January 14, 2002

To Members of the General Assembly:

This Annual Report is presented to assist you with a general overview of the State's financial condition in the particular areas of debt, investments and cash management, as well as other matters within the purview of the State Treasurer's Office. A general understanding of these issues will also assist the committees to examine the appropriations to the Treasurer's Office operating budgets as well as the appropriations for debt management.

The Appropriations and Institutions Committees, in cooperation with the Administration and this office, have been active partners in returning Vermont to fiscal stability and to a course of reducing the high debt burdens that the State had accumulated.

In recent years we began to trend down new authorizations of long-term debt to overcome Wall Street rating agency concerns. Consequently, the State has reduced its new authorizations in this decade from $83.4 million in FY '91 to $39 million in FY '02. As a result of this policy, the State's total debt decreased over the last five years from $536.2 million as of June 30, 1997 to $461.5 million as of June 30, 2001, a decline of 13.9%. Also more expensive financing mechanisms employed in the past, such as long-term capital lease obligations and certificates of participation, were refinanced with lower cost general obligation bonds. Total debt service - the amount appropriated to pay principal and interest on bonds – decreased by 6.66% to $70.0 million in FY'01 compared to FY'00 debt service of $75 million.

Between September 1999 and September 2000, the State's bond rating was upgraded by all three rating agencies. Standard & Poor's upgraded Vermont's rating from AA to AA+. Moody's Investors Service upgraded the State's rating from Aa2 to Aa1 and Fitch upgraded the State from AA to AA+. All three rating agencies recognized many improvements in Vermont's fiscal policies, financial management operations, debt burden, and uncomplicated debt management systems.

The 2001 Legislature reduced the $34 million debt authorization to $12 million by applying $22 million of surpluses to the projects in the FY'01 capital bill. The FY '02 capital bill authorized $39 million in long-term debt. The State issued $51 million in general obligation bonds in November and December of 2001.

As we prepare for fiscal year 2003, the Capital Debt Affordability Advisory Committee recommends that the State authorize new long-term debt in an amount not to exceed $39 million. This recommendation is consistent with the Committee's goal of maintaining a yearly issuance of $39 million into the foreseeable future because of the positive impact this level of debt issuance will have on the key debt indicators monitored by the Committee.

The State Treasurer is responsible for investment of the State's cash. The State's short-term portfolio earned nearly $13 million in interest income in fiscal year 2001, a yield of 5.5%, on an average daily balance of $232 million. This yield exceeded the average return on the three-month treasury bill auction rate of 5.1% The excellent yield on the State's short-term investments is attributable, in part, to the short-term investment program instituted by this office. Daily offerings are solicited from the institutional trading desks of dozens of national and local brokers in order to achieve the maximum rate of return and diversification in the portfolio.

The Abandoned Property Division of the State Treasurer's Office holds more than $16 million in unclaimed property, up from $12 million last year. Over $5 million in unclaimed property was turned over to the State in fiscal year 2001, compared to $2.2 million in fiscal year 2000, and nearly $2 million in claims were paid.

We are now confronting a period of economic and financial uncertainty. The recession has caused the loss of several thousand jobs in Vermont, along with shrinking revenues and investment returns. This will not be an easy session, but it’s essential that we maintain the progress we’ve achieved in recent years of moderating our debt and enhancing our credit ratings.

I look forward to working with the General Assembly to attain our shared goal of continued fiscal stability for the State of Vermont.

Sincerely,

James H. Douglas
State Treasurer

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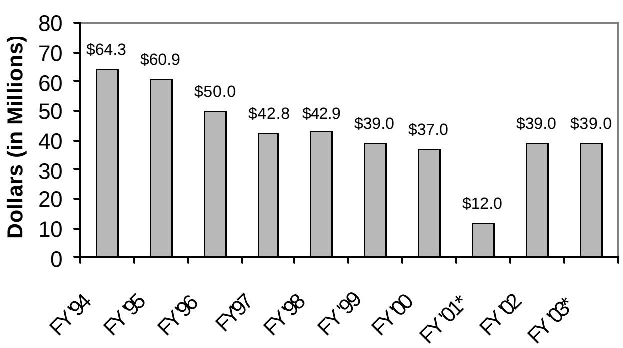
1. DEBT MANAGEMENT

A. GENERAL OBLIGATION DEBT

Since fiscal year 1995, the State Treasurer's Office, in conjunction with the Administration, has set a course to trend down new authorizations of long-term debt to overcome concerns of the major Wall Street rating agencies. Consequently, the State has reduced its new authorizations for general obligation debt from $73.7 million in FY '93 to $12 million in FY'01 and $39 million in FY'02, as shown in the following chart.

CHART 1
New Long-Term Debt Authorizations
FY '94 - FY '03

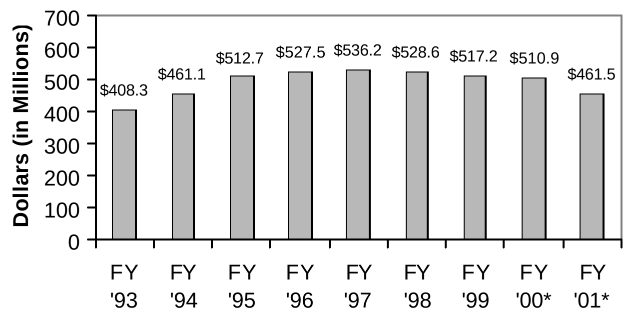


* Recommended

By lowering new authorizations the State of Vermont has begun to reduce its total level of outstanding long-term debt. The State's total debt decreased from $510.9 million as of June 30, 2000 to $461.5 million as of June 30, 2001, a decline of 9.7%., as shown in Chart 2 in the next column. In each of fiscal years 1999-2001, the State issued less general obligation debt than it retired.

In 1999, the Capital Debt Affordability Advisory Committee recommended a policy of maintaining a yearly issuance of $39 million of new debt into the foreseeable future because that level will have positive effects on key debt ratios monitored by the Committee. The State issued $37 million in general obligation bonds in FY'00, which represented the $39 million less $2 million in surplus allocated by the Legislature to the reduction of authorized debt.

