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TO: Governor Phil Scott
Susanne Young, Secretary of Administration
Mitzi Johnson, Speaker of the House of Representatives
Tim Ashe, Senate President Pro Tempore
Alice Emmons, Chair, House Committee on Corrections and Institutions
Peg Flory, Chair, Senate Committee on Institutions
Stephen Klein and Members, Joint Fiscal Committee

FROM: Beth Pearce, State Treasurer Beth

DATE: September 28, 2018

RE: Capital Debt Affordability Advisory Committee Report for 2018

Pursuant to 32 V.S.A. §1001, I am pleased to deliver on behalf of the Capital Debt Affordability Advisory Committee ("Committee" or "CDAAC") its "Recommended Annual Net Tax-Supported Debt Authorization" Report for 2018 ("Report").

This is the first year of the FY 2020-2021 biennium and the Committee is making a 2-year debt recommendation of $123,180,000. This represents a 7.0% reduction from the previously recommended and adopted authorization of $132,460,000. This is the third consecutive biennium for which the Committee has recommended a reduction in the authorized level of debt issuance, with prior reductions of 9.9% and 8.0% in the previous four years.

As noted in the Report, more limited debt issuance by other states, including our peer Triple-A rated states, has resulted in a weakening of Vermont's debt ratio comparative rankings. The Committee notes that even with this recommended reduction, coupled with the current expected debt issuance for FY2019, the State's overall debt outstanding will continue to rise over the next several years. Under the Committee's recommendation, however, the rate of increase will moderate and by 2028 outstanding debt levels will drop to just below FY2019 levels

At the same time, the Committee notes the rating agencies concerns with respect to the level of deferred maintenance and/or capital infrastructure replacement among many state and local governments, and we recognize the need to maintain a proactive capital funding plan. To that end, the Committee discussed the need to develop pay-as-you go funding structures that would be beneficial to the capital and asset management process. Several state and local government models were discussed. The Committee plans on taking up this issue in the next months, in concert with the Administration, the General Assembly and Joint Fiscal Office, with the goal of providing recommendations for consideration in the upcoming legislative session.

The State's general obligation bond ratings were affirmed in August 2017 by Moody's Investors Service (Aaa, highest rating), Fitch Ratings (AAA, highest rating), and S&P Global Ratings (AA+, second highest rating), all with stable outlooks. These bond ratings, the highest in the Northeast, are critical to Vermont's financial future and allows us access to capital at low rates. This not only supports the State's infrastructure needs but also lowers the cost of financing for various authorities that rely, at least in part, on our bond rating. I would note that Moody's has changed its ratings criteria and will now place additional emphasis on the economy and liabilities/fixed costs such as debt, pensions and other post-employment benefits (OPEBs) but also, indirectly, Medicaid and other costs. The rating agencies are also taking new approaches in evaluating revenue volatility and reserves.

Our pension and OPEB liabilities are significant and our history of not paying the actuarially determined employer contributions (ADEC) has contributed to today's budgetary pressures. I am pleased that since FY 2007 the State has made its requisite pension contributions and in FY 2018 made a significant effort to address its liability with an additional $26.2 million contribution to the teacher's system, over and above the ADEC. Also, the FY 2019 adopted budget includes an additional pension contribution over and above the ADEC in the amount of $10 million. In addition, the FY 2019 budget directs that, after all general fund reserve requirements have been satisfied, fifty percent of any remaining unreserved and undesignated end-of-fiscal year 2019 general fund surplus shall be transferred to the teacher system OPEB trust. These steps further our resolve to address these liabilities. We must remain disciplined in our practices to provide retirement security and value to the taxpayer.

The rating agencies have also focused on states' financial preparedness related to the next economic downturn. In that regard, the State also took efforts to build its reserves in the FY19 budget, which increased the fiscal 2019 stabilization reserve to $78.18 million from $77.0 million in fiscal 2018. In addition, other reserves were increased, including the human service caseload reserves, resulting in an increase of all general fund related reserves from $122.3 to $206.7 million. Taking into account the reduction in the appropriation due to the changes to the general fund transfer to the education fund, all general fund related reserves represents 13.1% of 2019 general fund related appropriations compared to 6.6% for fiscal 2018 general fund related appropriations. The rating agencies are taking a somewhat different approach to reserves with a recognition of the needs for higher levels of reserves, assessment of levels in the context of revenue volatility, budget flexibility and fiscal shock stress testing. Despite our progress, continued discussion of the use of budget surplus funds, the adequacy of different reserve levels and their availability will be needed.

Our nation's tax, budgeting and fiscal policies present tremendous challenges and/or stresses going forward that will impact the State. Vermont also faces challenges, both in demographics and in economic growth. There are no quick fixes. We must continue to work together to develop solutions that serve not just immediate budget priorities but also the long-term economic prosperity of the State and all its citizens. We must continue and build on past practices and protect the State's reputation for fiscal prudence, conservative debt management, reserve maintenance, and proactive budget management. We look forward to working with you as we address these challenges.

Please feel free to contact me with any questions.