Special Report 69-2

A REPORT TO THE GOVERNOR
AND THE FIFTH LEGISLATURE
STATE OF HAWAII

AIRPORTS SYSTEM FINANCING THROUGH REVENUE BONDS

Submitted by the
Legislative Auditor of the State of Hawaii

February 1969

CLINTON T. TANIMURA
AUDITOR

THE OFFICE OF THE AUDITOR
STATE OF HAWAII
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February 17, 1969

TO THE GOVERNOR AND THE MEMBERS OF THE FIFTH STATE LEGISLATURE:

We transmit herewith a copy of the report entitled, *Airports System Financing Through Revenue Bonds.* The report is the result of our examination of the constitutional provisions and legislative acts relating to the $30,000,000 issue of Airports System Revenue Bonds, Series of 1968, which the Department of Transportation offered for sale in January, 1969, but subsequently withdrew because the interest rates received were determined to be excessive.

It is our finding that the quality of revenue bonds for the airports system would be strengthened by pledging the aviation fuel tax as security for the bonds, and we have recommended in our report that appropriate legislative action be taken to authorize such a pledge.

In accordance with our practice of requesting agencies affected by our examinations to submit in writing their comments on our findings and recommendations, our report was transmitted to the Department of Transportation on February 6, 1969 (Attachment 1). By letter dated February14, 1969, the department submitted its response, which is included in our report as Attachment 2.

The department indicates that it will seek amending legislation in this session of the legislature to reauthorize the airport revenue bonds, pledging as security the aviation fuel tax. The department also indicates that timing is of the essence in securing permanent financing for the airports system, and that if early action is not taken by the legislature, the department would have no alternative but to proceed with the sale of the bonds as currently authorized.

Yours truly,

Clinton T. Tanimura

Clinton T. Tanimura
Legislative Auditor

cc: Hon. Fujio Matsuda
Hon. Andrew T. F. Ing

AIRPORT SYSTEM FINANCING THROUGH REVENUE BONDS

SUMMARY OF PROBLEM. In January 1969, the State of Hawaii, through the Department of Transportation, attempted to issue $30,000,000 of Airports System Revenue Bonds, Series of 1968, for the purpose of paying the cost of various improvements and additional facilities for Honolulu International Airport and other airports within the Hawaii Airports System. Two bids were received, quoting net interest rates of 6.17% and 6.19% for the bonds. Both bids were rejected because they were determined to be inordinately high. The highest interest rate ever accepted by the State for a revenue bond issue had been 5.2% for $20,000,000 of Harbor Revenue Term Bonds issued on September 1, 1967. Moreover, the financial feasibility study, conducted in support of the proposed new issuance of airport revenue bonds, was made on the assumption that the bonds could be issued at a 5½% interest rate. The high bids were reported to be attributable to uncertain money market conditions which developed at the time of the proposed issuance. While no definite date has been set for a return to the market, DOT indicates that the bonds will very likely be offered again this spring, probably in March, on the assumption that a more favorable market will have developed. This review does not deal with projected market conditions as a factor in securing favorable interest rates. The State has some latitude in determining whether it wants to enter a particular market, but the market conditions themselves are beyond the control or influence of the State. The State, however, does exercise some control over the quality of the bonds, and this review focuses upon bond quality of the proposed issue with a view towards identifying such weaknesses as may be corrected by legislative action.

METHOD OF FINANCING CAPITAL IMPROVEMENTS FOR THE AIRPORTS SYSTEM. Four methods of financing have been used to finance airports capital improvements: revenue bonds, general obligation bonds reimbursable from the Airport Revenue Fund, and to a lesser extent, federal grants and cash from the Airports Division revenue surplus.

In 1959, the Territory of Hawaii, through the Hawaii Aeronautics Commission, issued $14,000,000 in Aviation Revenue Bonds, the proceeds of which were used for the construction of a new terminal and other facilities at Honolulu International Airport. These revenue bonds are payable from and secured by both the revenues of the airports system and the aviation fuel tax. As of December 31, 1968, there were $12,735,000 of the revenue bonds outstanding.