CHART 2
Net Tax-Supported Debt Outstanding
FY '93 - FY '01



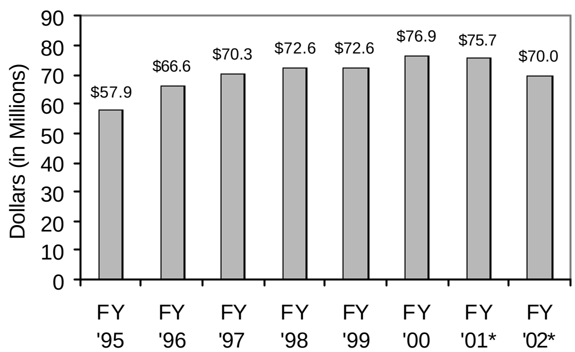
* Includes $6.64 million in bonds sold by VEHBFA on behalf of the Vermont Council of Developmental and Mental Health Services Acquisition Program.

For FY'01, the Committee recommended an issuance of $34 million that was $5 million less than the targeted annual issuance in order to compensate for a lease-purchase authorization by the 1999 Legislature for the Agency of Transportation. The $5 million lease-purchase authorization was repealed by the Legislature during the 2000 session and cash was appropriated. The Legislature allocated an additional $22 million in surplus cash to the reduction of authorized debt leaving a total of $12 million authorized for FY'01.

For FY'02, the Committee recommended, and the Legislature authorized, $39 million in general obligation debt. In November and December of 2001, the State issued $51 million in general obligation bonds. This represented the total of the authorized debt of $12 million for FY'01 and $39 million authorized for FY'02.

Total debt service, i.e. the amount appropriated to pay principal and interest on bonds, for FY'02 decreased by 6.66% to $70.0 million, compared to $75.1 million in FY'01. This decline comes after a 1.5% decrease in FY '01 and a 4.9% increase in FY'00. Future debt service payments will continue to fluctuate over the next decade and are not expected to show any steady decrease until FY'11, as shown in the following chart.

CHART 3
Net Tax-Supported Debt Service
FY '94 - FY '02



* Includes $6.64 million in bonds sold by VEHBFA on behalf of the Vermont Council of Developmental and Mental Health Services Acquisition Program.

B. THE STATE'S BOND RATINGS

Between September 1999 and September 2000, each of the three major credit rating agencies upgraded the State's general obligation bond rating. In September 1999, Moody's upgraded the State's rating from Aa2 to Aa1. In October 1999, Fitch upgraded the State from AA to AA+. In September 2000, Standard & Poor's upgraded the State's AA rating to AA+. This was the second upgrade by S&P in two years, as its previous upgrade from AA- to AA occurred in October 1998. Vermont now enjoys the highest bond ratings in New England.

Each rating agency cited several positive factors that were taken into consideration in the upgrades, including the following:

* Sound fiscal policies that have been consistently followed with conservative revenue estimates and moderate growth in spending limits;
* Strong financial performance with fully funded budget stabilization reserves;
* An uncomplicated debt management system with a nearly exclusive use of general obligation debt;
* A moderate and manageable debt burden that is declining due to rapid amortization schedules and reductions in the State's debt issuance, as well as the elimination of short-term borrowing;
* Successful implementation of school finance reform;
* Elimination of a $117 million contingent liability of the Vermont Home Mortgage Guarantee Board; and
* Strong capital planning that concentrates on using surpluses for capital projects and reducing future debt service costs.

Whenever the State of Vermont enjoys a higher rating it enhances the marketing of its long-term debt and should result in lower interest rates that the State pays to borrow money. It is also likely to reduce borrowing costs for municipalities that issue debt through the Vermont Municipal Bond Bank, as well as enhancing the State's reputation in the municipal marketplace.

Each of the three rating agencies affirmed its ratings of the State's general obligation debt during the $51 million bond issuances in late 2001. Factors cited by the agencies again included Vermont's fully funded reserves, expenditure levels that are under control, and substantial surpluses that have been applied to capital projects. The agencies further noted that the State's early intervention to address the decline in the economy by reducing expenditures, holding back on spending $6.5 million in one-time expenditures, and restraint in drawing on reserve funds were prudent and responsive reactions to the economic slowdown.

C. DEBT STATISTICS

In assigning a rating to a State, the rating agencies consider several key indicators. In 1995, the State, through the Capital Debt Affordability Advisory Committee, established guidelines for the State as acceptable ratios for these key debt factors. The Committee monitors the State's progress in meeting these guidelines annually and in formulating its recommendation of the total amount of long-term general obligation debt that the State can afford and should authorize each year. Several ratios continue to show improvement.

1. *Debt Per Capita*: One of the key debt factors monitored by the Committee is the ratio of the State's net tax-supported debt per capita. The guideline followed by the State establishes an acceptable ratio of debt per capita at $700 in 1995 dollars. Each year this figure is adjusted for inflation. After adjustment, the guideline for FY 2001 was $793 while the State's debt per capita ratio as of June 30, 2001 was $828, down from $925 in 2000. The State's ranking dropped from 9th to 15th. This is an improvement because the higher the ranking, the lower a state's debt per capita relative to all other states. Vermont's ranking is still relatively high with 35 states having less debt per capita than Vermont.

Currently for FY'02, the State's projected debt per capita of $758 is below the inflation-adjusted target of $793 for this year. After the issuance of $51 million in FY '02, assuming a continuing steady level of authorization of $39 million in future years, and employing the population forecast developed by Economic Policy Resources, the State's net tax-supported debt per capita is forecast to decrease each year and will be below the State guideline through 2012.

2. *Debt as a Percentage of Personal Income*: The State applies a guideline that the aggregate amount of projected State debt should not exceed five percent of projected State personal income. The State has steadily improved in this area and the State's ratio of debt to personal income for FY'01 dropped from 3.8% to 3.3%, the lowest level since 1990. The State's ranking in its debt as a percentage of personal income dropped from the 10th highest among the states in 2000 to 14th in 2001.

