STATE OF ARIZONA
Joint Legislative Budget Committee

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THEODORE A. FERRIS
STAFF DIRECTOR

MEMORANDUM

DATE: *February 2, 1988*

TO: *Senator John Mawhinney*
Representative Sterling Ridge

FROM: *Theodore A. Ferris, Staff Director*

SUBJECT: *LEASE PURCHASE FINANCING*

Recent media reports on lease-purchase financing have quoted Joe Smith, Executive Budget Office Director, as saying that with lease-purchase financing, ASU West will be completed only two years sooner at an additional cost of $57 million. Mr. Smith referenced a study done by his office last year. I thought as the prime sponsors of legislation mandating lease-purchase financing for certain state facilities, you might be interested in this "study." Therefore, I have obtained this two-page EBO memorandum and enclosed it herein.

I am also enclosing an overview of lease-purchase financing we prepared recently at the request of the House Appropriations Committee.

With respect to the EBO analysis and conclusions, I offer the following observations:

1) *Most importantly, EBO failed to perform the most rudimentary of long-term financing calculations -- they failed to discount future cash flows to arrive at a "net present value." In simplest terms, they assumed a dollar in 1998 or 2008 would be worth the same as a dollar today; in other words, for their analysis to be correct, there would have to be zero inflation. Of course, if future inflation were zero, interest rates would fall dramatically, the lease-purchase certificates would be refinanced, and the interest cost would be substantially reduced.*

   A proper discount factor would be around 6% -- this alone would eliminate most of the $57 million difference.

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2) I estimate that the core facilities at ASU West would be completed at least 30 months earlier with lease purchase financing. This is a significant difference, but of course, would be even greater, if \$10-13 million of financing is not provided each year under the "pay-as-you-go" approach.

3) EBO used construction cost inflation of only 4% per year for the period of delay versus a 20-year historical average for Phoenix of 6.3% per annum. This is a critical difference: Under 4% inflation, a project's cost would double in 17.5 years; However, with a 6.3% construction cost escalator, a project's cost would double in just 11 years. It is my belief, however, that construction costs will inflate more rapidly than even 6.3% in the near future, due to the current recession in the construction industry. Once construction begins its rebound, costs will rise disproportionately to the underlying general rate of inflation.

I believe that the EBO analysis was incomplete and economically unsound and, therefore, their conclusions were in error.

Please contact me if you would like further information in this regard.

TF:ab
Enclosures

xc: Senator Jack J. Taylor
Representative John Wettaw
Legislative-Leadership
Jane McVey Vandenbosch
Bob Lockwood
Kim Baker
Lynn Dunton