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VERMONT'S CAPITAL EXPENDITURE CASH FUND

Funding Recommendations & Analysis per 2022 Act 185 Section E.106.2

BACKGROUND

Every biennium, Vermont issues a new capital budget that historically has been funded through the authorization and issuance of General Obligation (G.O.) bonds. At prevailing interest rates, each bonded dollar can cost the State an additional 52 cents in interest over the life of the bonds[1]. As of June 30, 2022, the State had $579,000,000 in outstanding General Fund (GF) G.O. bond debt[2] and an FY23 GF debt service appropriation of over $76 million.

As part of an ongoing effort to reduce the State's dependence on borrowing, in 2022 the Administration and the State Treasurer proposed, and the General Assembly established, a **Capital Expenditure Cash Fund (CECF)** to be used for certain pre-construction capital costs and eligible capital projects. The fund was established in 2022 Act 185 Section E.106.1 and was seeded with a one-time appropriation of **$25 million** in Section C.102(b)(12) of the same act. An additional $20 million was identified in Section C.102(b)(5)(B) for redeeming G.O. bonds, with resulting debt service reductions to be transferred to the CECF.

Section E.106.2 of the bill charges the Commissioner of Finance and Management, in consultation with the State Treasurer and the Joint Fiscal Office, with conducting an analysis and making recommendations regarding a dedicated revenue source for the fund, completing a cost-benefit analysis of dedicating these revenues to the fund, and recommending any necessary statutory changes regarding the use of the fund.

1. A DEDICATED REVENUE SOURCE

Section E.106.2(a)(1): "a dedicated revenue source or State fiscal capacity to fund the Capital Expenditure Cash Fund;"

The CECF requires a sustainable funding mechanism not reliant on one-time appropriations of surplus revenues, which can vary greatly based on prevailing economic conditions. The Administration recommends long-term funding for the CECF be correlated to debt service savings resulting from the use of the fund, a positive feedback loop that will support robust fund balances and usage in the long run.

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[1] Assumes a 5.00% annual interest rate paid biannually over a 20-year bond, with principal retirement beginning in the first year
[2] According to the Capital Debt Affordability Advisory Committee (CDAAC) FY24 Recommendation

Precisely determining the savings to be reinvested in the fund is difficult, however. Consider the predicament of future lawmakers convening in the year 2033 tasked with appropriating some amount to the CECF based on debt service savings. To accurately calculate FY34 savings, it would be necessary to sum all the interest payments and administrative expenses that would have occurred in FY34 but were forgone because of prior Cash Fund usage. Such a calculation would require hypothetical debt service schedules for each fiscal year's CECF use, each of which would rely on a number of interest rate assumptions aligned with the timing of actual G.O. bond issuances which are driven by a variety of factors and do not occur on a predictable annual schedule. By 2043, the calculation could involve the amalgamation of 20 different hypothetical debt service schedules based on as many interest rate assumptions.

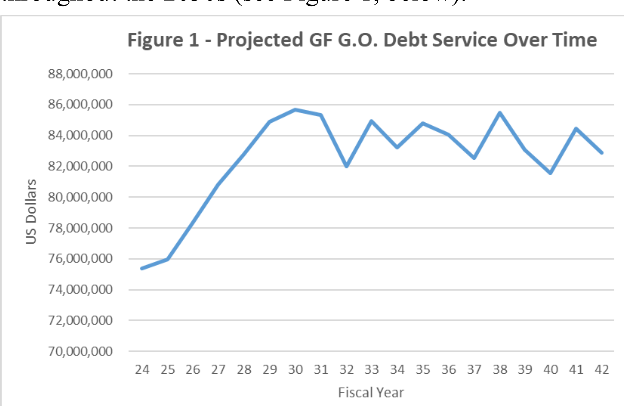
To achieve a similar result while avoiding this complex calculation and eliminating the reliance on fluid interest rates to benchmark savings, the Administration proposes an alternative funding mechanism for the CECF based on a fixed percentage of prior year General Fund appropriations, similar to the mechanisms in place for both the General and Transportation Fund Stabilization Reserves. **Specifically, the Administration proposes that for each operating budget:**

