

New Debt Management Approach

In order to improve the management of the System's Article XI-F(1) debt, we plan to begin managing this debt on a portfolio basis, rather than on a transactional or project-specific basis. The System will take on an appropriate amount of variable rate debt to lower its overall cost of capital. In addition, we plan to begin utilizing a commercial paper program to provide interim financing for capital construction projects. The benefits of these changes are:

- *Minimizing the cost of capital*
- *Managing volatility in interest rates*
- *Providing greater flexibility and clearer planning horizons*
- *Maximizing allowable arbitrage earnings*
- *Simplifying the administration of the debt portfolio*

Conceptual Framework:

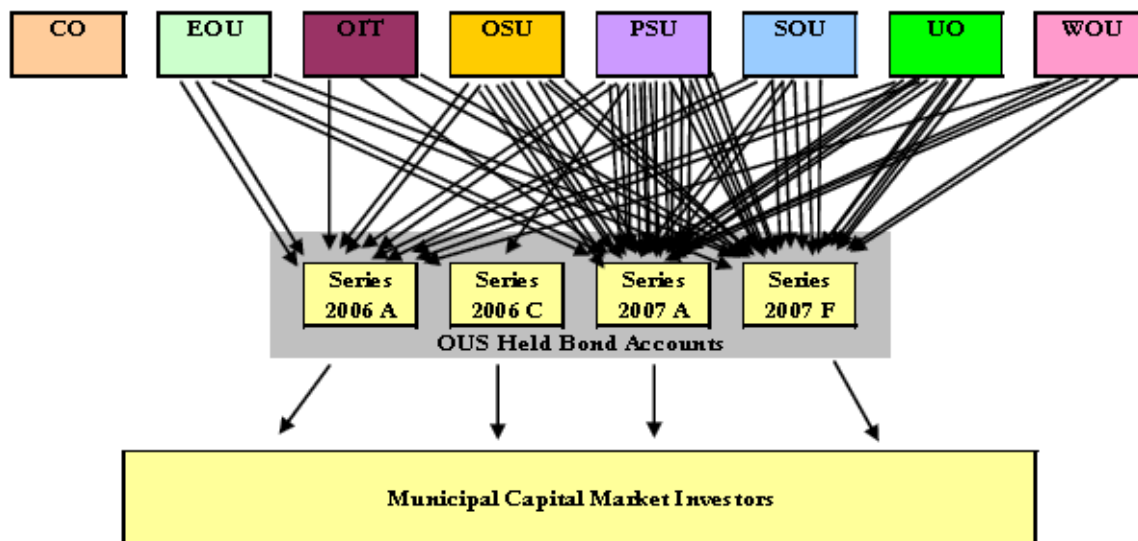
Currently, the System finances capital construction of its self-supporting and self-liquidating facilities exclusively with long-term fixed rate debt. Typically, the System issues long-term debt once or sometimes twice per year. This is done to spread the cost of such issuance over a larger pool of debt. Debt is issued in anticipation of campus needs and the proceeds, along with the obligation to make the debt service payments related to a particular debt issuance, are allocated to particular projects at a particular campus. The System simply acts as a conduit for the campuses to the capital markets. In addition, up until this point in the history of the System, no interim financing vehicles were available to fund construction costs in advance of long-term debt issuance or during construction, and the System did not have authority to issue variable rate debt or interest rate swaps. The current structure has the following disadvantages:

- Each campus takes market interest rate risk with each project financing, being captive to the interest rate at the time of debt issuance (with possible future reduction if the interest rate market allows for a refunding of the original debt)
- Issuance of long-term debt before a project has been started and/or in amounts that are not needed immediately to fund construction costs exposes the System to unnecessary interest costs and higher project costs
- Direct linkage of the debt service payments on a particular allocation of bond proceeds to the campus:
 - eliminates the ability to take advantage of the lower costs of variable rate debt as the volatility risk of variable rate debt would not be spread over a sufficient base
 - creates a significant accounting and processing burden to manage these distinct allocations (see diagram below)

- Not having an interim financing vehicle available has created unnecessary project timing constraints due to the timing of long-term debt issuance

Below is an illustration of the current debt repayment related to the 70 discrete allocations of bond proceeds to the corresponding universities for the four most recent issuances of F-Bonds.

