Commonwealth of Pennsylvania

Debt Management Policy

Office of the Budget

January 18, 2024

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Introduction

Debt Management Policies provide written guidance regarding the authorizations and requirements for issuing debt; guidelines to consider when determining the amount and type of debt to be issued; and, management of the debt portfolio. This Debt Management Policy identifies clear policy goals for the issuance of debt by the Commonwealth of Pennsylvania (the Commonwealth) within the legal frameworks for issuing Commonwealth debt, as well as specific guardrails to ensure that decisions to issue debt are made within a framework of fiscal stability and responsibility. Debt levels and related annual debt service costs are important financial considerations that impact the use of current resources. The Commonwealth's adherence to this policy signals to elected officials, the citizens, credit rating agencies, and the capital markets that the Commonwealth is well managed and able to meet its obligations in a timely manner.

Debt Authorization by the Commonwealth Constitution[1]

Article 8, Section 7, of the Pennsylvania Constitution sets out the parameters for issuing direct state debt. Section 7 defines "debt" as "the issued and outstanding obligations of the Commonwealth and shall include obligations of its agencies or authorities to the extent they are repaid from lease rentals or other charges payable directly or indirectly from revenues of the Commonwealth." In accordance with the Constitution, the Pennsylvania Treasurer must pay the debt service due on the Commonwealth's general obligation bonds whether or not the General Assembly has appropriated monies sufficient to pay the debt service.

The Commonwealth may issue debt backed by the full faith and credit of the Commonwealth for five purposes:

- *To suppress insurrection or for disaster relief*: The Commonwealth may issue debt without limit to suppress insurrection, rehabilitate areas affected by man-made or natural disaster, or to implement unissued authority approved by the electors prior to the adoption of this article.

- *Capital Projects, Tax Anticipation Notes, and Refundings*: The Governor, State Treasurer, and Auditor General acting together may:

    - issue general obligation debt as provided for in the Capital Facilities Debt Enabling Act;
    - issue tax anticipation notes that mature within the fiscal year, and which must be repaid from revenues received within the fiscal year in which they are issued; and,

[1] https://www.legis.state.pa.us/cfdocs/legis/LI/consCheck.cfm?txtType=HTM&ttl=0

    - refund existing debt provided that the refunding debt matures within the term of the original debt.

- *Voter-approved debt*: Debt may be incurred without limit if a majority of the electorate has approved incurring the debt.

Article 8, Section 9, of the Constitution prohibits the Commonwealth from assuming any debt issued by a county, city, borough, incorporated town, township or any similar general-purpose unit of government unless that debt was incurred to enable the Commonwealth to suppress insurrection or to assist the Commonwealth in the discharge of any portion of its present indebtedness.

Not all debt issued by or on behalf of the Commonwealth, its agencies, commissions, authorities, or other state entities is issued under these constitutional provisions.

General Obligation Debt

Commonwealth General Obligation Bonds (G.O. Bonds) are authorized and issued pursuant to and in full compliance with the provisions, restrictions, and limitations of: Section 7 of Article VIII of the Constitution; the current Capital Debt Authorization law which sets the total amount of G.O. Bond debt that the Issuing Officials may sell in a given fiscal year; the Capital Facilities Debt Enabling Act, the act of February 9, 1999 (P.L. 1, No. 1), *as amended*; the various Capital Budget Project Itemization laws enacted by the General Assembly; and, the laws of the Commonwealth. Individual G.O. bond issues are authorized by the Governor, Auditor General, and State Treasurer (the Issuing Officials). If the three Issuing Officials do not unanimously agree upon the issuance of a particular bond issue, then the issuance requires the consent of the Governor plus either the Auditor General or the State Treasurer.

Disclosures

The Commonwealth complies with all Security Exchange Commission (SEC) public reporting requirements and with the Continuing Disclosure Agreements it has executed as part of its debt offerings.

Use of G.O. Bond Proceeds

The Commonwealth uses its G.O. Bond proceeds to pay for capital projects, for voter approved referenda projects, and for constitutionally authorized disaster relief. G.O. Bonds are not issued to fund specific projects, but instead are issued on a cash flow basis to fund current projects within each project category.

