

## **INTRODUCTION**

Connecticut's budget for the biennium ending June, 30, 2011 includes a directive to the State Treasurer and the Secretary of the Office of Policy and Management to jointly develop a financing plan that will generate net proceeds of up to \$1.3 billion in general fund revenue for Fiscal Year 2011.<sup>1</sup> In accordance with that directive, State Treasurer Denise L. Nappier, OPM Secretary Robert L. Genuario and their respective staffs convened a working group to consider a number of financing approaches. The effort resulted in this report, which sets forth a number of options -- two of which are discussed in more detail in this report as illustrative of the complexity of any securitization or financing option.

The Office of the Treasurer and the Office of Policy and Management stand ready to work with the General Assembly in devising the best approach to this very difficult financial challenge, including a fuller review of the merits of these and other options.

## **BACKGROUND**

While the General Assembly's mandate was limited to generating revenues for Fiscal Year 2011, the process of developing this financing plan required consideration of the circumstances that have recently impacted the State's revenues, as well as expectations for the near term. The working group was particularly mindful that in Fiscal Year 2009, the State utilized several non-recurring revenue sources -- including Economic Recovery Notes to finance the \$948 million general fund deficit. Additionally, for the current biennium (2010 and 2011), the final budget relied on depletion of the \$1.4 billion Budget Reserve Fund, federal stimulus payments totaling \$1.9 billion, and \$1.3 billion from this financing plan to produce the required revenue. And finally, it should be noted that the 2010 fiscal year is currently projected to be \$500 million in deficit.

Taken together, these factors demanded that our assessment of any financing options be guided by the following principles:

- Minimize any negative impact on the State's credit rating and/or financial outlook;
- Minimize or avoid securitization of current general fund revenue streams to avoid further structural imbalances going forward;

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<sup>1</sup> Public Act 09-3, Section 88 (June Special Session), which required a plan to generate revenues of up to \$1.3 billion, was amended by Public Act 09-7, Section 179 (September Special Session) to require a plan that would generate \$1.2907 billion.

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- Any securitization of current revenues should primarily focus on non-general fund revenues;
  - Consider options that are cost-effective and avoid or minimize the impact on general fund revenues and cash flows;
  - Consider replacing non-general fund special taxes scheduled to expire in a manner that will not increase or absorb all of such taxes; and
  - Provide for the sale and/or lease of major assets as an alternative or in addition to securitization.

With these guiding principles in mind, the working group considered a variety of financing options, with the assistance of financial and legal experts, and evaluated these options within a specific framework that included considerations of cost, the potential amount of revenue that could be generated, legal and tax rules, market limitations, and the potential effect on the State's credit rating.

Many of the potential financing options make use of some form of securitization and involve issuing bonds to generate funds in the near term while pledging future revenues to pay interest and principal. The amount of money that could be raised depends on the size of the revenue stream, the consistency of those revenues, and the length of time that the bonds could be outstanding.

The options outlined in this report have been reviewed by the State's bond and tax counsel for legal and tax considerations. Legislative action will be required to implement the options described herein. In order to issue tax-exempt bonds, which generally are the most cost-effective means of financing, federal tax law must also be observed. This can place restrictions on several aspects of a financing, including the maturity of the bonds and the manner in which the bond proceeds are used.

Another major consideration during our evaluation was any potential effect a financing would have on the State's credit rating. Currently, two of the three major credit rating agencies have placed Connecticut's general obligation credit rating on negative outlook. Their major concerns include the use of one-time solutions to balance the Fiscal Year 2010/11 biennial budget, high current debt ratios, low funding ratios for the State's pension plans, the reliance on deficit financing, and a high unfunded post-employment benefit liability. The rating agencies, in general, do not look favorably on the use of debt to finance current operating deficits, and we attempted to take all possible steps to minimize any further deterioration in the State's credit rating.