3. *Debt Service as a Percentage of Revenue*: The State remained in compliance in FY'01 with its established guideline with respect to a third key debt ratio – debt service as a percentage of revenues. The guideline used for this ratio states that projected annual State debt service on bonds should not be in excess of eight percent (8%) of projected revenues in the aggregate General and Transportation Funds during the next ten years. Debt service as a percentage of revenues ratio was at 6.5% as of June 30, 2001.

Because the State issued no new bonds in FY'01, and a higher amount than in recent years in FY'02, this dramatic improvement in the key debt ratios may not be sustained. Nevertheless, the rating agencies continue to view positively Vermont's conservative approach to debt management.

D. RECENT DEVELOPMENTS REGARDING NET TAX-SUPPORTED DEBT

As is evident from the above discussion, the amount of the State's overall tax-supported debt as defined by the agencies is a significant factor in the award of a credit rating. The

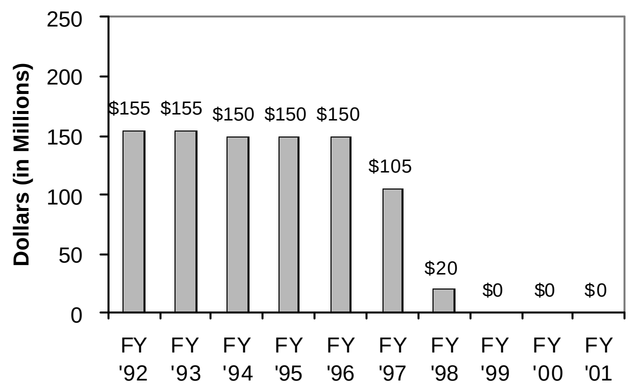
State's debt statement included, for the first time in 2001, $6.64 million of revenue bonds issued by the Vermont Educational and Health Buildings Financing Agency on behalf of the Vermont Council of Developmental and Mental Health Services Acquisition Program (hereinafter the Program). Providers in the Program are non-profit corporations formed to operate human services programs in the State for individuals in need of mental health and rehabilitation services. Because the State provides approximately 80% financial support through appropriation to the providers in the Program and the providers are delivering basic State services, the State's debt statement includes these obligations of the Agency as net tax-supported debt. One of the three rating agencies has concluded that although the bonds are not a legal state liability, because state appropriations are the predominant source of gross revenues of these providers and the providers deliver basic state services, the debt would be included in its calculation of net tax-supported debt when analyzing the state's credit.

As a result of this determination, an additional $17.5 million bond financing presented to the Vermont Educational and Health Buildings Financing Agency in FY'01 by the Program was deferred because of concerns it would increase the State's total net tax-supported debt by the amount of the borrowing. The Legislature also enacted 32 V.S.A. §711 last session that requires any entity that receives a majority of its operating expenses from either direct or indirect state appropriations to notify and obtain approval from the Governor and the State Treasurer prior to incurring any debt. The purpose of section 711 is to identify entities whose debt could affect the overall debt position of the State of Vermont prior to its issuance, to enhance the State's debt management practices with respect to the use and size of net tax-supported debt, and to protect the State's credit rating.

E. SHORT-TERM DEBT

The State has made great strides in the area of short-term debt. In the last three fiscal years, the State's strong cash position did not require the issuance of short-term debt. In the early 1990's, Vermont was issuing between $155 and $192 million annually, not including $65 million in deficit notes. See the following chart.

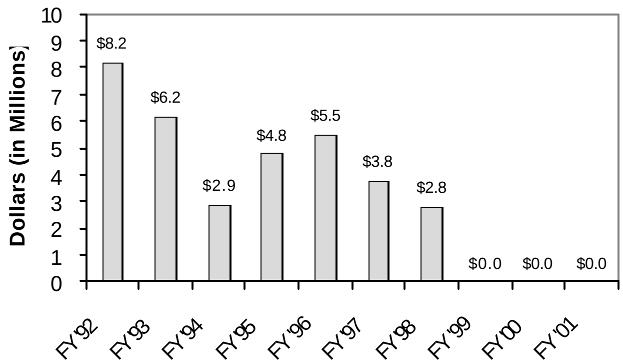
CHART 4
Short-Term Borrowing
FY '92 - FY '01



On numerous occasions the rating agencies expressed concern about why the State's cash flow position necessitated such high levels of short-term borrowing. The elimination of the need for short-term debt has been cited by all three agencies as a significant factor in their upgrades of the State's ratings. Besides the positive view held by the rating agencies, the State has saved significant money by avoiding interest charges on borrowed dollars as reflected in Chart 5 on page 5. The State's cash position in FY'02 has, to date, not been as strong as the past three years but no short-term borrowing is anticipated in the last half of FY '02.

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 on-going balanced budget), and a healthy budget stabilization reserve, so that seasonal or economic dips in revenue as well as heavy expenditures that do not match up precisely with times of heavy revenue collection are offset by this reserve. Vermont has achieved these two standards to require no short-term borrowing, and it is expected that the General Assembly will continue to maintain balanced budgets and fully funded reserves.

CHART 5
Interest Paid on Short-Term Borrowing
FY '92 - FY '01

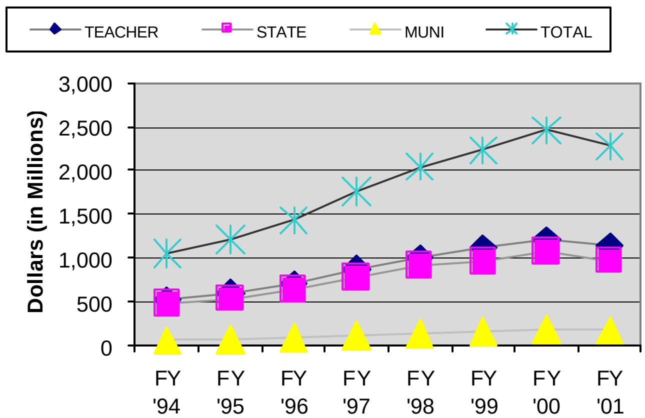


II. INVESTING

A. LONG-TERM INVESTMENTS

The State Treasurer's Office administers the investment policies and strategies adopted by the Boards of the Vermont State Retirement System, the State Teachers' Retirement System of Vermont, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of nearly $2.3 billion on June 30, 2001 that represents an increase of 59% for the past five years and a 9.7% average annualized growth rate. See Chart 6. A detailed statement of each plan's fiscal year 2001 assets including a comparison to fiscal year 2000 is attached as Appendix A.

