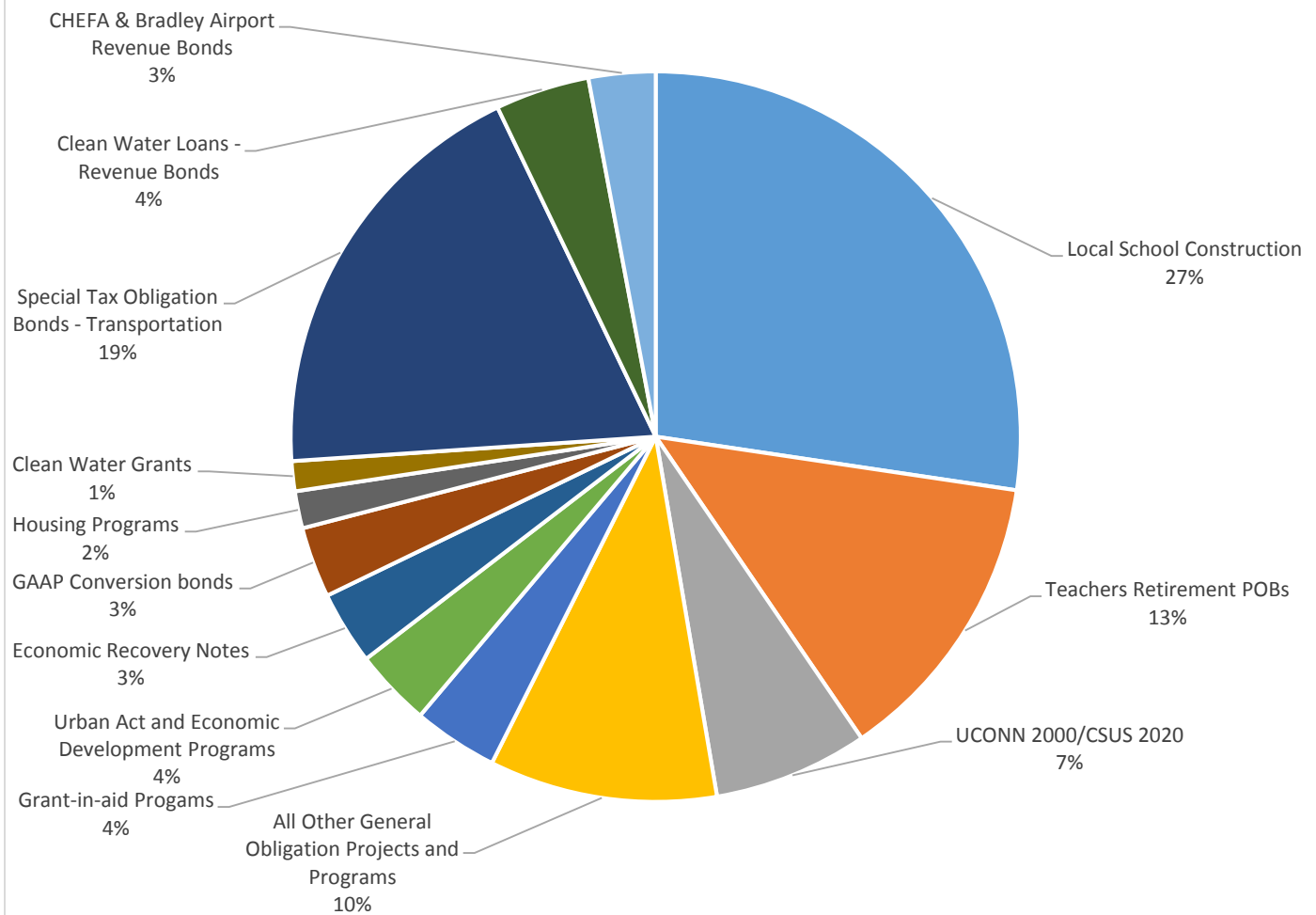
Bond projects are first authorized by the General Assembly. Then, in order for an authorized project to proceed and for bonds to be sold (the money borrowed), the bonding for the project must be allocated by the Bond Commission. Each year, the Bond Commission allocates more than \$1 billion in General Obligation bonds, plus a varying amount in revenue bonds. Given the critical needs of the state, made worse by years of failure to invest adequately in affordable housing, economic development, higher education, and public facilities. The Bond Commission should continue to allocate bond funds to worthy projects even as we work to reduce the state's overall debt.