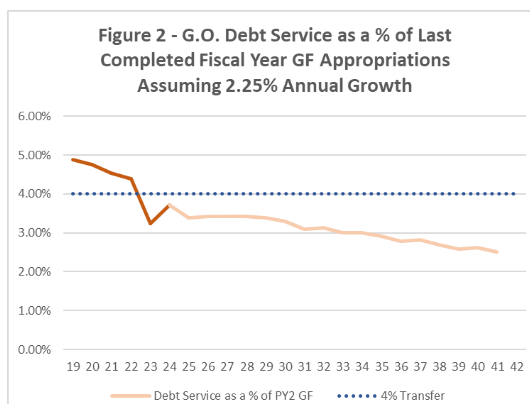
1. **4%[3] of the last completed fiscal year's total GF appropriations be calculated,**
2. **From this total, all GF debt service obligations for the budget year be subtracted, and**
3. **The balance be transferred into the Capital Expenditure Cash Fund.**
4. **In the event budget year GF debt service obligations exceed 4% of the last completed fiscal year, no transfer will be made.**

In FY24, for instance, the calculation would be performed as follows:

1. The total of all FY22 GF appropriations is $2,333,376,886; 4% of this total is $93,335,075.
2. The anticipated GF debt service obligation in FY24 is $75,377,993.
3. A GF transfer equal to (1) - (2) = $17,957,082 would be made into the CECF in FY24.

Based on current assumptions,[4] the State's annual GF G.O. debt service obligations are projected to rise steadily in the near-term, from $75.4 million in FY24 to an FY30 peak of about $85.7m, then trend between $81m and $86m throughout the 2030s (see Figure 1, below).



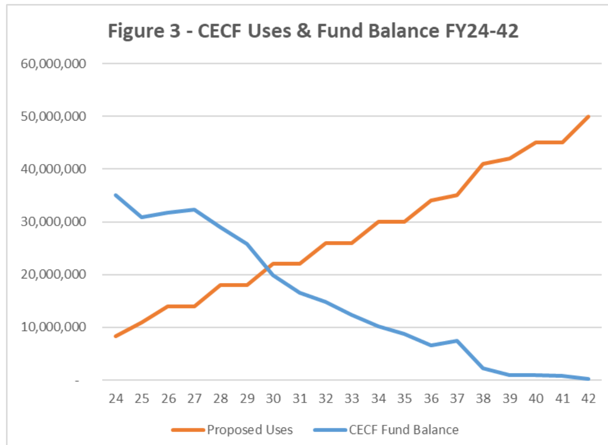


[3] 4% corresponds roughly to recent GF debt service appropriations as a percentage of last completed fiscal year total GF appropriations—the average from FY18-FY23 was 4.66%.
[4] See Appendix for detail on the debt service assumptions included in this report.

During the pre-pandemic decade following the Great Recession from FY10-FY20 Vermont's average annual growth in total GF appropriations was approximately 4.24%. Hedging for economic uncertainty in the coming decades, one might conservatively assume an average annual total GF appropriation growth of 2.25%. Under this assumption, total annual GF appropriations would rise from $2,316,461,700 in FY24 to $3,457,520,982 in FY42.

Under this scenario, even as debt service obligations continue to rise in the coming years, as a percentage of prior completed fiscal year GF appropriations they are projected to decline (see Figure 2, page 2), resulting in increasing balances available for transfer to the CECF under the 4% funding construct. The Administration believes this funding mechanism will be sufficient to capitalize the fund over the long term and, given its computational simplicity, should replace the existing early redemption transfer described in 32 V.S.A. §1001b(e) and Section C.102(b)(5)(B) of 2022 Act 185.