The bond market reception to the many securitization or revenue financing options available can vary widely and cause significant differences in the cost of

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each financing. For example, tobacco securitization bonds are expected to have higher interest rates than many other options due to the uncertainties in future cigarette consumption and the unpredictable effects of litigation. The State's experience with rate reduction bonds in 2004 was just the opposite: due to the secure nature of the revenue for those bonds, they received AAA ratings and priced at very attractive levels. (See Page 8 for background on prior RRB financings.)

Independent of what options ultimately are chosen to meet the \$1.3 billion requirement, the timing of the financing will have a significant impact on the State's cash position in Fiscal Year 2011. If the transaction is completed later in the fiscal year, some form of temporary borrowing, consistent with the Treasurer's existing authority, may be required until cash generated by the financing becomes available. The State's Budget Reserve Fund will be exhausted in Fiscal Year 2011, and the cash cushion that the reserve fund provided will be gone.

### FINANCING OPTIONS

Set forth below are a number of financing options – the first two of which are detailed more fully in this report. Other potential financing options were reviewed and are summarized below.

- Option 1: Issue bonds to securitize a portion of existing charges on electric bills of the State's two major electric utilities by redirecting about 37% of the revenue generated by existing charges in a manner that will not increase current electric rates to customers, as has been done in the past, through the issuance of Rate Replacement Bonds, or the "2010 RRB Option."
- Option 2: Issue bonds backed by expanded Lottery gaming revenues. Expanded revenues may be accomplished through the implementation of new Lottery games and increased marketing including the implementation of the Keno game. This financing option is referred to as the "Lottery Revenue Bond Option."
- Option 3: Issue bonds backed by tobacco revenues from the Master Tobacco Settlement Agreement. These bonds would be very expensive in today's market and currently the state treats the proceeds from the Settlement Agreement as general fund revenue.

- Option 4: Establish new fees and/or taxes or implement highway tolls and securitize future incremental revenues. These options were not reviewed in depth based on the guiding principle that increases on existing sources of general fund revenue should be avoided given the limited scope of this mandate. To the extent that the General Assembly enacts such changes in revenue, additional analysis can be done to assess the financing possibilities.
- Option 5: Securitize existing general fund revenues, such as the personal income tax, sales tax or casino revenues. These options were not reviewed in depth given the likely impact on future structural imbalances and cash flows, as well as the likely negative impact on the State's credit rating.
- Option 6: Investigate the merits of selling major state assets, with the caveat that careful consideration be given to the current and future strategic value of these assets in comparison to any proceeds that could be generated in today's market. Any such effort would require significant time to study and execute and may not be completed in time to address the revenue shortfall for Fiscal Year 2011.

The first two options would allow for the issuance of tax-exempt bonds. Because these bonds would be considered "deficit bonds" under the federal tax code, they are generally limited to no more than a ten-year final maturity. As such, all of the scenarios are evaluated using no more than a ten-year financing.

In general, if a financing can be executed with a shorter term, the State can benefit from a lower interest cost and more rapid amortization. The following table illustrates the differences in annual debt service cost and interest cost for a \$1.3 billion financing utilizing an AAA rated bond financing.

|                                     | <i>5 Year<br/>Financing</i>             | <i>7 Year<br/>Financing</i>             | <i>10 Year<br/>Financing</i>            |
|-------------------------------------|-----------------------------------------|-----------------------------------------|-----------------------------------------|
| <i>Annual Debt<br/>Service Cost</i> | \$306 Million in<br>Annual Debt Service | \$230 Million in<br>Annual Debt Service | \$180 Million in<br>Annual Debt Service |
| <i>Indicative<br/>Interest Rate</i> | 2.50% Interest Cost                     | 3.25% Interest Cost                     | 4.0% Interest Cost                      |

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**Analysis of Option 1: 2010 Rate Replacement Bonds (2010 RRBs)**

The “2010 RRB Option” can be completed by redirecting existing charges on the electric bills of Connecticut Light & Power (“CL&P) and United Illuminating (“UI”) using a rate replacement mechanism. The policy requirement for this financing option is that existing electric rates are not increased above current levels. In fact, depending on the outcome of any other potential replacement charges<sup>2</sup> separate and apart from this 2010 RRB Option, it is possible electric customers could still enjoy a rate decrease of some magnitude due to expiring charges.

