THE USE OF

LEASE-PURCHASE FINANCING

~~FOR THE CONSTRUCTION OF STATE BUILDINGS~~

~~BACKGROUND:~~

According to a recent study prepared by the National Conference of State Legislatures, entitled "Capital Budgeting and Finance – The Legislative Role";

> "State Legislatures face an important challenge over the next 10 to 15 years as the need to replace aging state and local capital stock becomes increasingly critical. In 1985, states spent more than $30 billion in revenue from all sources on state capital outlays .... States are directly responsible for financing highways, educational institutions, natural resource projects, state hospitals, correctional facilities, parks and recreation projects, and general public buildings .... Over the past decade, legislatures have strengthened their role greatly in reviewing, setting, and monitoring state agency operating budgets. The challenge for legislatures ... is to develop the same capacity for managing, setting, implementing, and overseeing capital budgets."

In Arizona, the Legislature took a major step toward strengthening the capital budgeting process with the enactment of Chapter 85, Laws of 1986. This act (1) creates a 10-member Joint Committee on Capital Review, (2) requires 5-year Capital Improvement Plans for each state agency, and (3) establishes a "Building Renewal Formula" approach to determining the necessary annual appropriation to properly maintain the state's near $2 billion worth of buildings.

Arizona's are a ~~*problems, however, are different than many other states. Although we, too, face maintenance, repair and rehabilitation needs, we are*~~ *a younger state,* ~~*and our most*~~ has developed a *pressing need* ~~*is*~~ *to finance the facilities necessary to meet the state's burgeoning population.* Examples of critical needs are roads and highways, new prisons, university classrooms and other university facilities, and general state office buildings.

Transportation revenue bonds ~~are~~ are used to finance construction of new roads, highways, bridges and other transportation facilities. The State Constitution restricts the use of certain vehicle, user, and gasoline and diesel tax receipts for transportation purposes, including bonding ~~(see Art. IX, Sec. 14)~~. A Corrections Fund was created in 1984 to help finance new prisons. It is funded from taxes on liquor and cigarettes, but at $22 million per year, is inadequate to keep pace with our soaring prison population. University buildings are increasingly financed through revenue bonds, which are repaid through earmarked tuition and fees.

General state office space and other state building requirements have traditionally been financed on a "pay-as-you-go" basis. This has been a tradition rooted in a conservative approach to capital budgeting and, certainly, has been necessitated by our State Constitutions limit on general obligation debt of $350,000, ~~(see Art. IX, Sec. 5)~~.

However, *in recent years, the capital budget has been squeezed by sluggish revenue growth and operating budget pressures.* Revenue growth has not kept pace with inflation and population, while expenditures for A.H.C.C.C.S. and Corrections will quadruple between FY 1983 and FY 1989.

Against this backdrop, the Arizona Legislature moved to adopt lease-purchase financing as an alternative method to finance the construction of state buildings. The state has long used lease-purchase financing as an installment-sales method of financing major equipment purchases, and the Department of Economic Security has successfully used lease-purchase financing to construct DES offices for nearly two decades now, according to separate statutory authority and in conjunction with the federal government.

A.R.S. 41-790.02 gives the Department of Administration the authority to enter into lease-purchase agreements to finance the acquisition or construction of state buildings, subject to the following conditions:

1. *The obligation of this state to make any payment under the agreement is a current expense of the department, payable exclusively from appropriated monies, and is not a general obligation indebtedness of this state or the department.*

2. *If the Legislature fails to appropriate monies or the department fails to allocate such monies for any periodic payment or renewal term of the agreement, the agreement terminates at the end of the current term and this state and the department are relieved of any subsequent obligation under the agreement.*

3. *The agreement shall be reviewed and approved by the Attorney General before the agreement may take effect.*

4. *The agreement shall be reviewed and approved by the Joint Committee on Capital Review before the agreement takes effect.*

As stated above and clearly in each agreement, all lease-purchase payments are a current operating expense of the affected agency, are subject to annual appropriation and, thus, are not a general obligation indebtedness of the state. Nevertheless, the state does accrue an equity interest, which after 20 years (or whatever amortization period is established) enables the state to acquire title for the property. Given this equity interest, it is not likely that the Legislature would terminate a lease-purchase agreement, although the option to do so, is appropriate and desirable from a legislative, budgetary standpoint.

The State of Arizona, Department of Administration has issued tax-exempt "Certificates of Participation" on two occasions, to finance several capital projects. The most notable are (1) the construction of the new 11-story Department of Revenue Building at 17th Avenue and Van Buren Street, and (2) the acquisition of the 5-story Capital Centre Building on 15th Avenue between Washington and Jefferson Streets.