Capital Project Asset Categories

A project that costs less than $100,000 cannot be funded from G.O. bond proceeds but must instead be paid from appropriated operating funds. Projects that cost $100,000 or more may be funded either from bond proceeds, or from appropriated operating funds, or from a combination of bond and appropriated funds, although generally they are paid from G.O. Bond proceeds because of the high initial cost and long-term utilization of such projects, except where special circumstances arise.

The Pennsylvania Constitution permits debt to be incurred without voter approval for capital projects itemized in a capital budget itemization act if issuing the debt will not cause the amount of all net General Obligation debt outstanding (after applying credit for refunded debt) to exceed one and three-quarters times (1.75x) the average of annual tax revenues deposited in all funds in the previous five fiscal years as certified by the Auditor General.

($ amounts in 000's)	**2021-22**	**2022-23**	**2023-24 (Budget)**
Average Tax Revenues Previous 5 years	$ 45,683,741	$ 48,339,806	$ 50,534,009
Calculated Debt Limit (1.75 X revenues)	$79,946,547	$ 84,594,660	$ 88,434,516
Outstanding Debt at end of Fiscal Year	$ 9,293,581	$ 9,510,380	$ 9,916,721
Capital Debt as a % of Debt Limit	11.6%	11.2%	11.2%

In considering a capital budget, it is necessary to take a much more deliberate approach to the amount of debt that may be incurred to finance a capital budget. Consideration must be given to the Commonwealth's ability to market bonds to finance projects and the affordability of the resulting debt service. Further consideration should also be given to increased operating costs that may result from the debt-financing of capital projects.

The capital and debt sections of the Governor's Budget provide a Five-Year Capital Plan with detailed information related to the capital budget process in the Commonwealth. The Commonwealth is authorized to issue five categories of capital projects:

- *Public Improvement Projects*. Includes new buildings, renovations, nonstructural improvements, and the acquisition of land. The majority of these projects are designed and constructed through the Department of General Services, although the Department of General Services does delegate the design, or construction, or both of some projects to other Commonwealth state-level agencies or instrumentalities and the

Commonwealth's state-related universities pursuant to delegation authorizations enacted by the General Assembly. The Department of Conservation and Natural Resources administers Keystone Recreation, Park and Conservation Projects.

- *Public Improvement-Original Furniture and Equipment Projects*. Includes the purchase of movable furniture and equipment through the Department of General Services to equip newly completed public improvement projects.

- *Transportation Assistance Projects*. Includes the purchase of railroad rolling stock and the construction or improvement of facilities operated by mass transportation agencies; the acquisition, construction, and equipping of rural and intercity common carrier surface transportation systems and their components as authorized in Act 10 of 1976; and, aviation transportation systems. These projects are administered by the Department of Transportation.

- *Redevelopment Assistance Capital Projects (RACP)*. The Commonwealth's RACP program provides partial funding for economic development projects that have regional or multijurisdictional impact, are expected to substantially increase or maintain current employment levels or tax revenues, and that have total cost of at least $1 million. The Office of the Budget administers the RACP program.

- *Flood Control Projects*. Provides funding for the Commonwealth's share of federal flood control works and improvements to prevent floods and to preserve, control, and regulate the flow of rivers and streams in the Commonwealth. These projects are administered by the Department of Environmental Protection.

- *Highway Projects*. Includes the costs to purchase rights-of-way; to construct new roads, bridges, and highways; to reconstruct, replace, or improve existing roads, bridges, and highways; to undertake highway safety projects. These projects are designed and constructed through the Department of Transportation.

Electorate Approved Debt

The issuance of electorate-approved debt is subject to the enactment of legislation that places on the ballot the question of whether debt shall be incurred. The legislation authorizing the referendum must state the purposes for which the debt is to be authorized and, as a matter of practice, includes a maximum amount of funds to be borrowed. Upon electorate approval and enactment of legislation implementing the proposed debt-funded program, bonds may be issued. All such authorizing legislation to date has given issuance authority to at least two of the Issuing Officials, one of whom must be the Governor.

The Commonwealth has authorization remaining from several voter-approved referenda and from two constitutionally authorized bond categories, but neither of these bond categories is currently active.

