SCOTT MEACHAM
OKLAHOMA STATE TREASURER

January 13, 2009

The Honorable Brad Henry
Governor of the State of Oklahoma
State Capitol Building, Room 212
2300 N. Lincoln Blvd.
Oklahoma City, OK 73105

Dear Governor Henry,

On October 9, 2008, you tasked me with conducting a study of the impacts of the national and international financial crisis on Oklahoma state government. You asked me to outline any steps the state could take to lessen the potential impacts and better insulate Oklahoma from future financial shocks occurring outside our state. I sent letters to various individuals and firms representing the state's pensions and endowments, the financial services sector and business leaders from across Oklahoma to seek their input. I also conducted numerous face-to-face discussions with different individuals.

I am now prepared to report back to you. By its very nature and considering the time limitations involved, this inquiry had to be limited in scope and summary in nature. It would be impractical if not impossible to consider every potential impact of the financial crisis in a two- to three-month period at the outset of the crisis. Therefore, I have limited the scope to a handful of areas where legislative or executive action can have an impact. Also, I avoided broader issues that would certainly help Oklahoma in the future such as increasing education funding, teacher pay, increasing personal incomes, improving the health of Oklahomans and other self evident actions the state could and should undertake. The areas I will address are the state economy and state revenues, state pensions and endowments, and state and local government bond issues.

The State Economy and State Revenues

In spite of the financial crisis that is gripping the national economy and devastating the budgets of many states, Oklahoma's economy has remained relatively unscathed to this point. While national unemployment stands at 6.7 percent, Oklahoma's unemployment is a very respectable 4.5 percent and has only risen slightly from the 4.2 percent where it stood at the beginning of 2008. As other states are experiencing severe revenue shortfalls, Oklahoma's revenues are up almost $225 million for the fiscal year over the prior fiscal year and are up almost $190 million over projected levels.

Oklahoma's current fiscal year budget surplus can be attributed primarily to gross production tax collections with sales tax and corporate income tax collections also making a positive contribution. With strong oil prices and solid natural gas prices during the first several months of the fiscal year, gross production collections led all other revenue sources at $194 million or 58.8 percent ahead of prior year collections. Sales tax collections have also been remarkably strong, running $49 million or 6 percent ahead of the prior year. Finally, corporate income tax collections have recovered from the 2008 fiscal year helping total income tax collections come in $51.9 million or 4.4 percent ahead of the estimate.

The only negative areas of current fiscal year collections have been motor vehicle taxes and, to a lesser extent, personal income tax collections. Motor vehicle tax collections are down $31.4 million or 25 percent. While running ahead of the prior year thus far this fiscal year, personal income tax collections are becoming somewhat of a concern. If not for the Clean Slate '08 tax amnesty program recently conducted by the Oklahoma Tax Commission, personal income tax collections would be below the prior year. As it now stands, personal income tax collections are up only $7.7 million or 0.7 percent from the previous year. However, the amnesty program has increased personal income tax collections by $38.2 million. Also of concern was a $3.6 million drop from the prior year's level in withholding collections last month following a $2.4 million decrease in the prior month.

Although the current fiscal year budget surplus is very good, when the cause of the surplus is examined in connection with the current economic environment, there is some cause for concern with respect to future state revenue collections. As mentioned previously, strong oil and gas prices were the most significant factor in strong revenue collections this fiscal year. However, prices have dropped dramatically from the historic levels they reached at the beginning of the fiscal year and are projected to stay low for the rest of the current fiscal year as well into the 2010 fiscal year. Oil began the fiscal year at $145 a barrel. By Christmas, prices had fallen to $37.82 per barrel. Similarly, natural gas prices have fallen from $10.62 per mcf to $5.87 per mcf. Making matters even worse for natural gas collections is that state wells have been experiencing historically high basis adjustments from the index prices as Oklahoma gas is forced to compete for scarce space in interstate pipelines. These negative price adjustments have been running $1 or more per mcf.

When the impact of the energy sector on the overall economy and on Oklahoma's overall revenue collections is considered, there should be an expectation of leaner times ahead for the state. Energy affects all state revenue categories. Jobs and economic activity produced by the sector feed personal income tax collections, corporate income tax collections, sales tax collections and motor vehicle collections in addition to the direct gross production taxes collected on the sale of oil and gas at the wellhead. Recent structural changes in Oklahoma's overall tax system have magnified this impact. The state's top personal income tax rate has been reduced from 7 percent in 2003 to 5.5 percent for 2009 and the standard deduction has been increased dramatically over the same time period. While tax cuts certainly will have a long-term stimulus effect on Oklahoma's economy, another effect of these historic reductions in personal income taxes has been to increase reliance on gross production taxes and other taxes to fund state government.