Chart 6
Growth of Pension Assets
FY '94 - FY "01



In order to insulate the portfolios from short-term market fluctuations, the three pension systems employ diversified investment strategies, which enable each portfolio to maintain stability through market cycles of different asset classes. Each system's assets are invested in stocks, bonds and real estate with an additional small allocation to alternative investments, such as venture capital partnerships. These investment categories have imperfect correlations, so if one category is faltering, another may be doing exceedingly well. This strategy minimizes the effects of short-term volatility that occurs within each asset class and is totally different from market timing, in which an investor attempts to predict the ups and downs of various markets. In this strategy substantial losses can occur if the timing decision is incorrect.

Fiscal year 2001 was a difficult year for the financial markets. Pension system assets decreased by 4.5% for the State Teachers' Retirement System of Vermont and 8.5% for the Vermont State Retirement System. However, the assets of the Vermont Municipal Employees' Retirement System increased marginally, by 0.1%. Variations in asset growth among the three systems are dependent on many factors. Among them are cash flow requirements, differences in asset allocation and early retirement incentives. The Table below displays the asset distribution of the three retirement funds:

Table 1
Asset Allocation of Three Retirement Funds
Quarter Ending June 30, 2001

Investment Category	Municipal	Teachers'	State
Domestic Equity	41%	41%	44%
Domestic Fixed Income	31%	14%	19%
International Equity	18%	15%	17%
Global Fixed Income	0%	19%	9%
Real Estate	7%	10%	9%
Other	3%	1%	2%

For the five years ended June 30, 2001, the median public retirement plan in the United States had an average annualized total return of 10.6%, compared with 10.6% for the Vermont State Retirement System, 11.1% for the Teachers' System and 12.2% for the Municipal Employees' System.

B. SHORT-TERM INVESTMENTS

The State Treasurer's Office manages the investment of the State's cash in its short-term investment program. The short-term portfolio earned nearly $13 million in interest income in fiscal year 2001 on average daily balances of $232 million. Of this amount, $7.9 million was transferred to the general fund. The yield on the portfolio was 5.5% for the year which is 0.4% higher than the average three-month treasury bill auction rate of 5.1%. The Treasurer's Office solicits offerings daily from the institutional trading desks of dozens of national and local brokers in order to achieve the maximum rate of return and diversification in the portfolio.

The Federal Reserve Open Market Committee has reduced the discount rate five times since July 1, 2001. These interest rate cuts have had an impact on short-term earnings estimates for FY'02. For the six months ended December 31, 2001, total short-term interest income was approximately $3.5 million on an average daily balance of $222 million with an average investment rate of 2.85%, which compares favorably with the average three-month treasury bill auction rate of 2.57% for the same period. Following these rate cuts, the investment rate for the month of December was a mere 1.89%.

C. THE VERMONT TRUST INVESTMENT ACCOUNT

The 2000 Legislature authorized the establishment of a trust investment account administered by the State Treasurer for purposes of investing restricted funds with non-expendable principal balances. The State Treasurer issued a Request for Proposals to investment managers in the State of Vermont and chose three firms to manage the fund: NL Capital Management, Inc. of Montpelier for fixed income and Hanson Investment Management, Inc. of Burlington and Prentiss Smith & Co. of Brattleboro for equity. In FY'01, the fund was 90% invested in fixed income in order to generate increased income for distribution during the early years. Over time, it is anticipated that the allocation to equity will grow to 40 to 50 percent, in order to generate additional capital appreciation.

The Trust Investment Account was funded in July 2000 with a principal balance of approximately $24 million, of which $17 million was allocated to the Tobacco Trust Fund, $6 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. Market value of the total fund on June 30, 2001 was $26,520,548 which reflected an annualized yield of 11%. Additions to the fund in July 2001 included $1 million to the Higher Education Trust Fund and nearly $3.5 million to the Tobacco Trust Fund. The majority of this additional funding was divided between the two equity managers, which increased the overall equity allocation from 10% to 20% of the total fund and decreased the fixed income portion to 80%. For fiscal year ended June 30, 2001, the fund had a total return of 11.0% versus the return of the S&P 500 equity index of –13.6% and the Lehman Aggregate fixed income index of 10.2%. If these index returns are applied proportionately to the investment allocations of the trust account, the benchmark return is 7.8%.

D. VERMONT HIGHER EDUCATION ENDOWMENT TRUST FUND

The 1999 Legislature established a Vermont Higher Education Endowment Trust Fund and appropriated $6 million for the creation and management of the fund by the State Treasurer. On June 30, 2001, the fund had a market value of $6,679,449 for an annualized yield of 11.0%. In August of 2001, the State Treasurer authorized the distribution of 5% of the average market value of the assets over the prior five quarters equally among the University of Vermont, the Vermont State Colleges and the Vermont Student Assistance Corporation. Each received $107,103 to be applied as non-loan financial aid to Vermont students attending Vermont post-secondary institutions. The 2001 Legislature appropriated an additional $1 million to the corpus of the Higher Education Endowment Trust Fund for a total of $7 million.

In addition to the above disbursements from the fund, the Vermont Commission on Higher Education Funding authorized the Treasurer to make available an additional 2% distribution of $58,239.80 to be divided equally between the University of Vermont and the Vermont State Colleges for application to their respective permanent endowments. In FY'02, the additional 2% endowment allocation will be $64,262 for each institution, provided that it is matched on a two-to-one basis by external donations for endowment purposes by the end of FY'02. A copy of the State Treasurer's Annual Report to the Commission on Higher Education Funding is attached as Appendix B.