The 2010 RRBs, previously known as Rate Reduction Bonds, have been successfully used twice by the State in the last ten years, as described more fully in this report.

The implementation of this option would require that the General Assembly adopt legislation to redirect existing per kilowatt charges on the electric bills of CL&P and UI customers for the repayment of the 2010 RRBs. Given current market conditions, it is estimated that not more than \$180 million of revenues from existing charges would be required annually to support the debt service on a ten-year financing that would produce \$1.3 billion in net proceeds to the State. The annual amount incorporates the funding of a required debt service reserve fund which would be available to make the final debt service payments.

It is estimated that the per kilowatt hour charge needed to generate \$180 million on CL&P and UI customer bills would be about \$0.0065 per kilowatt hour. Assuming an average monthly customer usage of 700 kilowatts hours, this would translate to about \$4.55 per month for an average residential customer bill. Please remember that this would be a redirection of existing revenue, not a revenue increase.

The goal would be to have the per kilowatt charges equitably apportioned for CL&P and UI customers, and to implement the rate replacement mechanism in such a way as to ensure that customers’ bills are, at the very least, not increased over current levels, or possibly reduced.

In order to repay the 2010 RRBs, several existing charges are available to be replaced by the 2010 RRB charge:

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<sup>2</sup> On January 8, 2010, Connecticut Light & Power submitted to the Department of Public Utility Control an application for approval to increase its distribution rates by roughly \$210 million.

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CL&P 2001 RRB Charge – Existing charges on CL&P bills to repay 2001 bonds issued to fund electric utility stranded costs generate \$234 million per year and are scheduled to sunset in December 2010. If about 37% of the charge was replaced with a “2010 RRB Charge,” the financing could raise approximately \$620 million for a ten-year financing.

UI CTA Charges – UI chose a slightly different method to recover its stranded costs. Rather than issuing bonds as CL&P did, UI has utilized a Competitive Transition Assessment (CTA) on its bills to amortize and recover its stranded costs, and that charge is due to expire in 2013. It is estimated that the current UI CTA charge generates revenues of about \$85 million per year. If about 37% of the charge was replaced with a “2010 RRB Charge,” the financing could raise approximately \$225 million over a ten-year financing.

Public Benefit Charges - The State assesses these charges on ratepayers to fund several public benefit programs. These surcharges include the Conservation and Load Management Program (\$81 million annually); the Clean/Renewable Energy Investment Fund (\$27 million annually); and the Systems Benefit Charge (\$64 million annually). These charges are also a potential source of funds for repayment of the 2010 RRBs. The total amount of revenue generated by these charges is approximately \$172 million annually.

If roughly 37% of the public benefit charges were redirected to a 2010 RRB transaction, the financing could raise approximately \$455 million for a ten-year financing.

The charges and associated funding for the Conservation and Load Management and Clean/Renewable Energy programs cannot be reduced prior to April 2012 pursuant to restrictions related to the State’s receipt of stimulus funds under the American Recovery and Reinvestment Act of 2009. However, if these charges are approved to be redirected to support a financing, this restriction can be accommodated through the structure of the debt repayment for the 2010 RRBs.

To the extent a portion of these existing charges are used for a financing, the impact would be that these programs would need to operate at reduced levels until the bonds are repaid. The program reduction method was also utilized for the 2004 RRBs, where the programs were reduced by about one-third, discussed below.

