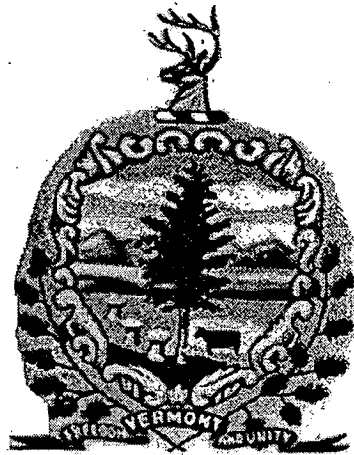


TREASURER'S ANNUAL REPORT TO THE LEGISLATURE



Vermont State Treasurer's Office

James H. Douglas, Treasurer

February 6, 1998

Vermont State Treasurer's Office
133 State Street
Montpelier, VT 05633-6200

February 6, 1998

Dear Members of the General Assembly:

I respectfully submit my annual report to the legislature as required by Title 32, section 101 of the Vermont Statutes Annotated. For three years the State Treasurer's Office has been engaged in a policy of "trending down" both long term and short term debt and it is finally having positive effects.

For the first time in this decade, the State of Vermont this year will retire more outstanding long term debt than it will issue in new long term debt. The State's short term borrowing need of \$20 million in FY '98 was the smallest amount in this decade.

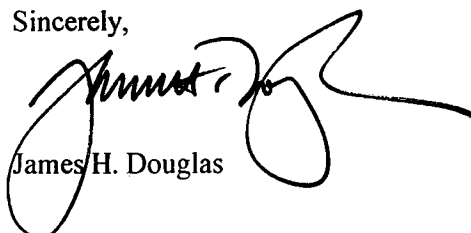
As a result, Vermont not only maintained its bond rating, but has solidified a stronger double A position in a refined Moody's rating system. If these trends continue, the State is expecting to position itself favorably for a higher rating from Standard and Poor's in the future. However, Vermont's long term debt level compares unfavorably with most other states. Vermont is ranked number eight in debt service as a percent of its budget and debt as a percent of the State's aggregate personal income. It ranks ninth in debt per capita. So a continued policy of reducing long term debt is essential.

Again this year we will seek legislation to give municipalities and their members in the municipal retirement system an opportunity to operate their own system outside of State government. Since there are no State dollars involved it is only logical to afford local government and their employees the right to operate their own pension system. In addition, this move would allow the State Treasurer's Retirement Division to focus its limited resources on the other two systems, those for State employees and teachers.

Also, we are proposing this year that exempt employees be provided the option to select a defined contribution retirement plan. This will give more portability to those employees who often do not benefit significantly from the current defined benefit retirement program. This selection of a plan would be entirely optional.

This report contains an overview of many of the programs I have instituted in the last three years as well as those that I recommend for the future. If you have any questions, please do not hesitate to give me a call.

Sincerely,



James H. Douglas

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Appendix A

Outline for a Defined Contribution Plan

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The Bond Swap Program

I. DEBT MANAGEMENT

Debt Management

The State Treasurer's Office continues to engage in a policy of "trending down" both long term and short term debt. After implementing this policy three years ago, "trending down" is finally having some positive effects. For the first time in this decade, the State of Vermont will retire more outstanding long term debt than it will issue in new long term debt. The State will retire approximately \$44.9 million in general obligation principal in FY'98 and issue \$43.5 million in new debt, resulting in a \$1.4 million decrease in general obligation par outstanding between July 1, 1997 and July 1, 1998. The State's short term borrowing need of \$20 million for FY'98 was the smallest amount in this decade. The amount and duration of short-term borrowing is usually dependent upon two critical factors: a recurring revenue stream matching recurring expenditures (in other words, an ongoing balanced budget); and a healthy stabilization reserve that can offset seasonal or economic dips in revenue as well as expenditure patterns that do not match up precisely with schedules of revenue collections. At the conclusion of FY'97 the State of Vermont was able to fill stabilization reserves in the General and Transportation Funds with surplus moneys meeting the two critical factors.

As a result of declining new authorizations in long term debt, decreasing short term borrowings, and a greatly enhanced cash position with adequately funded stabilization reserves, Vermont not only maintained its bond rating, but has solidified a stronger double A position in a refined Moody's rating system. If these trends continue the State is expecting to position itself favorably for a higher rating from Standard and Poor's in the future.