Based upon the somewhat grim outlook for energy prices and the continued national recession, the Tax Commission has projected sharply lower tax collections for next fiscal year. The State Board of Equalization met in late December and certified revenues available for appropriation by the legislature next session. The result was a $309.6 million or 4.4 percent reduction in funds available for appropriation and a projected $296 million or 5 percent reduction in general revenue fund collections. As you are aware, these numbers are only preliminary and the Board of Equalization will meet again in February to set the final numbers.

<u>Proposed Responses</u> Of course, little can be done in the short run to affect the state's economy and state revenue collections. However, there are some steps that can be undertaken to help over a longer time horizon. I would suggest that you:

1. Seek to increase the demand for Oklahoma natural gas. Oklahoma has abundant natural gas reserves. In general, the more stable the price for Oklahoma natural gas, the more stimulus to the state's economy and the greater the state's revenue collections. Natural gas is a clean burning, highly efficient energy source. The state should do more to encourage increased demand for Oklahoma natural gas.

2. Seek to diminish the negative basis adjustments Oklahoma natural gas is currently experiencing in the market place. Based upon industry input, I understand this phenomenon is being caused by other states' gas "crowding out" Oklahoma gas in the pipelines. Oklahoma producers then have to agree to accept lower prices to market their gas. It seems patently unfair that gas from different states should command different prices (other than transportation charges) based solely on where the state is located. Any solution would require Congressional action which would necessarily require enlisting the aid of Oklahoma's congressional delegation in this effort.

3. Seek to fully fund the EDGE Research Endowment. Oklahoma has traditionally been a boom-to-bust state whose fortunes have risen and fallen with the price of oil and gas. Although some efforts have been successfully undertaken to diversify Oklahoma's economy over the past several years, particularly in the areas of aerospace and biotechnology, much remains to be done. The EDGE Research Endowment was the number one recommendation of your EDGE task force as the best way to lay the foundation for the economy of Oklahoma's future. The endowment was funded with an initial down payment of $150 million toward the ultimate goal of $1 billion. The endowment's purpose is to fund transformational, job producing applied research and commercialization of technology efforts in areas where Oklahoma has natural competitive advantages such as energy, agriculture, aeronautics, biotechnology, sensor technology and weather. The initial round of EDGE grants was recently made but they were necessarily limited because of the lack of funding. Only by making the sacrifice today to invest in Oklahoma's future, will Oklahoma reap the benefits in the future from a diversified, growing economy.

State Pensions and Endowments

As large equity investors, the state's pensions and endowments have experienced significant declines in the value of their funds as domestic and international stock markets began their free fall in September through November. The funds and the amount of their unrealized losses year-to-date are as follows:

	1/1/08 Balance	11/30/08 Balance	Decrease in Value	%
Teachers Retirement System	9,498,944,000	6,728,546,000	2,770,398,000	-29.17%
Public Employees Retirement System	6,722,875,000	4,809,796,000	1,913,079,000	-28.46%
Firefighters Pension	1,856,852,000	1,397,464,000	459,388,000	-24.74%
Police Pension	1,821,989,000	1,376,488,670	445,500,330	-24.45%

Similar "paper losses" were experienced by state endowments such as the School Land Trust and other state investment portfolios such as Compsource. The School Land trust reported a decrease in fund balance of 19 percent from August 31 to October 31, alone, while Compsource reported its portfolio was down 8.6 percent or $91 million for the year as of November 14th.

Clearly, when state pensions and endowments report unrealized losses of over $5 billion dollars, it takes one's breath away and leads to an immediate impulse that something must be done. However, the "something" that must be done in the current environment is not to panic. It is significant to point out that any unrealized losses that the state pensions and endowments have experienced to date are just that—unrealized. The only way they would become actual losses is if the pension and endowments were to sell their investments now. Current and foreseeable long term benefits to beneficiaries of the pensions and endowments are not at risk. The most likely impact of the current downturn will be to diminish the long-term status of the unfunded liabilities of the systems.