The $25 million one-time transfer made to the CECF in FY23 presents lawmakers with several options for use of the fund in the near term. Based on current and recent historical interest rates, interest earned on the fund's balance is unlikely to constitute a meaningful source of funding for the CECF. The Administration therefore recommends the current balance be used over the course



FY	GF Appropriations	4% of PY2 GF Approp.	Total Debt Service	CECF Funding from 4% GF Transfer	Proposed Uses	Interest - 2%	CECF Fund Balance
22	2,333,376,886						
23	2,045,897,293						25,000,000
24	2,316,461,700	93,335,075	75,377,993	17,957,082	8,335,000	500,000	35,122,082
25	2,368,582,088	81,835,892	75,981,836	5,854,056	10,850,000	702,442	30,828,580
26	2,421,875,185	92,658,468	78,322,579	14,335,889	14,000,000	616,572	31,781,041
27	2,476,367,377	94,743,284	80,843,994	13,899,290	14,000,000	635,621	32,315,951
28	2,532,085,643	96,875,007	82,794,376	14,080,632	18,000,000	646,319	29,042,902
29	2,589,057,570	99,054,695	84,873,712	14,180,983	18,000,000	580,858	25,804,743
30	2,647,311,365	101,283,426	85,673,554	15,609,872	22,000,000	516,095	19,930,710
31	2,706,875,871	103,562,303	85,331,226	18,231,076	22,000,000	398,614	16,560,401
32	2,767,780,578	105,892,455	81,996,068	23,896,387	26,000,000	331,208	14,787,995
33	2,830,055,641	108,275,035	84,954,909	23,320,126	26,000,000	295,760	12,403,881
34	2,893,731,893	110,711,223	83,242,238	27,468,985	30,000,000	248,078	10,120,943
35	2,958,840,860	113,202,226	84,807,498	28,394,727	30,000,000	202,419	8,718,089
36	3,025,414,780	115,749,276	84,069,406	31,679,870	34,000,000	174,362	6,572,321
37	3,093,486,612	118,353,634	82,542,413	35,811,222	35,000,000	131,446	7,514,990
38	3,163,090,061	121,016,591	85,465,348	35,551,243	41,000,000	150,300	2,216,533
39	3,234,259,588	123,739,464	83,085,539	40,653,925	42,000,000	44,331	914,789
40	3,307,030,428	126,523,602	81,555,231	44,968,372	45,000,000	18,296	901,456
41	3,381,438,613	129,370,384	84,427,347	44,943,036	45,000,000	18,029	862,522
42	3,457,520,982	132,281,217	82,887,839	49,393,379	50,000,000	17,250	273,151
Total				**500,230,152**	**531,185,000**	**6,227,999**	

of the next several years to augment the amount available from the 4% transfer. The Governor's Recommended FY24-FY25 Capital Bill contemplates using $8,335,000 from the CECF in FY24 and $10,850,000 in FY25; using the existing fund balance and estimated annual transfers, this level of fund utilization could be gradually increased through the coming decades. Fully utilizing available CECF revenues in this way would result in a total CECF usage of over $531 million by 2042 (see Figure 3 and accompanying table, page 3).

Current statute allows for one-time transfers to the fund, and in years with sufficient revenue, the Administration recommends the CECF be used as a vehicle to appropriate one-time General Fund surplus towards capital and other eligible projects beyond those that could otherwise be supported by State borrowing or "regular" Cash Fund use. To that end, in FY24, in addition to the $17,957,082 GF transfer contemplated according to the 4% transfer construct above, the Administration proposes another $62 million one-time transfer from available General Fund surplus to support various eligible projects.

2. COST-BENEFIT ANALYSIS

Section E.106.2(a)(2): "for any revenue source or State fiscal capacity identified in subdivision (1) of this subsection, an analysis of the benefits and costs of dedicating this revenue source to the Capital Expenditure Cash Fund in comparison to other identified unfunded State fiscal pressures."

Although the State has multiple unfunded fiscal pressures, few compare from a potential cost savings perspective to the fiscal pressure created by the State's G.O. debt service. As mentioned earlier in this report, every bonded dollar costs the State and its taxpayers an average of $1.52 over the course of a 20-year bond. This translates into an average annual savings of about $26,250 in forgone interest on every $1 million of debt avoided. Funding the CECF according to the 4% transfer construct described above, and utilizing the fund as proposed, would result in overall debt service savings on the order of $200 million over the next 20 years, or approximately eight times the current CDAAC annual bonding recommendation of $54 million. Furthermore, increased use of the Cash Fund in lieu of additional G.O. bonding would be viewed favorably by credit rating agencies, potentially lowering the cost of what borrowing does continue in the future.