In summary, the 2010 RRB charge could be fashioned to replace a portion of existing charges, which currently generate an estimated \$491 million in annual revenues. The following is a sample apportionment of the existing charges for illustrative purposes:

|                                | <i>Estimated Annual<br/>Revenue<br/>Currently<br/>Generated</i> | <i>Sample Apportionment of a<br/>Rate Replacement Charge</i>      | <i>Remaining<br/>Revenue</i>                         |
|--------------------------------|-----------------------------------------------------------------|-------------------------------------------------------------------|------------------------------------------------------|
| <i>CL&amp;P CTA/RRB Charge</i> | \$234,000,000                                                   | \$120,000,000<br><i>(80% of total CTA to reflect total usage)</i> | \$114,000,000                                        |
| <i>UI CTA Charge</i>           | \$85,000,000                                                    | \$30,000,000<br><i>(20% of total CTA to reflect total usage)</i>  | \$55,000,000                                         |
| <i>Public Benefit Charges</i>  | \$172,000,000                                                   | \$30,000,000                                                      | \$142,000,000                                        |
| <b>TOTAL</b>                   | <b>\$491,000,000</b>                                            | <b>\$180,000,000</b><br><i>37% of annual revenue</i>              | <b>\$311,000,000</b><br><i>63% of annual revenue</i> |

Given that \$180 million would be drawn from a basket of \$491 million of existing charges for a ten-year financing, the total replacement charge for the 2010 RRB Option alone could be implemented with no increase in current electric rates.

Considerations - There are several considerations for this method of financing.

Interest Cost - This would be one of the lowest cost financings available, and it is expected to cost less than 4.0% for a ten-year financing.

Credit Ratings – Based on the State’s previous bond sale, together with recent sales in the marketplace, it is expected that these bonds should receive AAA credit ratings from all three credit rating agencies. These bonds enjoy the highest credit ratings because the repayment charges are collected on utility bills, resulting in a highly secure source of repayment. In addition, a provision that provides for an annual “true up” or reset of the charge to adjust as needed, based on collections, is another strong credit factor for the bonds.

Market Acceptance – This type of financing, whereby energy surcharges are securitized, is very well accepted in the marketplace.

Legal Framework and Ease of Execution - The required legal framework was developed in the State’s previous financings, including the enabling legislation, bond indenture, security features, regulatory framework, and financial statement reporting, and servicing agreements. Therefore, such a

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financing could be executed to provide the State with the required \$1.3 billion of revenue in a timely manner. The goal would be to close the transaction by the end of the 2010 calendar year, halfway through the fiscal year.

Impact on the State's Credit Rating and Future General Fund Deficit Projections - Under the 2010 RRB structure, current general fund revenues are not affected or required to pay debt service, so there should be no negative impact on the State's general obligation credit rating attributable to this financing option. Given the current projections for general fund deficits in 2012 and beyond, as well as negative outlooks on the State's credit rating by two rating agencies (Moody's and Fitch), it is prudent to select a financing solution for the \$1.3 billion which does not rely on future general fund revenues.

The revenue projections for 2012 to 2014, by both OPM and OFA, have reduced revenues by about \$200 million per year to accommodate the debt service on a \$1.3 billion securitization of existing general fund revenues. The "2010 RRB" option would actually allow these offices to add back the \$200 million per year of general fund revenues, thereby helping to address the structural imbalance in future budgets.

Background on Prior RRB Financings – This financing method has been used twice by the State:

CL&P 2001 Financing - In 2001, \$1.44 billion in RRBs were issued to provide funds to CL&P. The funds were used by the utility to recover some of the stranded costs associated with the mandated deregulation of the electric industry. Payment for the bonds was provided by a surcharge on electric bills, called the RRB charge, which is part of the Competitive Transition Assessment (CTA). Those bonds are scheduled to be repaid at the end of December 2010. We understand the existing charge is currently producing revenues in the amount of \$234 million annually.

State of Connecticut 2004 RRB Financing – In 2004, another RRB charge was used to pay the debt service on \$205 million of a second issue of RRBs. These bonds were authorized to offset a general fund deficit in 2003 and 2004. Those bonds were issued to preserve funding for the Conservation and Load Management and Clean/Renewable Energy Funds, which would otherwise have been swept fully to the general fund for two years absent the issuance of the bonds. Rather than sweeping these funds fully for two years, the financing provided that funding for

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the Conservation and Load Management and Clean/Renewable Energy Funds were reduced by the amount needed to pay debt service on the 2004 RRB bonds until the bonds were repaid. This use of a rate replacement mechanism meant that the financing could be executed with no impact on customer bills. The 2004 RRBs were defeased in 2008 utilizing the State budget surplus. This example is similar to the 2010 RRB financing option in that a charge was implemented that captures and redirected revenues generated from a portion of an existing charge and resulted in no impact on total charges to customers.