E. TOBACCO LITIGATION SETTLEMENT FUND AND THE TOBACCO TRUST FUND

In November 1998, Vermont was one of 46 states to enter into a settlement agreement with four major tobacco companies. The State's estimated share of settlement payments at the time was expected to total $806 million over the first 25 years of payment and an additional $156 million of strategic contribution payments to be paid between 2008 and 2017. To date the State has received payments that total $65,892,203.82.

Pursuant to the Agreement, the expected settlement amounts are adjusted for inflation and the effect of any decreases in the sale of tobacco products to the base year. To date, these have accounted for a 13% decrease. It remains difficult, therefore, to predict the amount of the future payments due from the tobacco settlement that will be received by the State. According to the Master Settlement Agreement with tobacco companies, Vermont's expected and actual receipt of settlement funds are as follows (in millions):

	Expected	Actual
FY 1999	$36.23	$33.21
FY 2000	36.23	33.21
FY 2001	28.47	24.68
FY 2002	34.18	29.06*
FY 2003	34.51	
FY 2004	28.80	

*Estimated ($8 million received to date)

In FY'00, the Vermont Legislature established a Tobacco Litigation Settlement Fund to be administered by the State Treasurer. For FY '02, the Legislature appropriated $17.25 million (the same as FY'01) to healthcare services and $7.41 million to programs in the Health and Education Departments for tobacco enforcement**,** prevention and education programs. The remainder of the receipts were added to the separately established Tobacco Trust Fund, a trust established to eventually endow the education and prevention programs. The Trust balance at the end of FY '01 was $19.3 million plus an additional appropriation of $3.9 million for a total of $23.3 million. Initial projections are for another $4.4 million to be appropriated for addition to the fund by the end of FY'02**.**

F. VERMONT VETERANS' HOME

By legislative act, the Vermont Veterans' Home was required to transfer its endowment fund to the State Treasurer for management. In September 2002, the Home transferred $455,441.85 to the State. The legislation allows the State Treasurer to invest these funds, if appropriate, with the long-term investments in the Investment Trust Account. The funds are currently invested with the State's short-term investments until a spending policy for these funds is established by the Board of Trustees for the Vermont Veterans' Home. A transfer of some or all of the funds for long-term investment in the Investment Trust Account may be appropriate once that policy is established.

III. RETIREMENT

A. OVERVIEW

The State Treasurer's Office administers three statutory pension systems: the State Teachers' Retirement System of Vermont with 10,264 active and 3,812 retired members as of June 30, 2001; the Vermont State Retirement System with 7,587 active and 3,563 retired members; and the Vermont Municipal Employees' Retirement System, with 4,814 active and 856 retired members. Both the State Teachers' Retirement System of Vermont and the Vermont State Retirement System are funded by employee contributions as well as those made by the State. The Vermont Municipal Employees' Retirement System involves no State money.

The administration of the three systems has grown in both size and complexity over the years. With the aging workforce, the administrative requirements of the programs are expected to increase for the foreseeable future. The Vermont Municipal Employees' Retirement System would be more appropriately administered through the municipalities themselves. This is not a new initiative. The Senate passed S. 99 during the 1997-98 Legislative Session that created an intermunicipal retirement system to assume the administration of the Vermont Municipal Employees' Retirement System. The reallocation of the time and effort dedicated to this program would alleviate many of the increasing pressures the Treasurer's Office currently faces in the administration of the State and Teachers' Retirement Systems. Although there are no immediate general fund savings associated with this transfer, future savings certainly can be expected through the deferral of new positions and costs, which will become necessary as our workforce continues to age and retire at an increasing rate. The State Treasurer expects to support this initiative in the 2002 Legislature.

B. FUNDING OF THE RETIREMENT SYSTEM

Pursuant to Governmental Accounting Standards Board Statement No. 25, the funding status of the State and the Teachers' Retirement Systems has improved (see Table 2), although the two largest systems remain actuarially underfunded. The General Assembly has appropriated less than the actuary's recommended contribution to the Teachers' System throughout the past decade. The higher than average investment returns of the past five years have improved the funding levels of the systems, despite the disappointing returns over the last year, largely due to the smoothing method utilized by the system's actuary.

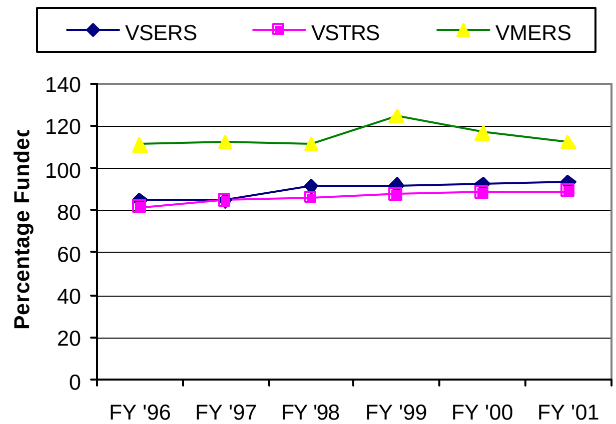
Table 2
Percent Funded Using GASB Opinion No. 25

	Teachers'	State	Municipal
Actuarial Value of Assets	$1,116,845,541	$954,821,086	$177,927,581
Actuarial Accrual Liability (AAL)	$1,254,341,000	$1,026,993,000	$158,786,000
Unfunded AAL (UAAL)	$137,495,648	$72,171,779	($19,141,542)
Funded Ratio	89.0%	93.0%	112.1%

A comparison of the funded status in recent years is contained in Chart 7 in the next column.

Based upon the actuarial recommendation, the Treasurer has requested $23,197,088 in FY'03 for the State's contribution to the Teachers' Retirement System and a $9,711,513 contribution to the State Retirement System.