However, there are future areas of concern. Without corrective legislative action to coordinate Act 60 state aid distribution payments with incoming revenues, short-term borrowing is expected to soar in FY'99 and FY 2000. In FY'99 both Education Fund and

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General Fund short term cashflow borrowing could reach \$65 million and in FY 2000 early cashflow calculations indicate that short term borrowing could approach \$250 million. This level of short term debt would have devastating consequences to the State's credit rating. Moody's, in particular, cited a trend of our enhanced cash position and the resulting lower borrowing needs as reasons for assigning a rating of Aa2. Short term debt payments in FY 2000 could approach \$12 million which would come from moneys earmarked for education.

In addition, Vermont's long term debt level compares unfavorably with most other states. Vermont is ranked number eight in debt service as a percent of its budget and debt service as a percent of the State's aggregate personal income. It ranks ninth in debt per capita.¹

Also, although reducing new authorizations of long term debt has been successful, the State still finds itself paying out more in annual long term debt payments than in previous years. In the first decade of the new millennium annual debt service payments will finally begin to decrease from previous years but only if new issuances of long term debt are at or below current levels.

Tables 1 and 2 display new authorization levels of long and short term debt from FY'92 to those proposed for FY'99. Table 3 displays debt service payments and Table 4 displays total outstanding debt.

Table 1

New Long Term Debt Authorizations From FY' 92 To FY '99
(In Millions of Dollars)

FY'92	FY'93	FY'94	FY'95	FY'96	FY'97	FY'98	FY'99 ²
\$65.3	\$73.7	\$64.3	\$60.9	\$50	\$42.8	\$42.9	\$39

¹ Rankings reflect figures as published by Moody's Investors Service. Actual debt ratios for the State were computed on the basis of the most recent, available data.

² This amount has been recommended by the Capital Debt Affordability Advisory Committee

Table 2

Short Term Borrowing Utilizing Revenue Anticipation Notes/Commercial Paper Notes/
Bond Anticipation Notes For Fiscal Years 1991 Through 1999
(In Millions of Dollars)

Fiscal Year	Maximum Outstanding During Fiscal Year	Total Outstanding At End of Fiscal Year
FY'91	\$191.5	\$65.0
FY'92	\$155.0	\$65.0
FY'93	\$155.0	0
FY'94	\$150.0	0
FY'95	\$150.0	\$20.0
FY'96	\$150.0	0
FY'97	\$105.0	0
FY'98 ³	\$20.0	0
FY'99 ⁴	\$65.0	0

Table 3

Tax-Supported Debt Service by Fiscal Year (1994-1999)
(In Millions)⁵

FY'94	FY'95	FY'96	FY'97	FY'98	FY'99 ³
\$50.7	\$57.9	\$66.6	\$70.3	\$74.5	\$75.4

Table 4

General Obligation Bond Principal Debt Outstanding From Fiscal Year Ends 1992 to 1999
(General obligation principal debt only, excludes notes, lease/purchase obligations that are included in annual debt service payments. (In Millions)

FY'92	FY'93	FY'94	FY'95	FY'96	FY'97	FY'98 ³	FY'99 ⁴
\$361.2	\$339.5	\$425.4	\$461.8	\$489.1	\$501.7	\$500.3	\$494

The State Treasurer's Office has been aggressive in reducing the costs of issuing both long and short term debt. Over the past three years bond counsel services were put out to bid for the first time in over twenty years, which resulted in a contract with fee

³ Estimated

⁴ Proposed

⁵ These numbers include debt service payments for both general fund and transportation fund projects as well as lease obligations and certificates of participation

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caps and ultimately substantial savings. We also reduced the number of financial advisors from two to one and just recently rebid this contract resulting in a reduced cost of services. In addition, Vermont is the first state to use only two rating agencies rather than three for its commercial paper program, and all bond bid openings and closings are conducted either via telephone/fax or through the mail, rather than by overnight trips to New York City. Lastly commercial paper costs for underwriter services, liquidity services and paying agent services have been reduced substantially through the bidding process. These steps have reduced the costs of issuing bonds and commercial paper by hundreds of thousands of dollars annually.

II. INVESTING

Over the past three years the State Treasurer's Office has instituted a competitive bidding system in its short term investment program and become more aggressive in investing the State's resources. *Overall, these changes have resulted in very favorable returns at reduced costs.* Table 5 displays historical and projected investment returns to the general fund from the State's short term investment program and Table 6 displays the returns during FY'97 in the three retirement systems.