From time to time, proceeds from general obligation bonds have been used for airport facilities and improvements. The Airport Revenue Fund is obligated to reimburse the General Fund for meeting debt service requirements incurred from such general obligation issuance. As of December 31, 1968, there were $6,951,438 in general obligation bonds outstanding for the payment of which reimbursement is required to be made to the General Fund from the Airport Revenue Fund.

LEGISLATIVE AUTHORIZATION FOR REVENUE BONDS: No revenue bonds have been issued for the airports system since the 1959 territorial issue. However, the legislature, in Act 195/1965, Act 38/1966, Act 217/1967 and Act 40/1968, authorized a total of $50,858,700 in revenue bonds for improvements and facilities in the statewide airports system. The $30,000,000 issue offered and withdrawn in January came under these authorizations.

The airport expansion program is expected to be financed by $120 million in revenue bonds authorized by the Certificate of the Director of Transportation, together with other available funds. While only $50,848,700 of this total has been authorized by the legislature, the Official Statement (*$30,000,000 State of Hawaii Revenue Bonds, Series of 1968*) states that it expected that additional projects will be approved and additional bonds authorized as the total program continues. The Department of Transportation proposed to issue the $120 million in revenue bonds over a two-year period, beginning with the initial $30,000,000 issue.

SECURITY FOR THE PROPOSED ISSUE. Unlike general obligation bonds, which are backed by the full faith and credit of the State and constitute a first charge of the general revenues of the State, revenue bonds are normally secured solely from the revenues of the undertaking for which they were issued. The pledge of revenues to secure the bonds may include revenues derived from user taxes or user charges or both, with the specific content of such pledge dependent on the legal requirements and policy of the issuing jurisdiction. It is the desired objective of issuing jurisdictions to offer the strongest pledge of security which it is capable of offering, in order to strengthen the quality of the bonds, minimize the factor of risk to the investor, and thus obtain more favorable interest rates than would be the case with a lesser pledge of security.

Unlike the $14,000,000 in aviation revenue bonds issued in 1959, which were secured by a pledge of the aviation fuel tax as well as revenues of the airport system, the proposed issue is secured solely by revenues of the system, with no taxes of any sort pledged as security. The *Official Statement* for the proposed issue defines revenues as all "income, revenues and money derived by the State of Hawaii from the ownership or operation of the Undertaking . . . provided, however, that the term 'Revenues' shall not include taxes . . . and provided, further, that nothing in this definition shall be construed or interpreted as requiring the use and application directly or indirectly of taxes to the payment of the Bonds." In the context of the specific proposed issue, the exclusion from the pledge of security is applicable to the aviation fuel tax.

To determine why the State has chosen to weaken its pledge of security by withholding the pledge of the aviation fuel tax, it is necessary to go back to the original debt provisions of the 1950 Constitution and trace certain actions which followed:

1. The 1950 Constitution provided that the debt provisions, including the debt limit, would not apply to indebtedness incurred under revenue bond statutes by a public enterprise of the State or political subdivision, or by a public corporation, when the only security for such indebtedness is the revenues of such enterprise or public corporation.

2. After statehood, the debt provisions were reviewed by the Supreme Court, and the $14,000,000 of aviation revenue bonds which had been issued in 1959 came under consideration, together with outstanding highway revenue bonds. In *Employees Retirement System v. Ho,* 352 P. 2d (1960), the Supreme Court held that the State Constitution contemplated only two classes of bonds, the one class being payable solely from the revenues of a government enterprise, which were not included when determining state debt for purposes of the debt limitation provisions, and the other class being all other bonds, which were to be included. Since the bonds of the Hawaii Aeronautic Commission were not payable solely from revenues of the enterprise but were also secured by the aviation fuel tax, the bonds had to be included in determining whether the state debt limitation had been exceeded. (The highway revenue bonds also had to be included since they were not payable solely from revenues but had taxing power behind them.) The effect of the decision was that the only bonds which could be excluded when determining whether the debt limit had been exceeded were bonds payable solely from revenues of the enterprise with no taxes of any sort being pledged to secure such bonds. It should be noted that nothing in the decision

precluded the issuance of revenue bonds secured by both *user taxes and user revenues* or user taxes only. The effect of the decision was only that revenue bonds, so secured, would have to be counted against the debt limit.