CHART 7
Analysis of Funding Progress Using GASB Statement No. 25
FY '96 - FY '01



C. DEFERRED COMPENSATION PROGRAM

The Board of Trustees for the Vermont State Retirement System administers a deferred compensation program that has been available since 1973 as a savings option for State employees, municipal employees, employees of agencies such as VSAC, VEDA and VHFA, and members of the General Assembly. In calendar year 2002, a plan participant may defer up to $11,000 per year of his or her annual compensation and invest that money in one or more of the 15 mutual funds offered in the plan. This maximum contribution amount was increased from $8,500 effective January 1, 2002. On June 30, 2001, the plan had 4,668 State participants and 202 local participants for a total of 4,870 participants. As of June 30, 2001, total assets in the plan were valued at $138 million. Contributions in the amount of $10.97 million were made to the plan by participating employees during FY'01. Because the deferred compensation plan qualifies as a section 457 plan under the Internal Revenue Code, the portion of salary that is deferred is not taxed at the time of deferral. The Board of Trustees for the Vermont State Retirement System adopted a policy to waive fees for new enrollees in the plan after January 1, 2001 for the first full year of enrollment. This is one way to encourage participation in a plan that decreases taxable income during active employment and increases savings for retirement.

D. Defined Contribution Retirement Program

In 1998, the General Assembly offered active exempt State employees the option of remaining with their existing defined benefit plan or transferring their accrued benefits to a newly established defined contribution plan. Out of a pool of 806 eligible exempt employees, 349 (43%) elected to leave their State retirement defined benefit plan and transfer to the defined contribution plan whereby employees select from a menu of investment options. Exempt employees hired on or after January 1, 1999 are given the option of choosing between the two retirement plans. In 1999 the defined contribution plan was extended to terminated, vested State members who were exempt employees at the time of separation from service. Of the 51 eligible vested members, 45 elected to transfer to the DC plan. The defined contribution plan has continued to grow in terms of total participants. At June 30, 2001, the plan had 514 participants, an increase of 11% from FY'00, and a total market value of $27,672,298.

In calendar year 2001, 111 new exempt employees entered the State's workforce. Thirty-seven (37), or 33%, chose the defined contribution plan; 43, or 39%, defaulted to the defined benefit plan and 31, or 28%, have not yet made an election.

Under the defined contribution plan, which is modeled after private sector 401(k) plans, employees contribute 2.85% of their annual salary to their individual accounts. The State makes a fixed contribution of 7% to each employee's account. Employees are responsible for making all investment decisions regarding contributions among investment options selected by the Treasurer. At retirement or termination, employees receive the amount of contributions in their account, plus investment earnings. The defined contribution plan provides portability for an increasingly mobile workforce. It also reduces the unfunded liability for the State because the State does not assume the liability of a future pension benefit.

The Vermont Municipal Employees' Retirement System was given statutory authority in 1999 to approve a defined contribution plan for its members. The Board implemented a defined contribution plan on July 1, 2000. The plan provides the employer municipality with the first option of deciding whether to offer a defined contribution plan to its employees. Once a municipality elects to offer the plan to all eligible employees or to specific employment groups, an individual employee has the choice to remain with the defined benefit plan or transfer to the new defined contribution plan. New employees of municipalities offering both a defined contribution plan and a defined benefit plan will have a choice of either plan. During the first year, 62 employers offered the plan to approximately 800 employees. Two hundred (200), or 25%, elected to transfer to the DC plan effective July 1, 2000.

In FY'01, 177 new municipal employees were offered the VMERS optional defined contribution plan. Fifty-two (52), or 30% chose the defined contribution plan and 125, or 70% elected or defaulted to the defined benefit plan.

The State's experience with the defined contribution plan offered to exempt and municipal employees shows a strong interest on the part of employees in such a plan. The benefits to the employee of portability, the freedom to develop an investment portfolio that meets individual needs, the ability to pass the money to one's heirs, and the potential for higher investment returns and higher benefits at retirement have proven attractive. The State also benefits from offering a defined contribution plan not only because it has no future liability for benefit payments for those who choose the plan, but because the plan presents an attractive recruitment benefit for those who may not desire to remain in public employment for the duration of their careers. Providing potential employees with the option to choose a plan that best suits their career goals makes the State more competitive with the private sector. Moreover, fewer current employees with longevity will feel tied to jobs where they have reached a career plateau solely because it makes no economic sense to leave due to the structure of the defined benefit plan.

To date, the Legislature has made the defined contribution option available only to exempt State employees and municipal employees. The State's classified work force and the State's teachers should be provided the same option. Prior to the 2001 legislative session, the Vermont State Employees Association (VSEA), the Vermont National Education Association (VT-NEA) and the State Treasurer met and explored the optimal characteristics of a defined contribution plan for those two employee groups. Consensus was reached that a defined contribution plan as an optional retirement plan, if properly designed, could be beneficial. Recommended characteristics of the plan include:

1. The same employer contribution rate of 7% that is provided to exempt employees;
2. Oversight of the plans by the retirement board for the respective groups;
3. A one-year election window during which employees could choose between the defined benefit and defined contribution plans;
4. A significant educational component regarding the two plans;
5. Cost neutrality to the DB plan.

H. 368, *An Act Relating to a Defined Contribution Plan for State Employees and Teachers*, that incorporates the characteristics outlined above, is currently pending in the House Government Operations Committee.

E. LEGISLATIVE SUMMER STUDY

A legislative study committee was created during the 2001 session to perform a comprehensive study of the eligibility criteria for plans within the Vermont State Retirement System. The committee reviewed all positions in state government in order to recommend which members of the system are most appropriately included in each plan. Specifically, the committee's mandate was to:

(1) determine which state employees should be required to retire at age 55;
(2) determine the need to combine, eliminate, or create a new retirement plan or plans to include those employees which warrant early retirement consideration;
(3) conduct a study of the feasibility of transferring state law enforcement officers and state firefighters hired before July 1, 2000, into the group C plan.

The committee was comprised of two members of the House Committee on Government Operations, one member of the House Committee on Appropriations, three members of the Senate Committee on Government Operations, the Commissioner of Personnel, the State Treasurer, or designee, two representatives of the Vermont State Employees' Association, the Director of Retirement, the Chair of the Vermont State Retirement System Board of Trustees, and the Commissioner of Finance and Management, or designee.