Per 32 VSA §306(a)(1)(B) and (C), a report is submitted annually to the legislature enumerating certain State unfunded budget pressures, including:

1. *Deferred maintenance of transportation road and bridge infrastructure;*
2. *Pension and other postemployment benefit (OPEB) liabilities for the Vermont State Employees' Retirement System (VSERS) and the Vermont State Teachers' Retirement System (VSTRS)*
3. *Childcare fee scale funding requirements pursuant to 33 V.S.A. §3512 to bring total year funding to current market rates and current federal poverty level;*
4. *Reach Up funding full benefit obligations, including the standard of need for the current fiscal year, prior to any rateable reductions made pursuant to 33 V.S.A § 1103(a) which ensure that the expenditures for the programs shall not exceed appropriations;*
5. *Statutory funding levels from the Property Transfer Tax to the Current Use Administration special fund (32 V.S.A §9610(c)), the Vermont Housing and Conservation Fund (10 V.S.A §312), and the Municipal and Regional Planning Fund (24 V.S.A. §4306(a));*
6. *Projected fund liabilities of the funds identified in note iii.B. of the "Notes" section of the most recent Annual Comprehensive Financial report (ACFR), including Workers' Compensation Fund, the State Liability Self-Insurance Fund, the medical insurance fund and the dental insurance fund;*

7. *A summary of other nonmajor enterprise funds and internal service funds where deficits exist in excess of $1,500,000.*

Of these pressures, only (1) and (2) are of comparable magnitude to the State's G.O. debt, and in both cases the long-term impact of directing 4% of prior year GF appropriations less current debt service obligations towards their mitigation is complex to calculate. In the case of deferred transportation infrastructure, such a transfer would constitute a substantive and ongoing revenue shift between two of the State's major funds (from the General Fund to the Transportation Fund) which have fundamentally different revenue streams and statutory purposes. Furthermore, the manifold and variable nature of the State's transportation infrastructure assets combined with current and future price volatility in the construction sector make it difficult accurately to estimate the cost savings of current investment on a time scale comparable to that of the debt service reductions proposed in this report.

With regard to the State's unfunded pension and OPEB liabilities—which are themselves in part the result of many years of divergence between the actuarial assumptions used to determine necessary State contributions to both systems and actual demographic and investment experience—it is difficult to calculate with precision the impact an additional revenue stream such as the one proposed to support the CECF might have on the State's unfunded obligations over the long term. Last year the legislature passed Act 114 of 2022 which adjusted certain retirement benefits and augmented the State's commitment to funding retirement liabilities in the near term. The legislation appears to have had a positive effect on the overall actuarially adjusted unfunded liabilities of both systems. Pending updated actuarial experience studies, it may be too soon to say whether additional investments are necessary.

3. PROPOSED STATUTORY AMENDMENTS

Section E.106.2(a)(3) "Amendments to 32 V.S.A. §1001b(c) on the use of the Capital Expenditure Cash Fund, including:

- **(A) If uses of the fund should be prioritized in statute;**
- **(B) How to prioritize the use of the Fund to emphasize strong financial management in Vermont State government;**
- **(C) If an allowed use should include internal State debts or deficits; and**
- **(D) If an allowed use should include State assistance for projects to mitigate emergent health and safety needs."**

(A)-(B) The primary intent behind the creation of the Capital Expenditure Cash Fund was to reduce State borrowing. The Administration believes the fund will prove successful if it is used to fund capital expenditures that would otherwise be financed through the issuance of general obligation bonds. At this time, statutory proscription regarding the use of the fund beyond what is already enumerated in 32 V.S.A. §1001b(c) should not be a priority. However, since the eligible uses of the fund listed in statute align with expenditures typically made as part of the capital budgeting process, and to reflect the intention that the CECF be used to offset capital borrowing, the Administration recommends that uses of the fund be determined through the capital budgeting process rather than the operating budget. To that end, an amendment to 32 V.S.A. §1001b(c) is recommended below to bring the statute into alignment with the Administration's current practice of proposing CECF expenditure as part of the Governor's recommended capital bill, and to maintain legislative committee jurisdictional continuity over capital expenditures.