3. The 1968 Constitutional Convention considered the 1960 Supreme Court decision as it applied to revenue bonds. Because revenue bonds normally yield higher interest rates than general obligations, it did not wish to encourage the use of revenue bonds. At the same time, it recognized that the issuance of revenue bonds may be appropriate under some circumstances, and that if such bonds were issued, they were to be excluded from the debt limit even if both *user taxes and user revenues* were pledged as security. The intent was to strengthen the quality of revenue bonds, by permitting the strengthening of security without invoking the penalty of the debt limit. The proposal of the convention was adopted in the November 5, 1968 general election.

4. From a constitutional standpoint, the State can now issue aviation revenue bonds secured by a pledge of both revenues and the aviation fuel tax, with such debt being excludable from the debt limit. That it has not done so is due to action recommended by the administration and taken by the legislature in the 1968 legislative session. In 1968, the State was approaching the constitutional debt limit under the old 15% of assessed valuation of property formula. At the same time, it was faced with relatively large capital improvement requirements for the airports system, which it proposed to finance through the issuance of revenue bonds. The administration proposed that such bonds be secured only by revenues and not by the aviation fuel tax. This proposal was followed in Act 40, SLH 1968, which authorized an additional $38,280,000 in revenue bonds for airport improvements. The administration also proposed that prior legislative acts authorizing revenue bonds but not yet issued for the airports system be amended to restrict the pledge of security to revenues and to exclude taxes of any kind. Action so amending revenue bonds authorization made in Act 195, SLH 1965; Act 38, SLH 1966; and Act 217, SLH 1967; was taken by the 1968 legislature through Acts 54 and 75. The intent of the amendments is made clear in the urgency section of Act 75: " . . . On advice of independent bond counsel in New York, the Department [of Transportation] is proposing these amendments to the prior authorizations to insure that the subject revenue bonds will not be counted against the debt limit of the State."

The series of actions and events summarized above present an anomaly: (1) Acts 40, 54 and 75 restricted the pledge of security for aviation revenue bonds so as not to have the bonds counted against the debt limit; (2) the Constitution clearly excludes from the debt limit revenue bonds which are secured by user taxes as well as user revenues; (3) the $30,000,000 aviation revenue bond issue could have been marketed or could now be marketed without diluting the pledge of security if it were not for action proposed and taken in the 1968 legislative action.

Rating of the Revenue Bond Issue: The $30,000,000 proposed issue of aviation revenue bonds was rated and reviewed by Standard and Poor's in the January 4, 1969 issue of its *Bond Outlook*. Standard and Poor's assigned a BBB rating to the proposed issue, a rating equivalent to a medium grade classification. (The State carries an AA rating with Standard and Poor's for its general obligation bonds, a rating equivalent to a high grade classification.)[1] In its report to investors, Standard and Poor's specifically called out the fact while receipts from the aviation fuel tax are applied to purposes of the State's airport system, the proposed revenue bonds are not secured by the tax.

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[1]A general obligation bond rating reflects an evaluation of the issuing jurisdiction while a revenue bond rating reflects an evaluation of the specific enterprise.

The other major rating service, Moody's, did not assign a rating to the proposed issue. Moody's did not cite any specific reason for not rating the issue, the only explanation being in a standard footnote contained in its December 30, 1968 report: "As a matter of policy, we do not rate bonds of this type." Moody's did point out, however, that "an additional $90 million (in aviation revenue bonds) may be issued without regards to the earnings test." Moody's also rendered the following in its opinion section: "Essentially a construction project with a liberal provision for additional bonds even beyond the current authorization. However, aviation is a more essential transportation mode than on the mainland states."

Ratings are not a reflection of bond maturity or marketability except in rare cases where the combination of maturity and marketability itself has a direct bearing on the prospects of payment. Security, or safety (relative certainty of the payment of interest and principal) remains as the principal, almost the sole ingredient of ratings. Bonds are appraised according to two basic risk factors. They are:

(1) The risk that bond quality will be diluted by inordinate increase in debt.