### **Analysis of Option 2: Lottery Revenue Bonds**

Another financing option is to issue Lottery Revenue bonds backed by expanded lottery revenues. Lottery revenues may be able to be expanded by the Lottery Corporation using a new Keno game, as well as expanded marketing or implementation of other new games. Prior estimates concluded that the new Keno game alone could generate \$60 million in additional revenue once the game is fully implemented. Other enhancements in marketing existing games may be able to produce additional lottery revenue as well.

Rather than treating the proceeds as general revenues, proceeds from this financing could be used to fund debt service due on general obligation bonds during the remainder of the 2011 fiscal year. Such a financing could be executed for up to \$600 million, requiring approximately \$90 million in annual debt service.

Considerations - There are several considerations for this method of financing.

Interest Cost – Given that the expected credit ratings are relatively lower on Lottery Revenue bonds versus the 2010 RRBs, we would expect the interest cost to be about 75 basis points higher than for the 2010 RRB options, or about 4.75%.

Credit Ratings – Credit ratings on a lottery revenue financing will depend in part on the final legal provisions and the size of total lottery revenues in comparison to the level of annual debt service. In general, we would expect Moody's and Fitch to rate the bonds at the A level. Standard and Poor's generally rates lottery revenue bonds AAA as long as certain provisions are met.

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Market Acceptance – There is good market acceptance of lottery bonds, but given the lower credit rating, we would not expect demand to be as strong as for the RRB bonds.

Legal Framework and Ease of Execution - Lottery bonds would require the creation of an entirely new credit structure and financing program and, therefore, such a bond sale would take much more time and expense to complete than the 2010 RRB Option. Nonetheless, the goal would still be to complete the financing before the end of the 2010 calendar year.

It bears noting that the implementation of Keno might present legal complications given the current compact between the State and the Indian tribes regarding gaming.

Impact on the State's Credit Rating and Future Deficit Projections of the General Fund - Absent an expansion of lottery revenues, a lottery financing would take away future general fund revenues and would not be viewed favorably by the credit rating agencies. However, if lottery revenues can be successfully expanded and there is no reliance on general fund revenues, such a financing should not have a negative impact on the State's credit rating and, moreover, should minimize any impact on future general fund deficit projections.

### **OTHER OPTION ENUMERATED IN SECTION 88 OF PUBLIC ACT 09-3**

Selling Securities for the State Pension Plan – The legislation also mentions a strategy that could allow the sale of securities to, or securing a loan from, the State's pension plans. This language was taken from a similar provision adopted by the General Assembly in 2003. There are two main reasons why this option is unattractive:

1. Taxation - The State can issue tax-exempt bonds for this purpose, thereby providing a lower cost of borrowing. However, the State pension plans, as tax-exempt trusts, only invest in higher yielding taxable securities. Therefore, a tax-exempt rate -- which would be fair to the State -- would be an unacceptably low rate for the pension plan; and a taxable rate fair for the pension plan that would generate sufficient investment return would be unacceptably high to the State for the financing.
2. Credit - The State's pension plans already depend on the general fund for a large portion of its cash flow through the annual contributions of

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over \$1.5 billion. From a risk management standpoint, it does not make sense to further expose this investment portfolio to the State's general fund by extending a loan or otherwise investing in securities backed by the general fund.

Finally, involving the pension fund does not make sense given that the State enjoys ready market access for its bonds from investors for which the tax exemption and credit are a better fit.

## **CONCLUSION**

While the two principal options presented herein each have policy, financing and practical hurdles that must be overcome, they each meet the financial principles outlined above that guided our review. Whichever option(s) is pursued, our collective judgment is that passage of enabling legislation must be completed by May of 2010 to ensure adequate time to execute such a large and complex financing.