PROBLEM STATEMENT:

The ~~current~~ Mecham administration, elected in 1986 took ~~has taken~~ a position against lease-purchase financing for new construction. Consequently, and given the state's continuing struggle with its operating budget, *the state's construction program for general office space and certain other state facilities ~~is~~ could not keeping pace with our needs.* The two, most immediate problem areas ~~are~~ were general state office buildings and the ASU-West Campus. Prior to the lease-purchase approval,

~~First,~~ The State of Arizona ~~does~~ did not have enough office space to accommodate the requirements of office-using state employees. According to figures recently released by the Department of Administration, *the state leases approximately 1.6 million square feet of commercial office space* throughout Arizona. This translates into *an annual cost of $15.8 million.* As the number of office- using state employees grows, the shortage of office space will become more acute.

The construction of the DOR building and the Capital Centre was financed by lease-purchase certificates of participation. The total financing requirement of those buildings will be $32.9 million and $33.7 million, respectively. However, because the payments are made over a twenty year period, the real, effective cost is significantly less. If the stream of lease-purchase payments is discounted (at a 5 percent rate) the estimated cost of those buildings is $20.3 million and $20.9 million, respectively in today's dollars. The cost of lease-purchase financing is, therefore, only slightly higher than appropriating the entire amount at the time of construction. In the latter case, the state would have had to pay $19.6 million and $20.8 million, respectively.

Moreover, if the Department of Revenue had continued to lease the same amount of commercial office space (61,000 square feet), their cumulative rental payments would have totaled $32.6 million by 2008. On the other hand, the total accumulated cost of their new facility (160,000 square feet) is only $32.9 million; and by 2008, the state will own the facility.

In 1987, the Department of Administration projected that state agencies, who could potentially move to the Capitol Mall, were leasing approximately 528,000 square feet of commercial office space at an annual cost of $6.0 million. Undoubtedly, these figures are higher in 1988. If no new buildings are constructed, the accumulated rental payments of these agencies will reach $178.6 million by 2008. If lease-purchase financing was used to build new facilities for the DOA identified agencies at the Capitol Mall, it would cost the state about $108 million over a twenty year period. The state would, therefore, save about $70 million in rental payments over twenty years, at which point, we would own the buildings. These savings would be reduced by whatever amounts are spent on building maintenance, repair and utilities.

[redacted] The *construction of the ASU-West Campus had been hampered by a "Catch-22" situation.* As indicated, most recent university construction has been financed via revenue bonds supported by student tuition/fees. This revenue source, however, was ~~is~~ limited at ASU-West due to relatively low enrollments and student class-loads (part-time students). Until the core campus facilities are completed and enrollments and credit-hours rise, this revenue flow will be insufficient to support revenue bonds. Thus far, the Legislature has appropriated $28.5 million in 4 years for ASU-West construction. At this pace, the core facilities would ~~will~~ not be completed until FY 1995.

[redacted]:

H.B. 2037 proposed that the Department of Administration use lease-purchase financing to *commence construction* of the following:

By June 1, 1988 (already designed)

- Supreme Court Building
- 16th Avenue Parking Structure
- Az. Historical Society Museum at Papago Park

By February 1, 1989 (preliminary plans are already complete)

- Tucson Office Building
- Legislative Archives and Office Building
- D.E.S. - West Office Building
- A.S.D.B. (Tucson) - Food Service Facility

~~The quick expansion of state offices in Phoenix and Tucson will allow us to turn the corner and begin to decrease the annual outflow of rent to the private sector.~~

Also, the bill [redacted] authorized the Board of Regents to proceed with further construction at the Arizona State University - West Campus by utilizing lease- purchase. ~~It is anticipated that the Board of Regents will issue $48 million worth of certificates of participation to complete Phase I of the ASU-West Construction Program. The use of lease-purchase financing will allow these core campus facilities to be completed at least 20 months or as much as 4 1/2 years earlier than on a pay-as-you-go basis (assuming "pay-as-you-go" appropriations range from $7 to $13 million per year).~~ This, in turn, is expected ~~will~~ boost enrollments and student credit-hours, which provided cash-flow for the lease-purchase payments. All ASU-West tuition/fees in excess of $1,000,000 will be earmarked for the lease-purchase payments with the General Fund making up any difference in the ASU-West operating budget. In this sense, lease-purchase financing acts as a "bridge" between the present and a time at which tuition/fees are sufficient to support revenue bonds.

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