(2) The risk that ability to meet maturing bond principal and interest may be impaired under depressed business conditions.

The investor wants assurance not only that a community is able to pay today, but also that it shall be able to meet obligations in the future. In the case of the proposed $30,000,000 issue, Moody's opinion hinted at the first risk, while Standard and Poor's called out, among other factors, the security aspects of the issue.

THE AVIATION FUEL TAX. The entire receipts of the aviation fuel tax are applied to the purposes of the airports system of the State. Other revenues come from airport use charges, landing fees, aeronautical rentals, concession fees, non-aeronautical rentals and other miscellaneous charges, but the importance of the aviation fuel tax, as the largest source of airports system revenues, may be seen from the following table:

AIRPORT DIVISION REVENUES

	Fiscal Year Ending June 30, 1968
Aviation Fuel Tax	$3,759,196
Concession Fees	2,529,147
Aeronautical Rentals	897,450
Miscellaneous	262,693
Airport Use Charge (Honolulu)	138,997
Landing Fees (neighbor islands)	403,300
Non-Aeronautical Rentals	150,737
Total	$8,141,520

It is reasonable to assume that a pledge of security, which included the receipts of the aviation fuel tax, is a stronger pledge of security than one which excluded it.

CONCLUSIONS

1. In our examination of past and current constitutional provisions and the legislative acts affecting the issuance of the aviation revenue bonds, we can identify no reason for withholding the pledge of security of the aviation fuel tax other than to avoid having the bonds charged to the legal debt limit. Rather than restrict the pledge of security, one alternative available in 1968 would have been to limit the new authorization and/or amend prior authorizations for revenue bonds to yield an amount needed for initial financing requirements but not exceeding the debt limit. In any event, the denial of the aviation fuel tax as security for the bonds in order to escape the debt limit is no longer a valid reason in view of the current constitutional debt provisions.

2. Dilution of the pledge of security represents a dilution of the quality of the bonds. While it is *speculative* to assume that a pledge of the aviation fuel tax would automatically bring about a more favorable credit assessment and a lower interest rate, it is *reasonable* to assume that the State's chances of obtaining a better interest rate are improved if the security pledged included, rather than excluded, the tax which provides over 45% of the revenues of the enterprise.

RECOMMENDATIONS

1. It is recommended that those portions of Acts 38, 54 and 75, SLH 1968, pertaining to the restriction of security for aviation revenue bonds,be amended to permit application of the constitutional provision which allows for a pledge of both user taxes and user revenues as security for revenue bonds.

2. It is recommended that any re-offering of the revenue bonds, or additional offerings under current or new authorizations, be supported by the security of the aviation fuel tax as well as user revenues.

COPY

Attachment No. 1

CLINTON T. TANIMURA
AUDITOR

THE OFFICE OF THE AUDITOR
STATE OF HAWAII
IOLANI PALACE
HONOLULU, HAWAII 96813

February 6, 1969

Dr. Fujio Matsuda, Director
Department of Transportation
State of Hawaii
Honolulu, Hawaii

Dear Dr. Matsuda:

Our office has examined the constitutional provisions and legislative acts pertaining to the issuance of revenue bonds for the airports system in the context of the $30,000,000 issue of Airports System Revenue Bonds, Series of 1968, which was offered and withdrawn in January, 1969. A preliminary report of our examination is enclosed.

It is our practice to request agencies affected by our examinations to submit in writing their comments on our findings and recommendations. We would appreciate receiving your comments by not later than February 12, 1969, as we plan to report to the legislature on this matter on February 13.

Sincerely yours,

Clinton T. Tanimura

Clinton T. Tanimura
Legislative Auditor

Encl.

RECEIVED

FEB 15 1969

OFFICE OF THE AUDITOR
TIME ____________

Attachment No. 2

JOHN A. BURNS
GOVERNOR

FUJIO MATSUDA
DIRECTOR

E. ALVEY WRIGHT
DEPUTY DIRECTOR

JOHN H. McAULIFFE, JR.
DEPUTY DIRECTOR

LAWRENCE F. O. CHUN
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
869 PUNCHBOWL STREET
HONOLULU, HAWAII 96813

IN REPLY REFER TO:

DEP-F 1.7617

February 14, 1969

Mr. Clinton T. Tanimura
Legislative Auditor
State of Hawaii
Iolani Palace
Honolulu, Hawaii 96813

Dear Mr. Tanimura:

Thank you for the opportunity to make comments on your report, "Airports System Financing Through Revenue Bonds".