The Committee concluded that the statutory definition of law enforcement officers who can be subject to mandatory retirement and the requirement for certification were appropriate and defensible under federal age discrimination law. The Committee further concluded that physical fitness requirements should be imposed on Group C members. The Committee will not recommend the addition of a new retirement group at this time although it did recommend that direct care providers at the Vermont Veterans' Home and the Vermont State Hospital be allowed to retire after 20 years in those positions with no early retirement adjustment.

The Committee reviewed the feasibility of transferring all law enforcement officers and firefighters hired before July 1, 2000, now Group F members, into Group C and concluded it would most likely be cost prohibitive to consider such a transfer at this time. A majority of the Committee voted to recommend a one-time option to join Group C to these individuals hired before July 1, 2000. The Treasurer and Director of Retirement did not favor this recommendation. Optional membership in a particular retirement group is not advisable as it diminishes the planning and cost control elements of a retirement plan and erodes the employer's ability to determine the structure and affordability of benefits. Over the years, the Legislature has enhanced many of the retirement benefits available to state employees. These benefit changes have been generally made effective prospectively, and not retroactively. To allow one group of employees to opt for an enhanced benefit will set a precedent when other groups that may have been previously ineligible for an enhanced benefit seek a similar option. The Committee's full recommendations are included in a separate report presented to the General Assembly.

F. One-Time Stipend for Military Service

Legislation was enacted effective July 1, 2001 that provided a one-time stipend of $500.00 for each year, up to a maximum of three years, to retired members of the State and Teachers' Retirement Systems who served in the military during World War II, the Korean or Vietnam Conflicts. In order to qualify for the stipend, a retiree must have served, prior to becoming a member, a minimum of one year of full time service in the military during the periods December 7, 1941 through December 31, 1946, June 25, 1950 through January 31, 1955, or August 5, 1964 through May 7, 1975, for which the retiree had derived no military pension benefits other than for non-regular (guards or reserves) service. In addition, the retirees must have retired before the military service was available as a grant to active members.

Almost 600 applications have been filed since July 1, 2001 with the Retirement Office. Eligible retirees have until June 30, 2002 to apply for the one-time stipend. To date, a total of $410,463 has been paid to over 373 State retirees, and $139,565 to over 160 Teacher retirees. Applications continue to be received, and there are approximately 50 pending applications that are currently being processed. Assuming most eligible retirees have applied for the stipend already, the final payout figure for both systems is expected to be approximately $600,000.

IV. Abandoned Property

The primary function of the Abandoned Property Division is to locate and return money and other property to its rightful owners or their heirs. This property is most often in the form of money, but it can also be securities, mutual funds and contents of safe deposit boxes. This property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers and governmental agencies throughout the United States. The State of Vermont acts as custodian to safeguard it until it can be claimed by its rightful owners or heirs.

Currently, more than $16 million of unclaimed property is held by the State Treasurer. In FY'01, holders of unclaimed property turned over $5 million to the Abandoned Property Division. This is an increase of nearly $3 million from FY'00. There are several reasons for this increase. Several years ago the Treasurer's office initiated an amnesty program that allowed holders to report for the first time without fear of receiving a penalty. This was highly successful and encouraged holders to report every year. The Abandoned Property Division also stepped up its outreach program to holders. Holder information is now posted on the Treasurer's website and holders are able to print out reporting forms.

The Abandoned Property Division paid a total of $2 million in claims in FY'01. The average claim paid was $651.99. The largest claim paid was $404,000.00.

Vermont makes a diligent effort to locate missing owners and reunite them with their lost assets. The help of town clerks and state legislators has been enlisted and the names of owners have been posted on the internet. In FY '00, the Treasurer's Office was one of the first states to be linked via the internet to a central national website through which the public can more easily access the office's website. Users of the State's website now have the ability to download reporting and claim forms. Thousands of "owner" letters are sent each year, the office staffs a booth at the Champlain Valley Fair, and owners' names are published annually in newspapers around the State as required by statute. Reciprocity with other states in order to return abandoned property to the state in which the owner most recently lived has also proved effective in returning property to its rightful owner as quickly as possible. It also allows holders to report only once instead of reporting to multiple states.

V. AUDIT COMPLIANCE

In fiscal year 1999, an Audit Compliance Division was created within the State Treasurer's Office. This Division conducts independent reviews of the diverse operations and controls within the office to determine whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically in reaching the organization's objectives.

This year, with the implementation of the new accounting system, VISION, the Division has been conducting a post-audit of the office's expenditures on a daily basis and assisting in solving problems as they are discovered in the new system.

The Division continues to assist the Accounting Division in reviewing the more than 250 departmental cash accounts. A format for controlling these accounts has been implemented and additional financial disclosure has been prepared for the State's Comprehensive Annual Financial Report (CAFR).

In addition, the Division has been actively involved in reviewing the work performed by the State's contractor who provides the accounting for the State's pension funds. Some adjusting entries were necessary to incorporate all the financial data on an accrual basis for the State's CAFR.

VI. FINANCIAL MANAGEMENT

A. ELECTRONIC BANKING/PAYMENTS/ TRANSFERS

The State Treasurer's Office encourages electronic transmissions of such items as vendor payments, payroll, welfare and other benefits. Most payments to municipalities are now handled electronically. In August 1999, the Department of Taxes began a program to receive tax payments electronically. In 2002, it will offer electronic payment of refunds to some taxpayers. Our goal continues to be to increase the proportion of financial transactions that occur electronically.

The Treasurer's Office has encouraged State employees and retirees to authorize direct deposit of their paychecks and retirement checks. Direct deposit is a more efficient, less costly and safer method by which to transfer funds. In December 2001, 78% of retired municipal employees, 86% of retired State employees, and 89% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2000 percentages of 77%, 84%, and 86% respectively. Currently 6,683 State employees, or 75%, have their biweekly pay deposited directly to their bank accounts.

B. PROJECT VISION

The Department of Finance and Management implemented a new financial management system, Project VISION, on July 1, 2001. The system has posed many challenges to the Treasurer's Office and has delayed completion this fiscal year of some treasury functions, such as reconciliation of bank accounts. The Office is working closely with the Administration to insure the continued development of report capabilities and processes necessary for the Treasurer's Office to do its work.