(C) By contrast to general obligation bond debt service, internal State debts and deficits do not incur additional external liabilities in the form of interest due to bondholders, and while they constitute an important fiscal liability in their own right, the Administration recommends use of the Cash Fund remain restricted to funding projects that would otherwise incur additional external financial pressure for the State.

(D) To the degree that State assistance for projects to mitigate emergent health and safety needs fall within the purview of the capital appropriations process and to the degree such projects align with the eligible uses of the Cash Fund specified in 32 V.S.A. §1001b(c), such projects conceivably could be funded by the CECF, however the Administration does not recommend additional statutory language to address the contingency at this time.

In addition to the amendment to 32 V.S.A. §1001b(c) described above, to codify the funding mechanism proposed in Section 1 of this report, the Administration strongly recommends an amendment to 32 V.S.A. §1001b(b), and that 32 V.S.A. §1001b(e) be deleted. All amendments are noted by <u>underline</u> and ~~strikethrough~~ as follows:

§ 1001b. CAPITAL EXPENDITURE CASH FUND

(a) Creation. There is hereby created the Capital Expenditure Cash Fund to be administered by the Commissioner of Finance and Management, in consultation with the State Treasurer, for the purpose of using general funds to defray the costs of future capital expenditures that would otherwise be paid for using the State's general obligation bonding authority and debt service obligations.

(b) Fund. The Fund may consist of:

(1) any appropriations or transfers made by the General Assembly; ~~and~~

(A) <u>Annually, the State's appropriations act shall provide a net transfer from the General Fund to the Capital Expenditure Cash Fund. This amount shall be equal to 4% of the last completed fiscal year's General Fund appropriations, less the amount determined by the State Treasurer and the Commissioner of Finance & Management as necessary to fund the State's General Fund-backed general obligation debt service in the year for which the transfer is being made. If the amount of General Fund-backed general obligation debt service exceeds 4% of the last completed fiscal year's General Fund appropriations, no transfer shall be made in that budget year.</u>

(2) any interest earned by the Fund.

(c) Use of funds. Expenditure shall only be made from the fund by appropriations by the General Assembly. Plans for use shall be submitted as part of the ~~operating~~ <u>capital</u> budget adjustment or ~~operating~~ <u>capital</u> budget process. Monies in the Fund shall only be used for:

(1) costs associated with a proposed capital project that occur prior to the construction phase of that project, including feasibility, planning, design, and engineering and architectural costs;

(2) projects with an anticipated lifespan of less than 20 years;

(3) costs associated with the ~~early~~ redemption of general obligation bonds and other State tax supported debt; and

(4) other eligible capital projects receiving an appropriation from the General Assembly.

(d) Fund balance. All balances in the Fund at the end of any fiscal year shall be carried forward and remain part of the Fund.

~~(e) Early redemption transfer. If any expenditures are made from the Fund or the General Assembly appropriates general funds to pay for the early redemption of general obligation bonds pursuant to subdivision (c)(3) of this section, then an amount equal to the reduction in debt service required in any fiscal year resulting from that redemption shall be transferred to the Fund.~~