As the equity and bond markets recover from the current historic shock, state policymakers will be in a much better position to evaluate long-term funding needs of the systems. Initial actuarial reports of required state contributions over the next few years will likely show a significant increase in required state contributions as current low portfolio valuations impact future projected funding needs. Only after the portfolio values recover and these abnormally low valuations fall out of the analysis will a true picture of the long-term funding needs of the systems emerge. Given the significant commitments made by the legislature and the governor to increase funding for the teachers' system and the public employees' system over the next several years, it would probably be most prudent to wait for the "dust to settle" on the current crisis before evaluating any additional funding needs.

The issue for the police, fire and law enforcement retirement systems is a little different. The state has not made commitments to increase funding to these systems. A one-time transfer of premium taxes flowing into these systems was made to help the state deal with the budget crisis of 2003. In return, state leaders agreed to increase the percentage of insurance premium taxes flowing into the funds until the funds transferred were replenished. The problem is that additional tax credits have been extended against the premium tax and existing credits have been utilized more over the past few years that have caused the pool of available premium tax to shrink significantly. The net result has been a decrease in the funded liabilities of these systems. The current drop in portfolio values will only compound this problem for these systems.

Proposed Responses The unfunded liability situation for Oklahoma's state pensions merits close watching over the next few years to see where the liability stabilizes once the financial markets recover. I would suggest that you:

1. Allow the state pension and endowments to maintain their current long-term strategies during the current market down cycle. There will undoubtedly be those who call upon the systems to change their equity allocations or do other things to attempt to quickly make up their equity losses. If left alone, these paper losses should go away as the markets recover. The worst thing the systems could do now is liquidate large positions and realize huge permanent losses or engage in big, highly speculative bids to quickly regain lost equity value.

2. Both the School Land Trust and Compsource are statutorily prohibited from investing in international securities. This restriction applies to no other state endowment fund or the pension system. The effect of this restriction is actually to reduce diversification and increase rick by making the entire portfolio dependent on the performance of the US economy. This prohibition should be removed and the School Land Trust and Compsource should be subject to the same prudent investor standard as are the other state endowments and pensions.

3. Seek legislation changing the funding of the firefighter's, police and law enforcement pensions so their funding from a specified percentage of premium tax comes from the gross premium tax payable before any credits are applied.

State and Local Bonds

Another issue that came to light during the onset of the financial crisis dealt with the marketing of state and local government bonds. Significant impacts were felt with both existing variable rate issues and all new issues. The result was lack of ability to market state and local governmental bond issues and significantly higher borrowing costs at a time when market rates were actually declining significantly.

During the early stages of the financial crisis, most of the large insurers of state and local debt either went out of business or their credit quality was downgraded so much that they were no longer viable as insurers. This caused the market for variable rate state and local bonds, known as auction reset bonds, and other similar variable rate bonds to start failing as early as February of last year. Large mutual funds quit buying the bonds because of the insurance issues and, by that time, the large brokerage firms and banks were starting to experience severe liquidity problems which prevented them from providing needed liquidity to the market. Rates went up;

and in some cases, there were failures to market the bonds at any rate which caused the bonds to be purchased under agreement by liquidity providers or trustees.

Rates on state-issued variable rate debt literally skyrocketed overnight. Rates on issues by strong credit quality entities such as the Oklahoma Capital Improvement Authority, the Oklahoma Turnpike Commission and the Oklahoma Municipal Power Authority went from in the 2 percent range to 8 and 9 percent. In an unprecedented move for the Treasurer's Office, we stepped in and started placing bids on these issues that were much lower than the rates being "set" by the auction rate market maker. We set our rates at a rate equivalent to what we were receiving on new longer-term investments so there was no loss of earnings in our portfolio.

The state found itself in a classic win-win. The state issuer received a much lower rate by as much as 4 to 5 percent. The Treasurer's Office found a very safe place to invest short-term money at a time when alternative short-term investments were paying very low rates. With each of these issuers, we purchased their variable rate issues until such time as they could refinance, drop their insurer or take other action to return the rates on their issues to a more favorable rate.