Current Operating System of Recent Series F-Bonds:



With the passage of House Bill (HB) 2199 during the 2007 legislative session, OUS now has the ability to issue variable rate debt, thus permitting a blended portfolio approach with variable and fixed rate debt. Also permitted under HB 2199 is the ability for OUS to enter into short-term financing vehicles and interest rate swap agreements. With these new authorities, the System plans to implement a commercial paper (CP) program to provide interim financing for construction projects and to begin pooling and managing its Article XI(F)1 debt as a portfolio. Under this approach, utilizing low cost CP, campuses would be able to begin their capital projects on a time schedule that is uninhibited by the timing of long-term debt issuances. The System would time and structure the underlying long-term debt issuance to provide for the lowest cost of capital, utilizing a mix of fixed and floating rate debt. The System would provide the funds to repay the CP and/or fund the remainder of the construction costs to the campus via a loan from the System to the campus at a cost of capital that is established based on the interest costs of the entire portfolio of debt—a blended cost of capital. This will effectively de-link the debt payments by the campuses to the System from the debt service payments from the System to the bond-holders. As this approach is implemented, the System will act less like a pass-through vehicle for the universities to the capital markets. Instead, the System will act more like an active financing vehicle strategically managing the debt portfolio via continuous management of the entire debt portfolio and setting an equitable blended rate to all universities.

This new approach to the management of long-term Article XI-F(1) debt will have the following advantages:

Minimizing the Cost of Capital

The System will minimize its cost of capital by utilizing a commercial paper program for interim financing to lower interest costs during construction and minimize the portion of taxable debt and maintaining a portion of the System's outstanding debt on a floating rate basis.

The System will manage its debt portfolio to minimize its taxable component. Unlike tax-exempt debt, taxable debt will not be considered a perpetual component of the System's liabilities. Taxable debt will be utilized to fund projects ineligible for tax-exempt financing or for those projects for which the System wants to preserve maximum operating flexibility.

Due to the financing flexibility and typically low interest cost associated with variable rate debt, it is desirable to maintain a portion of the System's aggregate debt on a floating rate basis. However, variable rate debt also introduces volatility to the System's debt service obligations. Therefore, the System will balance the mix of variable and fixed rate debt according to a target guideline that will be established based on the System's ability to hedge such exposure either through interest earned on its operating cash balances, through reserves maintained for that purpose, or some combination thereof. The actual percentage of variable rate debt outstanding will fluctuate from time-to-time due in part to financing needs, utilization of the CP program, and prevailing market interest rates.

The use of interest rate swaps will be employed primarily to manage the System's variable rate exposure. The System will utilize a framework to evaluate potential interest rate swaps through the evaluation of its variable rate allocation, market and interest rate conditions, the compensation for undertaking counterparty exposure, and their costs and benefits. Under no circumstances will an interest rate swap be utilized that is not fully understood by the System or that imposes inappropriate risk on the System. The OUS' swap activity will follow the parameters outlined in the State of Oregon's swap policy, which is incorporated by reference in the System's debt policy.

Managing Volatility

The System will manage interest rate volatility by establishing a standard "blended cost of capital" charged to the campuses that is sufficient to cover debt interest costs, fund the administrative costs of debt management, and build a reserve to hedge variable rate movement.

Providing Greater Flexibility and Clearer Planning Horizons

The System will provide greater flexibility and clearer planning horizons to the campuses by de-linking the actual debt service payments on outstanding debt from the campus projects that the debt funded. Utilizing internal loans from the System to fund their capital projects, campuses can:

- better predict their debt service costs at the beginning of a project
- take out debt on terms more tailored to their specific project
- repay debt early
- focus their concern on managing the project and less on the financing

By establishing a blended cost of capital, campuses can worry less about the interest rate markets and the timing of bond issuances, focusing instead on the project itself.