The following chart shows recent years' bond allocations by category.



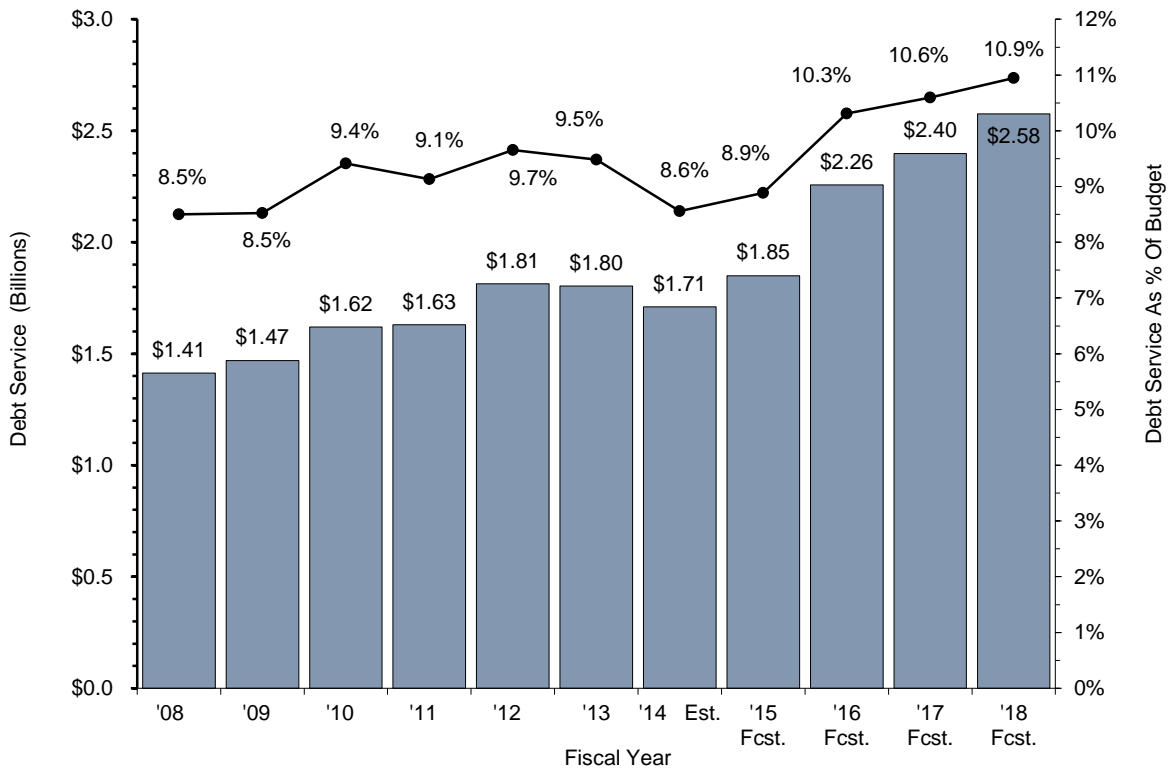
The total outstanding bonded debt of the state is approximately \$20 billion, including General Obligation bonds as well as revenue bonds issued for transportation projects, Bradley Airport, loans to schools and hospitals, loans for sewer projects to local governments, and the pension obligation bonds issued to shore up the Teachers' Retirement System. The largest categories of debt are for local school construction, transportation projects, and teachers' retirement. The following table shows the breakout of total debt by category.

Bonded Debt Outstanding as of October 31, 2013



The state must ensure that repayment of our bonded debt remains affordable in the future. The best measure of this is the future share of our budget that will be dedicated to debt service. That percentage is currently around 10%. It is expected to rise modestly in the coming years based on existing debt plus expected borrowing in the coming years. Adjusted for the significant change in how we budget federal grants made last year, this amount is expected to rise to 11% in 2018. This remains affordable to the state, given the importance to our economy and quality of life that our bonding investments support. Debt service, as well as its share of the state budget are shown on the following table.