Other Types of Borrowings

Other Bonded Debt. Debt issued to rehabilitate areas affected by disasters is authorized by specific legislation. Authorizing legislation has given issuance authority to at least two of the three Issuing Officials, one of whom must be the Governor.

Anticipatory and Temporary Borrowings

The Commonwealth may borrow funds in anticipation of receiving tax revenues or bond proceeds.

- *Tax Anticipation Notes*. The Commonwealth receives a significant share of its General Fund revenues in the last four months of each fiscal year (March – June), while the Commonwealth's General Fund payments and disbursements are distributed more evenly throughout the fiscal year. As a result, the Commonwealth may experience operating cash flow shortages during certain months of the fiscal year, particularly between December and March. When necessary, the Issuing Officials will issue tax anticipation notes to provide liquidity in the General Fund or the Motor License Fund through the end of the fiscal year in which the bonds are issued. All three of the Issuing Officials must agree to issue tax anticipation notes. The principal amount of such notes, when added to already outstanding amounts, cannot exceed in the aggregate 20 percent of the revenues estimated to accrue to the General Fund or the Motor License Fund within that same fiscal year. Tax anticipation notes must mature within the fiscal year in which they are issued. The Commonwealth cannot fund deficits between fiscal years with any form of debt. Any year-end deficit balances must be funded in the succeeding fiscal year budget. No tax anticipation notes are outstanding.

- *Bond Anticipation Notes*. Pending the issuance of general obligation bonds, the Commonwealth may issue bond anticipation notes subject to the same statutory and constitutional limitations generally imposed on general obligation bonds. The term of such borrowings may not exceed three years. Issuing authority rests with the Issuing Officials. No bond anticipation notes are outstanding.

Temporary Borrowings

The Commonwealth may internally finance its General Fund or other fund temporary cash flow needs in lieu of issuing tax anticipation notes or using other mechanisms. These internal financings are an exercise of the State Treasurer's statutory authority to prudently invest Commonwealth funds, and therefore require the State Treasurer's agreement to be entered into. Since these internal financings take the place of tax anticipation notes, the Commonwealth also seeks the Auditor General's acknowledgment when entering into them. The Commonwealth pays a market-based rate of return negotiated with the State Treasurer on these financings.