Maximizing Allowable Arbitrage Earnings

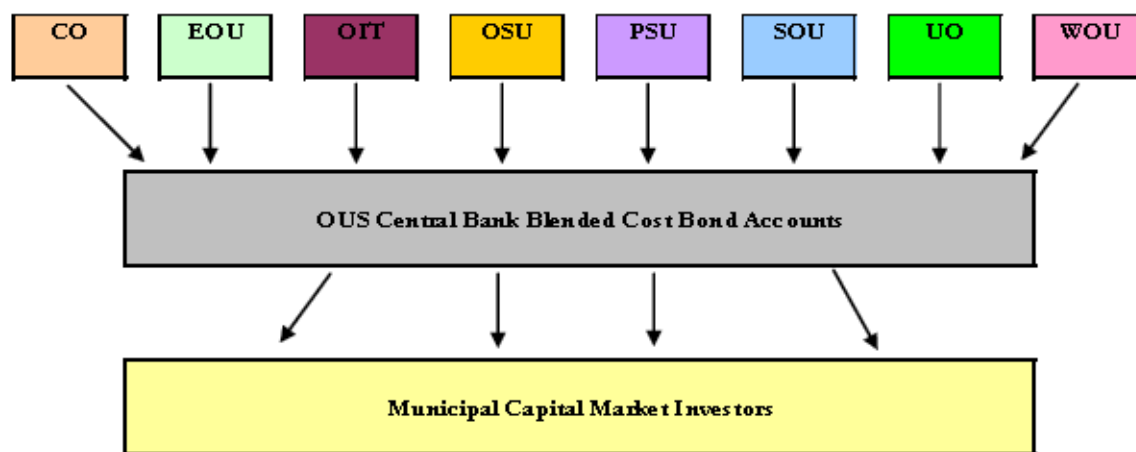
The System will maximize allowable arbitrage earnings by more strategically entering the capital markets and by more strategic management of debt sinking funds to help avoid arbitrage rebate.

Simplifying the Administration of the Debt Portfolio

The System currently maintains separate accounts within its sinking funds for each bond allocation within each debt-paying entity for each institution. Implementation of a pooled debt management approach will allow the elimination of these separate accounts and streamline the flow of funds and the accounting for those transactions.

The following diagram illustrates the simplification of the debt repayment process that this approach affords.

Central Bank Blended Cost and Pooled Funding Approach:



Estimated Cost Savings:

A recent study performed by PFM, the System's financial advisors, shows that, with a 30 percent variable rate debt exposure, the System could achieve average annual debt service savings of approximately \$1.7 million (based on the actual debt issued and the interest rate environment over the past three years). Currently, OUS does not retain the investment earnings on its operating cash balances, which prevents the traditional approach of utilizing this natural hedge against variable rate debt volatility. The System

plans to ask the 2009 Legislature for the authority to retain the interest on its operating cash balances. The inability to retain interest on the operating cash balance does not change the underlying fundamentals - that exposure to the variable rate debt market will lower the overall cost of capital. It does, however, change the manner in which the System will hedge such exposure and the planning horizon within which a large variable rate exposure can be undertaken.

Conclusion:

OUS has been given new tools by the Legislature with which to manage its Article XI-F(1) debt. The ability to utilize interim financing, issue variable rate debt, and enter into interest rate swap agreements provides the System the flexibility to reengineer its debt management process and improve its financial performance by:

- *Minimizing the cost of capital*
- *Managing volatility*
- *Providing greater flexibility and clearer planning horizons*
- *Maximizing allowable arbitrage*
- *Simplifying the administration of the debt portfolio*

Over the next several months, we will move toward implementation of these new strategies through work sessions with the State Treasurer's office, the Department of Administrative Services, the Legislative Fiscal Office, and campus administrators. Over those months, we will bring proposed changes to existing policy and new policy constructs that will provide the framework for this structure to the Board for discussion and implementation.

Next Steps:

- April – Meeting(s) with the State Treasurer's office, the Department of Administrative Services, and the Legislative Fiscal Office to ensure the ultimate viability of the program
- April/May – Meeting(s) with campus administrative leaders to develop a detailed implementation plan, including identification of needed new policies and/or changes in existing policies. Examples include:
 - Governance and administration
 - Setting of blended cost of capital
 - Type and level of reserves needed
 - Level of variable rate debt exposure
- May/June – Implementation plan discussion and first read of policy changes with Finance and Administration Committee
- June/July – Policy approval by Finance and Administration Committee