The Treasurer's Office purchased these state issues under statutory authority which allows the purchase of state and local obligations that are investment grade or above. The same statutes for some reason provide a different standard for obligations of Oklahoma state public trusts. These obligations can only be purchased if they receive the highest rating from one of the credit rating agencies. Because of the problems that were occurring with the insurers, the obligations of these entities were being downgraded without regard to the underlying credit worthiness of the issue itself or the issuer. Therefore, even though the Treasurer's Office had excess liquidity, we were statutorily prohibited from helping these entities.

The other problem the financial crisis caused for state and local governments was the inability to market new bonds. As the financial crisis deepened in September and October, the entire municipal market ground to a halt as a majority of the liquidity left the market. Many issues across the state and nation had to be delayed because of a lack of buyers. According to one underwriter, there have been only 4 long-term fixed rate transactions over $100 million across the entire nation since September 15.

When there are insufficient buyers in the municipal market, one of two things happen when a new issue is brought to market. It can either fail and some or all of the bonds can not be sold or, more likely, the bonds are sold but at a much higher rate than was anticipated. This, in turn, causes a multitude of problems for the governmental issuer. Since bonds are typically issued by a governmental entity to finance a construction project, a failure to sell the bonds means the governmental entity will not have the funds to proceed on schedule which often will cause the ultimate cost of the project to be more than anticipated. Also, if the bonds are sold at a higher rate than was planned, this can cause significant budgetary problems for the governmental issuer who had budgeted borrowing costs for the project at a much lower level.

Proposed Responses The action any state can take to address unprecedented market conditions like our nation has experienced during the past year are, of course, limited; but there are some things that can be done to help. I would suggest that you:

1. Seek to change statutes for permissible investments by the treasurer to allow investment in issues of Oklahoma state public trusts on the same basis as state and local issues. The effect of this change would be to allow the investment in any Oklahoma municipal debt by the treasurer as long as the credit quality was investment grade and the treasurer deemed the investment prudent and in the best interest of the State.

2. Establish a State of Oklahoma Bond Guarantee Program to serve as a guarantor of state and local government issued obligations. The program, similar to the Texas Permanent School Fund, would issue guarantees on state and local bond issues in return for a fee. This would provide state and local issuers a more stable source of credit enhancement than currently exists with bond insurance firms.

3. Allow the State of Oklahoma and local governments the option to sell obligations on a negotiated basis. Current law requires the sale of governmental obligations in Oklahoma be on a competitive basis. As indicated earlier, this situation subjects the issuer to risk of a failed marketing or higher than expected rates. Many states are starting to allow negotiated sales to lessen the risk of adverse market conditions on the date their issue is taken to market.

4. Seek an increase in the constitutional 10 percent cap on school district indebtedness. The Oklahoma Constitution caps school district indebtedness at 10 percent of net asset valuation. This excessively low limit forces school districts to pursue much more costly and risky lease revenue financings to avoid this arbitrary cap. It also causes school districts to under invest in facilities to the detriment of Oklahoma's school children.

5. Seek Congressional delegation support to eliminate the "bank qualified" limitation on banks purchasing municipal issues and the adverse alternative minimum tax treatment that individual purchasers of municipal issues receive. As discussed previously, the current problem with the municipal market in Oklahoma and across the nation is a lack of buyers. Two different federal tax law provisions actually discourage two large potential groups from purchasing municipal bonds. Banks, a significant potential buyer of municipal issues, are limited to buying only "bank qualified" issues. Without being overly technical, theses are very, very small issues. The vast majority of municipal issues are not bank qualified. The other group that is discouraged by federal tax law from investing in municipal issues is individual investors. Interest paid on municipal bonds is included in alternative minimum taxable income that causes many investors to avoid investing in municipal bonds.

Conclusion

The financial crisis that is currently gripping our nation is unprecedented and the worst economic threat our country has faced since the Great Depression. Although the economic climate is very dire across most of the nation, the story in Oklahoma is much better. Thanks to our commodities-based economy, strong banking and real estate sectors and some emerging diversification, Oklahoma has weathered the storm very impressively to date. With significantly lower energy and agricultural prices, however, it appears Oklahoma will feel the effects of the later part of the recession. With nearly $600 million in our rainy day fund and good fiscal safeguards in place, we are better postured than we have ever been to manage the remainder of the downturn, however long it may last.

Thank you for the opportunity to conduct this review on your behalf. I look forward to working with you to implement any of the recommendations you feel should be acted upon.

Sincerely,

Scott Meacham
Oklahoma State Treasurer
Cabinet Secretary for Finance and Revenue

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