Table 5

Net Interest to the General Fund By Fiscal Year (FY'94 to FY'99)
(In Millions)

FY'94	FY'95	FY'96	FY'97 ⁶	FY'98 ³	FY'99 ³
\$0.5	\$1.7	\$2.9	\$4.9	\$3.0	\$2.9

⁶ Unaudited

Table 6
FY'97 Retirement Funds Investment Returns

Vermont State Employees Retirement System FY'97 Investment Return	Vermont State Teachers Retirement System FY'97 Investment Return	Vermont Municipal Employees Retirement System FY'97 Investment Return
22.35%	22.34%	20.90%

The institution of the weekly competitive bidding system three years ago for short-term investments has increased our rate of return and liquidity while at the same time decreasing exposure. Although required by law for some time, we adopted in 1995 guidelines for short-term investments, consistent with statutory restrictions. The guidelines delineate acceptable investments, require diversification and place safety above yield. The State retirement fund, through the board of trustees, has begun to invest in a Standard and Poor's 500 index fund as part of its overall investment strategy. This has resulted in significant cost savings without sacrificing returns. *Both the State and the Teachers' retirement systems are seeking legislation to institute a prudent person principle for their investment guidelines.* Prudent person legislation was approved in 1996 for the municipal system and allows greater flexibility while continuing to hold the trustees accountable for investment decisions. The most significant change in the past year is the addition to our staff of a Director of Investment Services. This should result in even more enhanced investment decisions as well as closer monitoring of the various investment managers.

III. ECONOMIC DEVELOPMENT

Over the years the State Treasurer's Office has been called upon to fund the expansion of various Vermont Economic Development Authority programs through the State's cashflow. Currently the State of Vermont has approximately \$19 million in notes outstanding to VEDA for the programs that make loans available to local development

corporations and private companies. These loans are in essence a revolving line of credit. Once a payment is made to the State from any outstanding loan, VEDA is authorized to draw that amount from the State's treasury for other loans. This funding mechanism of using the State's cashflow has two fundamental problems: one, it puts enormous pressures on the State's cashflow, especially in tight financial times, thereby requiring additional borrowing; and two, it is not a lasting and sustainable funding mechanism for VEDA, which needs approximately \$10 million in new moneys each year in order to meet the loan demand generated through its two major programs. The State Treasurer's office, working closely with VEDA, developed a sustainable funding mechanism that uses the existing assets of VEDA to borrow from the capital markets each year and repay investors using the cashflow of the existing loan portfolio. This program will allow VEDA to approve \$10 million in new loans each year to local development corporations or private companies without a State appropriation or loans from the State's cashflow. In addition, the State's existing loans to VEDA will be paid in accordance with an amortization schedule that complies with existing statute. VEDA has just completed its refinancing under the new recapitalization model. Although there may be slightly higher rates for VEDA borrowers, the rates will still be well below market rates available through most other financing arrangements. In the end, the economic development community will have lasting and sustainable funding for these two programs at a predictable level.

IV. RETIREMENT

A. OVERVIEW

The State maintains three statutory pension plans: the Vermont State Teachers' Retirement System, with 10,280 active and 3,188 retired members as of June 30, 1997; the Vermont State Retirement System, with 7,227 active and 3,308 retired members; and the Vermont Municipal Employees Retirement System, with 4,068 active and 689 retired members. Both the Vermont State Teachers' Retirement System and the Vermont State

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Retirement System are funded by employee contributions as well as those made by the State of Vermont. The Vermont Municipal Employees' Retirement System involves no State money, but nevertheless is administered by the State Treasurer's Office (please see later discussion). Assets for the three retirement systems exceed \$1.7 billion and are divided among the plans as displayed in Table 7 below.

Table 7
Total Assets at Market Value by Pension System as of June 30, 1997
(In Millions)

State Teachers Retirement System	Vermont State Retirement System	Vermont Municipal Employees Retirement System
\$865.86	\$779.31	\$109.88

B. PRIVATIZATION OF THE MUNICIPAL RETIREMENT SYSTEM

The municipal retirement system presents a dilemma for the Treasurer's Office. There are complaints from board members that too little time is spent administering the system, yet staff estimates that management time on the system is disproportional to overall assets of the three pension systems administered by the retirement division. In essence, retirement personnel spend one-third of their time managing a system whose assets are only a small percentage of a \$1.7 billion asset base.

The disproportionate time commitment is understandable given the fact that contract administration, board and budget preparation, fund manager oversight and other functions take as much time on \$110 million retirement system as they do on a half billion dollar system. In addition, this disproportionate time commitment puts enormous strain on staff's capabilities to properly administer the three systems in an era of governmental downsizing. Given that staff additions will be difficult to achieve in the near future, other options must be considered to meet the Treasurer's goal of effective and efficient management of the three retirement systems.