At the time the 1968 Legislature was in session (May, 1968), the New York law firm, Wood, King, Dawson, Love and Sabatine, who is the bond counsel for the State as well as the Department of Transportation, felt it necessary to clearly state in the statute authorizing the sale of revenue bonds that the bondholder could not look to the aviation fuel tax as security for his investment. This requirement was brought about by the 1960 Hawaii Supreme Court case, Employees Retirement System v. Ho, in which the Supreme Court held that the pledging of aviation fuel taxes as the sole security for a so-called revenue bond mandated that the entire amount of aviation revenue bonds outstanding be counted against the State debt limit. Since the State was near its constitutional debt limit, it was the intention of the Department as well, we believe, as that of the Legislature that all airport capital improvements be funded by the use of "true" revenue bonds which would not be counted against the State debt limit as defined by the Ho case. Furthermore, to have included the fuel tax as a pledge would have limited the issue to, say $10 million, and would have locked us in at this point as the State would have been at or near its debt limit. This was unacceptable to us as our airports' program required vast sums of money over a relatively short period of time. Furthermore, we questioned the wisdom of using the balance of the State's debt limit for a self-sustaining operation such as the statewide system of airports. Finally, at the time the 1968 Legislature convened, there was no assurance that a constitutional change would be made and consequently the enabling legislation was drafted and enacted into law within the constitutional parameters then existing.

The Constitutional Convention in November, 1968, clearly excluded from the debt limit revenue bonds secured by user taxes (such as aviation fuel taxes) as well as user revenues. The Department of Transportation recognized and supported this change in the Constitution. The proposed thirty million dollar aviation revenue bond issue could not now be marketed pledging as security user taxes without first obtaining legislative authority which would invoke a reauthorization of the method of financing.

The Department of Transportation will introduce a bill in this session of the Legislature to reauthorize the fifty-four million dollar airport revenue bond authorization, pledging as security the aviation fuel taxes. Included in the bill will be a provision that will give the State maximum flexibility in the way the reauthorized program will be financed. In addition to pledging aviation fuel taxes for revenue bonds sold for capital improvements projects at Honolulu International Airport, use will be made of reimbursable general obligation bonds for the neighbor island capital improvements program. Finally, in order to make proper use of the cash generated by the 0.35 coverage from the revenue bonds sold for Honolulu International Airport projects, the bill will provide the Governor with the authority to substitute cash financing for either revenue bonds or reimbursable general obligation bonds.

It must be pointed out that merely reauthorizing the program as set forth above will not guarantee any lower interest rates, at least for revenue bonds. Still outstanding would be the fourteen million dollar Series A revenue bond issue which would cause any subsequent revenue bond issue to assume a junior lien status unless issued on the same terms and conditions as the Series A bonds. There is some question as to the merits of a second issue on the same terms and conditions as the Series "A" bonds. In the first place, the terms are not particularly favorable to the State. Secondly, such an issue would still be called "revenue bond" and to that extent such a designation would increase interest costs and any benefits of such a course of action would be proportionally reduced.

With respect to the reauthorization bill which will be introduced in the Legislature this session, it must be emphasized that time is of the essence. Special and general funds have recently been advanced from the Airport Fund and the General Fund, totaling to date \$11.3 million. We expect to borrow and encumber an additional \$17.4 million by March 31, 1969. Since we have had to borrow these large sums of money internally to keep the program moving, you can see that time is of the essence as far as permanent financing is concerned. If early action is not taken by the Legislature, the Department will have no alternative but to proceed with the sale of the \$30 million issue as presently authorized unless the Director of Finance is prepared to advance the Department of Transportation additional funds.

If there are any further questions regarding this somewhat complex problem, we would welcome the opportunity to discuss the matter with you.

Sincerely,

Fujio Matsuda

FUJIO MATSUDA
Director