APPENDIX A – CECF FUNDING FY24-FY42; DEBT SERVICE ASSUMPTIONS

FY	GF Appropriations[1,2]	4% of PY2 GF Approp.	Total Debt Service[3]	CECF Funding from 4% GF Transfer	Proposed Uses	Interest - 2%	CECF Fund Balance
22	2,333,376,886						
23	2,045,897,293						25,000,000
24	2,316,461,700	93,335,075	75,377,993	17,957,082	8,335,000	500,000	35,122,082
25	2,368,582,088	81,835,892	75,981,836	5,854,056	10,850,000	702,442	30,828,580
26	2,421,875,185	92,658,468	78,322,579	14,335,889	14,000,000	616,572	31,781,041
27	2,476,367,377	94,743,284	80,843,994	13,899,290	14,000,000	635,621	32,315,951
28	2,532,085,643	96,875,007	82,794,376	14,080,632	18,000,000	646,319	29,042,902
29	2,589,057,570	99,054,695	84,873,712	14,180,983	18,000,000	580,858	25,804,743
30	2,647,311,365	101,283,426	85,673,554	15,609,872	22,000,000	516,095	19,930,710
31	2,706,875,871	103,562,303	85,331,226	18,231,076	22,000,000	398,614	16,560,401
32	2,767,780,578	105,892,455	81,996,068	23,896,387	26,000,000	331,208	14,787,995
33	2,830,055,641	108,275,035	84,954,909	23,320,126	26,000,000	295,760	12,403,881
34	2,893,731,893	110,711,223	83,242,238	27,468,985	30,000,000	248,078	10,120,943
35	2,958,840,860	113,202,226	84,807,498	28,394,727	30,000,000	202,419	8,718,089
36	3,025,414,780	115,749,276	84,069,406	31,679,870	34,000,000	174,362	6,572,321
37	3,093,486,612	118,353,634	82,542,413	35,811,222	35,000,000	131,446	7,514,990
38	3,163,090,061	121,016,591	85,465,348	35,551,243	41,000,000	150,300	2,216,533
39	3,234,259,588	123,739,464	83,085,539	40,653,925	42,000,000	44,331	914,789
40	3,307,030,428	126,523,602	81,555,231	44,968,372	45,000,000	18,296	901,456
41	3,381,438,613	129,370,384	84,427,347	44,943,036	45,000,000	18,029	862,522
42	3,457,520,982	132,281,217	82,887,839	49,393,379	50,000,000	17,250	273,151
Total				**500,230,152**	**531,185,000**	**6,227,999**	

Notes:

1 FY22 per FY22 ACFR; FY23 per Gov. Rec. BAA; FY24 per Gov Rec. Budget
2 FY25-FY42 Assume 2.25% annual total GF appropriation growth.
3 See debt service breakdown below

FY	Current GF Debt Service[4]	$47.68m FY24 Issuance[5]	$54m Annual Issuance[6]	$20m Redemption Savings[7]	Authorized But Unissued (ABU) Debt Spendown[8]	Total Debt Service
24	69,375,076	5,327,917		-		75,377,993
25	67,268,018	4,705,750	5,400,000	(2,600,000)	1,208,068	75,981,836
26	63,231,394	4,580,250	10,665,000	(2,540,000)	2,385,935	78,322,579
27	59,540,644	4,454,750	15,795,000	(2,480,000)	3,533,600	80,843,994
28	55,444,063	4,329,250	20,790,000	(2,420,000)	4,651,063	82,794,376
29	51,641,638	4,203,750	25,650,000	(2,360,000)	5,738,325	84,873,712
30	47,932,988	4,078,250	30,375,000	(2,300,000)	5,587,316	85,673,554
31	43,217,169	3,952,750	34,965,000	(2,240,000)	5,436,308	85,331,226
32	35,643,519	3,827,250	39,420,000	(2,180,000)	5,285,299	81,996,068
33	34,498,869	3,701,750	43,740,000	(2,120,000)	5,134,291	84,954,909
34	28,817,706	3,576,250	47,925,000	(2,060,000)	4,983,282	83,242,238
35	24,549,475	3,450,750	51,975,000		4,832,273	84,807,498
36	20,172,891	3,325,250	55,890,000		4,681,265	84,069,406
37	15,142,406	3,199,750	59,670,000		4,530,256	82,542,413
38	14,696,850	3,074,250	63,315,000		4,379,248	85,465,348
39	9,083,550	2,948,750	66,825,000		4,228,239	83,085,539
40	4,454,750	2,823,250	70,200,000		4,077,231	81,555,231
41	4,368,250	2,692,875	73,440,000		3,926,222	84,427,347
42		2,567,625	76,545,000		3,775,214	82,887,839

Notes:

4 As of January 2023
5 Assumption from Treasurer's Office, Fall 2022
6 Per Fall 2022 CDAAC Report
7 Per Section C.102(b)(5)(B) of Act 185. Assumes redemption savings at 3% coupon over 10 years starting FY25.
8 2022 ACFR stated $198.08m ABU less FY24 $47.68m issuance for net ABU of $150.40 million.
Assumes issuance of $60.4m of net ABU over 5 years, starting FY25, and ongoing ABU balance of $90m thereafter.