General Fund Debt Service Expenditures



Note: FY 2014-18 adjusted for net budgeting of medicaid for comparison to prior years

Not only is the state's current bonded debt affordable to current and future taxpayers, it is also in line with other states. The best comparison of state indebtedness is total state and local debt compared to personal income. This measure is most appropriate because it does not penalize Connecticut for lacking county government, or for our higher cost of labor. Most importantly, it does not penalize Connecticut for having one of the most generous state programs for financing local school construction in the country. In other states, school building is paid for by counties and local governments. Recall that school construction and teachers' retirement make up a combined 40% of total state debt. The following table shows that Connecticut ranked 24th in the nation in 2011 by this important measure, below three of our neighboring states.

State and Local Debt Burden - 2011

Ranked by State and Local Debt As a % of Personal Income IPO- 2011			Ranked by Per Capita State and Local Debt-2011		
Rank	State	Debt/PI	Rank	State	Amount (\$)
1	New York	34.4%	1	New York	17,849
2	Alaska	29.5%	2	Alaska	14,194
3	Kentucky	28.9%	3	Massachusetts	14,162
4	Illinois	27.4%	4	Illinois	12,073
5	Nevada	26.4%	5	New Jersey	12,067
6	Massachusetts	26.1%	6	<u>Connecticut</u>	<u>11,879</u>
7	Texas	25.7%	7	California	11,459
8	South Carolina	25.7%	8	Washington	11,245
9	California	25.7%	9	Rhode Island	11,122
10	Washington	25.3%	10	Texas	10,553
11	Rhode Island	24.9%	11	Colorado	10,510
<u>24</u>	<u>Connecticut</u>	<u>20.6%</u>	12	Hawaii	10,213
UNITED STATES		20.3%	UNITED STATES		\$ 8,496

Source: U.S. Department of Commerce, Census & BEA

- Connecticut's state and local debt burden ranks 24th in the nation in 2011 as a percentage of personal income.
- The state's burden as a percentage of personal income is lower than its three neighboring states.

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Despite accusations that the administration has borrowed for operating expenses, there have been no new deficit financings during the last three years. Any recurring expenses included in the bond program are very small as a share of the state's debt and also represent recurring expenses that are of a capital nature. In fact, in the spring of 2011, the Malloy administration cancelled the proposed \$646 million debt financing that had been adopted as a budget balancing maneuver by the prior administration. This debt financing would have been repaid through a charge on consumer electric bills.

Finally, it is noteworthy that the state has a conservative approach to debt repayment, with General Obligation bond issuances typically structured to repay a consistent amount of the outstanding principal over the 20 year amortization period (level principal method). This method of repayment retires debt more quickly and at lower overall costs than the level payment method sometimes employed in other places.

GAAP Deficit

As part of the state's conversion since 2011 to budgeting consistent with Generally-Accepted Accounting Principles (GAAP), we have begun to pay down the cumulative GAAP deficit which was as high as \$1.7 billion in 2011. While the scale of this debt is relatively smaller than our other types of debt, this deficit has immediate negative consequences for the fiscal health of the state. It has rightly been a priority of this administration to pay down this deficit as quickly as possible.

The cumulative GAAP deficit represents the accumulation of many years of papering over unbalanced budgets by delaying the payment of bills into the following year or counting income earned after the year is done. We have revised our budget practices to avoid these gimmicks in the future, but we still must make up for those past acts. If we do not do this, our fiscal condition will only get worse, like depositing money into an overdrawn checking account.

Our approach to paying this debt includes several features. First, we recently issued \$560 million in GAAP conversion bonds which were used to retire half of the debt. This had an immediate positive impact on the state's cash position and fiscal health. Second, we have committed through statute to repay the remaining debt through annual payments of \$46 million from 2016 through 2028. The chart below shows the history of the GAAP deficit and its projected retirement.

General Fund Accumulated GAAP Deficit (*\$ in millions*)