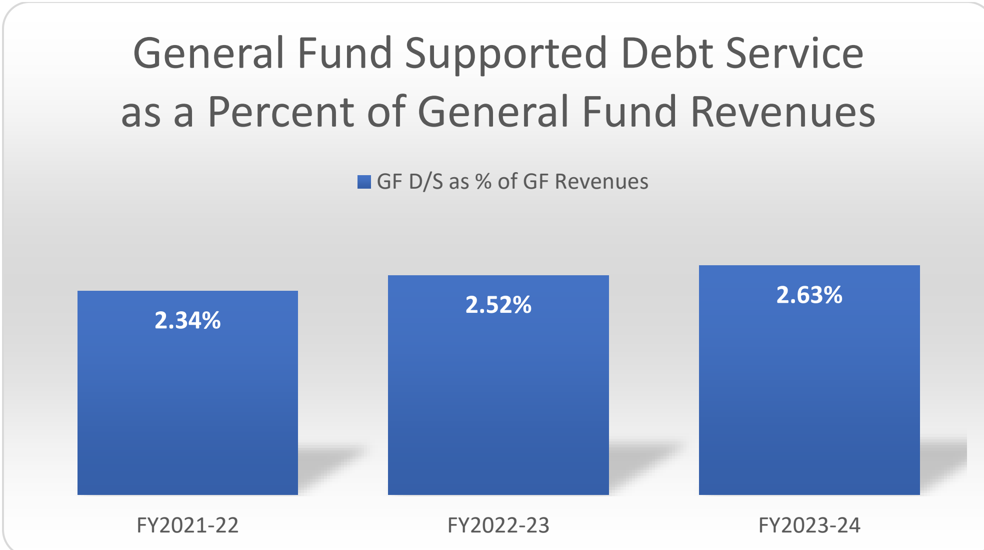
Redemptions prior to maturity

A significant tool in structuring bonds and managing debt is the ability to make bonds callable after a certain period has elapsed after issuance. This provides the advantage of enabling the issuer to achieve savings through the issuance of refunding bonds in the event interest rates decline. Although the ability to refund bonds for savings may be advantageous, there may be situations where the Commonwealth may realize greater benefit by issuing non-callable bonds. The Commonwealth may determine whether a particular bond issue should be sold as callable or non-callable. When considering whether to refund a particular bond issue, the Commonwealth will consider the Net Present Value (NPV) Savings calculation of any proposed refunding, and will likely not consider refunding a bond issue if the projected NPV savings are less than 3%. The present value should be calculated on the transaction as a whole and on a maturity-by-maturity basis. Refunding opportunities should be monitored on an ongoing basis to evaluate potential savings.

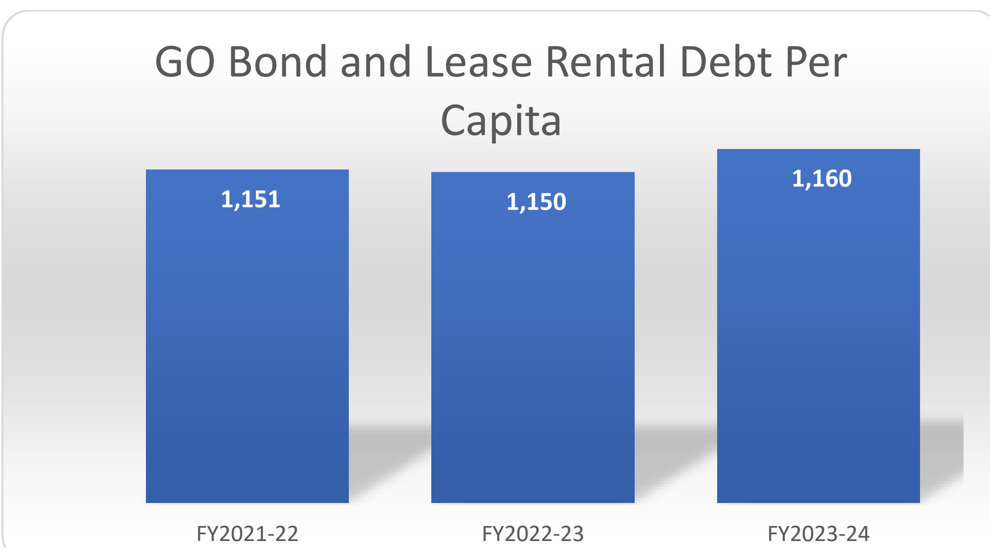
Parameters for Debt Issuance

In addition to the Constitutional limitations on debt issuance noted above, this Policy provides a series of parameters to further ensure that debt is incurred with consideration for the fiscal health of the Commonwealth. The benchmarks for these guardrails are based on recommendations from rating agencies and best practices identified by public financial associations or other large public issuers.

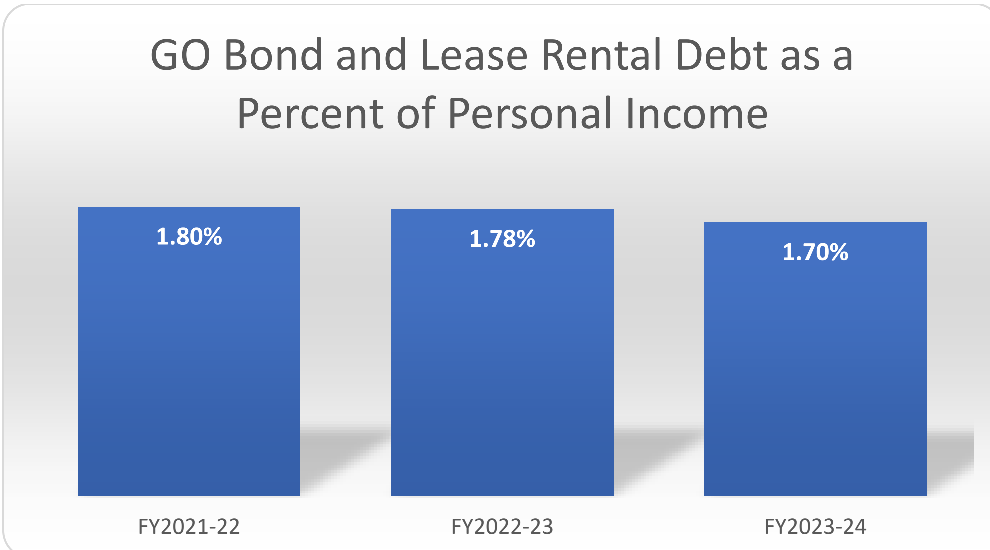
- *Debt Service as a Percent of Revenues*. Bond issuers are considered to have a "low debt burden" if their General Fund Debt Service is maintained at or below 5 percent of their annual revenues.