A recurring question is often heard: If the State of Vermont contributes no money to this system and is no longer legally required to fund the system, why is the municipal retirement system under State control? It is a question that has only one plausible answer: History. In 1975 when the retirement system was established the Legislature assigned it to the retirement division of the Treasurer's Office because the State contributed to the system and had a legal requirement to fund the system. Now neither of those reasons remains.

Again, this year the Treasurer's Office and the Board of Trustees propose that the municipal retirement system be operated as a non-profit corporation outside of state government, controlled and operated by those local governments and their employees who belong to the retirement system. There are several advantages to both the Treasurer's Office and current members of the system in implementing such a proposal:

Local governments and the members, rather than state government, would be controlling and operating the system. This would entitle the system to set its own budget, have its own staff, and determine its own direction without the day to day oversight of the State.

The cost of conversion and operating this new system would not be significantly higher than personnel and operating costs under the current system. A budget has been prepared outlining two years of estimated expenditures. In addition, preliminary talks with money managers and other contractors indicate little price impact because of the establishment of a new entity. They would continue to offer discounts based on their relationships with the other two systems.

Existing retirement division staff would be able to focus on managing and servicing the two larger systems where the State of Vermont contributes moneys to the retirement funds and has a legal responsibility to fund the two systems.

Maintaining the status quo in terms of staffing and management of the municipal retirement system is not a viable option to meet the existing or future demands of the system. Changes are recommended for the express purpose of improving the system and providing better service to its members.

C. FUNDING OF THE RETIREMENT SYSTEMS

Governmental Accounting Standards Board ("GASB") Opinion No. 5 regarding standardized disclosure measurements of the present value of pension benefits, as adjusted for the effects of projected salary increases and any step rate benefits estimated to be payable in the future, has been superseded by GASB Opinion No. 25. Table 8 below presents the funding status of Vermont's three retirement systems as determined by this new methodology.

Table 8

Percent Funded Using GASB Opinion No.25

	State Teachers' Retirement System	Vermont State Retirement System	Vermont Municipal Employees' Retirement System
Actuarial Value of Assets	\$692,685,000	\$639,128,000	\$81,395,000
Actuarial Accrual Liability (AAL)	824,468,000	753,885,000	75,058,000
Unfunded AAL (UAAL)	131,783,000	114,755,000	(8,336,000)
Funded Ratio	84%	84.8%	108.4%

Based upon the actuarial recommendation, I request \$27 million in FY'99 as the State's contribution to the teachers' retirement system.

D. STATUS OF DEFINED CONTRIBUTION VERSUS DEFINED BENEFIT STUDY

In 1996 the General Assembly directed the State Treasurer to perform, first a preliminary review of options and fiscal implications of shifting the State employees' retirement system and the teachers' retirement system from defined benefit plans to defined contribution plans, and then, upon Joint Fiscal Committee approval, a comprehensive study. Under a defined benefit plan – which is the current plan of the two systems – the pension benefit the employee receives at retirement is calculated according to a formula based on age, years of service, and final average salary. Defined benefit

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plans may provide credit for past service and cost-of-living adjustments, as well as early retirement and disability benefits. Both the employer and employee may make contributions to a defined benefit plan, but the employer assumes the liability of the accrued pension benefit.

In a defined contribution plan, employees contribute a specific amount (a percentage of their annual salary) to their individual accounts. Their employer makes a fixed contribution to each employee's account. Employees are responsible for making all investment decisions regarding contributions; investment choices are made from options selected by the employer. At retirement, employees receive the amount of contributions in their account plus investment earnings.

The legislature appropriated up to \$50,000 for the preliminary study and an additional \$125,000 should the Joint Fiscal Committee decide to authorize phase two, the implementation study. After an RFP process, the Segal Company was selected for the preliminary study at a cost of \$36,000. The preliminary report was finished by August 15, 1996 and presented to the Senate and House Government Operations Committees and later to the Joint Fiscal Committee. The committees approved a more in-depth study and after an RFP process, the Segal Company was again selected at a cost of \$99,000.

The State Treasurer's Office is now in the final stages of designing a program to offer some options to a group of State employees. Please see Appendix A for an outline of the plan.

E. STATUS OF TOBACCO DIVESTITURE

At the initiative of the State Treasurer, the three retirement boards have voted to divest their equity portfolios from companies that derive substantial revenues from the manufacturing and sale of tobacco products. As of December 31, 1997 all but one of the