ELIZABETH A. PEARCE
STATE TREASURER

RETIREMENT DIVISION
TEL: (802) 828-2305
FAX: (802) 828-5182

UNCLAIMED PROPERTY DIVISION
TEL: (802) 828-2407

ACCOUNTING DIVISION
TEL: (802) 828-2301
FAX: (802) 828-2884

STATE OF VERMONT
OFFICE OF THE STATE TREASURER

Discussion Paper: Bond Financing for Water Quality Improvements

Several parties have asked the Treasurer's Office to outline a possible bond program, separate from Vermont's General Obligation (G.O.) Bonds, to support water quality improvements. We believe this can be best illustrated by describing the key elements of Vermont's successful Special Obligation Transportation Infrastructure Bonds (TIBs) program.

This discussion paper provides an executive summary of the TIBs, and then provides more detail regarding (1) the applicable State statutes creating revenue sources, funds, authorizations and pledges to establish the TIBs, and session law authorizing individual bond issues and payment of debt service, (2) the additional steps taken by the Treasurer's Office to perform the required financial analysis, legal documentation, credit review, and marketing and sale of the TIBs, and (3) some important considerations regarding any new bond program.

Executive Summary

The TIBs program was created during the 2009 Legislative Session to improve bridges, culverts and other long-lived transportation infrastructure. The related statutes established dedicated revenue sources, a dedicated fund, bonding authorization, a debt service fund, and a pledge to bondholders. During FY2014, the fund collected approximately $21 million, consisting of $19.2 million from a 2 percent assessment on the retail price of motor fuel, and $1.8 million from a $0.03 per gallon assessment on diesel fuel. These revenue sources were attractive for supporting bonds because they were increments on the existing gas tax, which has a long collection history and a well-established procedure for collection; as such, it was relatively easy for rating agencies and investors to become comfortable that revenue projections were reasonably accurate and well-understood. The fund has supported the sale of three series of bonds totaling $36.385 million, the proceeds of which have been used to leverage over $171 million of Federal funds and thus enable over $205 million of transportation projects, after bond-related expenses. Debt service (i.e., annual principal and interest payments) on the bonds totaled $2.4 million in FY2014, so the fund was able to support $18.6 million of pay-as-you-go transportation projects after paying debt service on the bonds. Statute requires that projects financed with bonds must have at least 30 years remaining useful life, while projects funded on a pay-as-you-go basis must have at least 10 years of remaining useful life. Finally, statute includes a pledge that as long as bonds are outstanding, no changes will be made to reduce or otherwise impair the revenue sources supporting the bonds. The bonds are structured to have level annual debt service payments lasting 20 years, with the final payment on the most recent 2013 bond sale due June 15, 2033.

Relevant Statutes and Session Law

The TIBs program required statutory creation of dedicated revenue sources, a dedicated fund, bond authorization, a debt service fund, and a pledge to bondholders. The relevant statutes include:

Revenue sources

32 V.S.A. § 3003(a) – establishes a $0.03 per gallon motor fuel transportation infrastructure assessment on diesel fuel.

32 V.S.A. § 3016 – establishes a motor fuel transportation infrastructure assessment of 2 percent of retail price exclusive of all federal and state taxes.

Dedicated fund

19 V.S.A. § 11f – creates the TIB fund as a special account within the transportation fund, and sets forth permitted purposes for both bond proceeds and pay-as-you-go funds.

Bond authorization

32 V.S.A. § 972 – authorizes the State Treasurer to issue TIBs as authorized in the annual Transportation Bill, sets forth terms and conditions for issuing bonds, how the bonds are repaid, and permitted projects.

Debt service fund

32 V.S.A. § 951a(a)(2) – establishes the Transportation Infrastructure Bonds Debt Service Fund as a governmental debt service fund.

Pledge to bondholders

32 V.S.A. § 978 – General Assembly pledges "that the State will fulfill the terms of any agreement made with the holders of Transportation Infrastructure Bonds and will not in any way impair the rights or remedies of the holders of the bonds until the bonds, interest, and all costs associated with the bonds are fully paid." **This covenant is extremely important, and would be required as a precondition of any new bond program.**

In addition to statutes, session law both authorizes bonds, and appropriates funds to pay debt service and replenish reserves. Authorizations for the three bond issues were provided in Transportation Bills (Sec. 13 of Act No. 123 of 2010; Sec. 19 of Act No. 153 of 2012; Sec. 10 of Act No. 12 of 2013), and appropriations for debt service and replenishment of reserves (if needed) are included in the Appropriations Bill, most recently for FY2015 in Sec. B.1000 of Act No. 179 of 2014.

Additional Steps to Set Up a Bond Program

After the General Assembly created the necessary statutes, the Treasurer's Office worked with its financing team including its bond attorney, financial advisor, underwriters, feasibility consultant, trustee and paying agent, rating agencies, printers and advertisers to design the TIBs program. Major steps included creating necessary legal documentation, completing a feasibility study, structuring the bonds and necessary debt service coverage, obtaining credit ratings, marketing and selling the bonds, and administering the bonds going forward.

Completing the initial set-up of the program required approximately four months, and subsequent bond sales have taken approximately six weeks to complete from start to finish. Total issuance costs been just under $300,000 for each bond sale. The bonds currently are rated "high investment grade" at AA+ by Standard and Poor's, Aa2 by Moody's Investors Service and AA by Fitch Ratings, and the interest rates have ranged from 2.45% to 3.65% depending upon prevailing interest rate levels at the time of the sale.

Considerations for a Water Quality Bond Program

In general, we believe that a water quality bond program could be structured incorporating many of the same elements as the TIBs program. Two very important and to-be-determined factors in the set-up of a new bond program would be the source of revenues, and the amount of bonding required.

With respect to revenues, the success of the TIBs program bond sales relied on the motor fuel assessments being a broad and established repayment source with a long history of collections and well-established collection procedures. At the same time, because the TIB revenues are an increment on the gas tax, the rating agencies generally include the TIBs in their estimate of Vermont's "net tax-supported debt" along with the State's G.O. bonds; in practice this has not presented a problem because amount of outstanding TIBs (and presumably of new water quality bonds) is small compared to the State's G.O. bonds. A brand new revenue source would have roughly opposite considerations; while related bonds may not be considered net tax-supported debt, the revenue would be more difficult to use to support bonding until several years of collection history were established.

With respect to bond capacity, the key metric is the debt service "coverage ratio," which is simply the annual revenues collected divided by the annual principal and interest payments on outstanding bonds. The TIBs' stated minimum target coverage ratio is 3-to-1; in FY2014, the coverage ratio was actually almost 9-to-1 (that is, $21 million divided by $2.4 million).

In broadly approximate terms, at a 3-to-1 coverage ratio, given prevailing levels of interest rates and assuming AA category credit ratings similar to the TIBs and 20-year level debt service, we estimate that $5 million of annual revenue could support roughly $20 million of bonds, and $10 million could support roughly $40 million of bonds. These amounts could vary slightly depending upon whether all the bonds were sold all at once, or if issuance was spread out over several years.

The Treasurer's Office would be pleased to discuss any aspects of this discussion paper, and to provide analysis as needed with respect to policy proposals or other bond-related considerations.