- *General Obligation Debt and Lease Rental Debt per Capita*. It is recommended that General Obligation Debt and Lease Rental Debt burden per capita be maintained at or below $1,750 per person. At the time of issuance of this policy, the Commonwealth's aggregate General Obligation Debt and Lease Rental Debt burden is less than $1,750 per person.



- *General Obligation Debt and Lease Rental Debt as a percent of Personal Income*. It is recommended that General Obligation and Lease Rental Debt as a percent of Personal Income be maintained at or below 2 percent. At the time of issuance of this policy, the Commonwealth's aggregate General Obligation Debt and Lease Rental Debt burden is less than 2 percent.



Additional Considerations for Debt Issuance

While changing market conditions and current statutory requirements require Commonwealth officials to be flexible when considering whether to issue a bond, and the optimal size, timing, and structure of a bond issue, the starting point for structuring each issuance should begin with the following considerations:

- *Loan Term*: Statutes authorizing bond issues often define the maximum term of the bonds, and may require equal payment requirements (except in the case of refunding bonds). In addition to these statutory restrictions, the duration of debt should be shortened to the extent practical to minimize the interest costs on the financing, and the final maturity of the debt should not exceed the useful life of the assets being financed unless it serves a compelling Commonwealth interest. Tax anticipation notes must be repaid within the fiscal year in which they were issued from revenues received during that year.

- *Tax status*. Bonds issued by the Commonwealth, or its agencies or instrumentalities, may be sold as tax-exempt or taxable bonds. The choice of whether to issue taxable or tax-exempt bonds depends on a number of considerations, including the purpose(s) for which the issuer has sold the bonds, how and when the issuer intends to expend the bond proceeds, and the relative cost of issuing either type of bond under then-prevailing market conditions.

- *Bond Insurance*: Due to the requirement for GO competitive sales, the Commonwealth as an issuer does not seek or offer credit enhancements (also known as bond insurance) for its G.O. bonds. Instead, bidders on G.O. bonds may choose to purchase bond insurance as part of their bid on one or more of the serial maturities in a G.O. bond. This is known as "bidder's option" bond insurance, and the cost of the insurance premium becomes part of the bidder's aggregate bid for the bonds. In these cases, bidders must consider the economics of the premium cost as part of their bid. A bidder's decision to purchase bond insurance as part of its bid does not affect the Commonwealth's side of the bond transaction.

- *Variable Rate Debt*: The Commonwealth traditionally issues conventional fixed-rate debt with interest payable semi-annually to bondholders. The advantage of fixed-rate debt is the long-term certainty provided by locking in the State's interest cost and not being subject to interest rate volatility. Fixed-rate debt should continue to be the primary means for infrastructure financing, although exceptions may be considered when variable rate debt is more appropriate, in accordance with the policies related to variable-rate debt herein. The Commonwealth will follow these guidelines for the issuance of variable rate debt:

    - *Expected reduction in total borrowing cost*: In determining expected savings, a comparison should be made between fixed-rate financing at then current rates and variable-rate transaction, based on an appropriate floating rate index. Each cost analysis must include all fees associated with the proposed transactions, including routine borrowing fees, remarketing agent fees, liquidity provider fees, and other transaction costs.

    - *Variable-rate debt limitations*: Rating agencies suggest limiting the amount of variable-rate debt to 15%-20% of total outstanding debt. To further reduce Commonwealth risk, this policy adopts that variable-rate debt should not exceed 10% of outstanding debt.

    - *Derivatives*: Alternative financing arrangements — generally referred to as derivatives — are available in the market as alternatives to traditional bonds. Derivative transactions are specialized, detailed, technical transactions that have limited utility and should only be entered into after receiving the advice of qualified financial advisors. A Commonwealth agency can only enter into a derivative after it has been specifically authorized to do so by the General Assembly.

Other State Related Obligations

Lease Financing. The Commonwealth, through several of its departments and agencies, leases various real property and equipment. Commonwealth debt includes obligations that are paid from lease rentals or other charges payable directly or indirectly from revenues of the Commonwealth, and some of these leases and lease payments are pledged as security for debt obligations issued by certain public authorities or other entities within the Commonwealth. All lease payments payable by Commonwealth departments and agencies are subject to, and dependent upon, approval of an annual spending authorization by the General Assembly via the Commonwealth's annual budget process. The Commonwealth is not required by law to appropriate or otherwise provide moneys to pay lease payments.

Investment of Bond Proceeds

The Treasury Department deposits and invests Commonwealth funds subject to the prudent investor standard, including the proceeds of the Commonwealth's bonds and the funds held for the payment of interest on and maturing principal of the Commonwealth's bonds, as authorized by the General Assembly in the Commonwealth's Fiscal Code. The General Assembly requires the State Treasurer to maintain an investment policy. Information about the Commonwealth's investments, annual and quarterly investment reports, the State Treasurer's investment policies, and other related information is available from the State Treasurer's website at www.patreasury.gov/investments/.

Rating Agency Communication

The Commonwealth and its authorities endeavor to maintain and improve their bond credit ratings. The Office of the Budget maintains open lines of communication with its three main rating agencies (S&P, Moody's, and Fitch), and informs the ratings agencies of major financial events in a timely manner. All communications are made by the Secretary of the Budget; the Director of the Bureau of Redevelopment, Capital, and Debt; or, those individuals designated by them. All meetings are scheduled at least once a year.

Selection of Bond Professional Services

The Commonwealth periodically procures bond counsel, disclosure counsel, one or more financial advisors, and underwriters in accordance with the Commonwealth Procurement Code or in accordance with the statute that authorizes a particular debt issue.

- The Office of the Budget retains the Commonwealth's disclosure counsel.

- Bond counsel is retained for each bond issue in accordance with the statute that authorizes the debt issue. The Issuing Officials competitively select bond counsel for G.O.

Bonds. The Commonwealth's other bond issuing entities are responsible for selecting their own bond counsel.

- The Office of the Budget contracts with one or more firms to serve as the Commonwealth's independent registered municipal advisor (IRMA) within the meaning of the Security Exchange Act of 1934 and Rule 15B(a)(1).

- The Commonwealth sells its G.O. bonds through competitive sales. In a competitive sale, underwriters submit sealed bids and the sale is awarded to the underwriter syndicate with the lowest all-in True Interest Cost (TIC). Some Commonwealth agencies and instrumentalities may sell their bonds via negotiated sales.

Arbitrage Compliance

The Commonwealth, through the Office of the Budget, maintains a record-keeping and reporting system to comply with the Internal Revenue Code's arbitrage rebate compliance requirements for the Commonwealth's G.O. Bonds. The Commonwealth is committed to minimizing the cost of arbitrage rebate and yield restriction on its G.O. Bonds, while strictly complying with this requirement. Other state agencies and instrumentalities that issue bonds are responsible for performing arbitrage compliance on their bonds.

Post Issuance Compliance

The Office of the Budget is responsible for developing and maintaining post issuance compliance procedures to help ensure compliance with Federal Tax Law over the term of each issuance of tax-exempt bond or other tax notes. The Budget Office shall provide post-issuance compliance training to state personnel that are responsible for managing the State's bond funded capital programs.

Policy Review and Revision

While this policy may be reviewed and revised at any time, the Commonwealth will review this Debt Management Policy at least once every two years to ensure that it remains consistent with best practices of public sector debt issuance.

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