The Treasurer's Office is seeking the conversion of a limited service Accountant B position to a full-time position in its FY'03 budget. This position is essential to the added responsibilities of the Treasurer's Office as a result of Project VISION.

The Treasurer's Office now produces daily vendor payments whereas, under FMIS, the checks were produced by CIT. The Treasurer's Office upgraded its printing equipment and produces pressure-sealed, as opposed to heat-sealed, vendor checks. This has proved to be a more efficient process that results in fewer damaged checks and delays. With the upgrade of its printing equipment, the Treasurer's Office has converted its printing of state payroll checks to a pressure-sealed process which has replaced the prior process that required staff to print, fold and stuff the biweekly payroll checks. Payroll checks are now produced in a matter of hours. Although direct deposit by all state employees is by far the most efficient method of disbursing payroll, the new equipment has brought greater efficiency to the production of paper checks.

C. BANKING SERVICES

Effective July 1, 2001, the State's master banking services were awarded, after a competitive bid process, to the Howard Bank. The Howard Bank's performance to date has been satisfactory and Bank personnel have worked thoughtfully and diligently to provide secure and efficient services to the State. As a part of the conversion process, the Howard Bank assisted, where possible, in consolidating the over 100 accounts opened over the years by state departments without approval from the Treasurer's Office. They have also provided the appropriate collateralization for all Bank-North accounts.

D. Interaction With the Auditor of Accounts' Office and Compliance With Audit Findings

Interaction with the Auditor of Accounts' office is essential to improvements in the State's financial reporting systems. The Auditor's office has offered financial reporting recommendations over the years that have proven helpful. In addition, every audit finding is taken seriously and, since the Treasurer's Office handles more than $4 billion of retirement and State funds, its Audit Compliance Division is used to ensure proper financial controls. The number of audit findings relating to the Treasurer's Office has declined significantly in recent years.

E. Act 60 Receipts

The Treasurer's Office monitors the receipt of payments mandated by Act 60 after the Departments of Education and Taxes have notified towns and school districts of their respective liabilities. In FY'01, all towns and school districts eventually made their Act 60 payments with the exception of the Town of Victory. Victory has not made Act 60 payments since December 1, 1999 and the Vermont Tax Department has filed suit against the town in an effort to obtain compliance with Act 60's requirements.

To date, in addition to Victory, one school district, one unorganized town, and one town have not yet made their FY'02 Act 60 payment that was due on December 1, 2001. The Treasurer's Office is in the process of conferring with these entities to encourage compliance and calculating the interest on the late payments. As in the past, unresolved delinquencies will be referred to the Attorney General for collection.

VII. Legislative Reporting Requirements

A. Brandon Training School

Section 23 of Act 62 (Capital Bill) of the Public Acts of 1995 specifies that the State Treasurer notify the chairs of the Senate and House Institutions committees upon receipt of monies from the sale of the Brandon Training School property as well as certain federal receipts associated with the Vermont Veterans' Home. The State has received amounts due from the federal government for reimbursement of expenses associated with the Vermont Veterans' Home, and received $32,100 from sale of property belonging to the Brandon Training School.

B. McBride Principles

Act 50 of the Public Acts of 1989 specifies that the State Treasurer and the Retirement Boards compile a list of corporations that conduct business in Northern Ireland in which the State Treasurer and Retirement Boards have invested funds. Notification from external investment managers is due in the Treasurer's Office on January 1 of each year. This list is available for examination in the State Treasurer's Office.

C. Burma (Myanmar)

Act 13 of the Public Acts of 1999 specifies that the Treasurer shall implement the purposes of the Act by voting in favor of shareholder resolutions concerning an individual company's doing business with the government of Burma. In addition, the Treasurer shall separately notify the company that Vermont wishes to convey its grave concerns regarding the company's economic ties to the government of Burma. The Treasurer has complied and continues to comply with his obligation under this statute.

VII. LEGISLATIVE PROPOSALS FOR 2002

The Treasurer will recommend the following legislation to the 2002 General Assembly:

A. CREDIT CARD PROGRAM

The Treasurer recommends that the Legislature consider a single statute giving all State agencies and departments the authority to accept credit card payments for fees, licenses, and other payments, rather than the piecemeal department by department approach used to date. The proposal places oversight of the credit card program in the Treasurer's Office which would negotiate bank contracts on behalf of all the departments. H. 77, *An Act Relating to State Agency Acceptance of Credit and Debit Card Payments*, passed the House in 2001 and is pending in the Senate Finance Committee.

B. DEFINED CONTRIBUTION PLAN (SEE DISCUSSION IN SECTION III-D)

H. 368, *An Act Relating to a Defined Contribution Plan for State Employees and Teachers*, is currently pending in the House Government Operations Committee. H. 368 provides for an optional defined contribution plan for all state employees and teachers.

C. AMENDMENTS TO 32 V.S.A. §711 (SEE DISCUSSION IN SECTION I-D)

The Legislature enacted 32 V.S.A. §711 in the 2001 session that requires any entity that receives a majority of its operating expenses from either direct or indirect state appropriations to notify and obtain approval from the Governor and the State Treasurer prior to incurring any debt. The purpose of section 711 is to identify entities whose debt could affect the overall debt position of the State of Vermont prior to its issuance, to enhance the State's debt management practices with respect to the use and size of net tax-supported debt, and to protect the State's credit rating. There is some concern that the reach of section 711 may unnecessarily include entities such as towns and school districts. The State Treasurer's Office, in concert with the Administration, will consider whether §711 could be amended to clarify its reach, in particular by exempting municipalities and school districts, without affecting the intended purpose of the act.

D. TRANSFER OF ADMINISTRATION OF VERMONT MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM (SEE DISCUSSION IN SECTION I-A)

The State Treasurer supports the transfer of administration of the Vermont Municipal Employees' Retirement System to the municipalities themselves. The reallocation of resources currently dedicated to this program would enable the Treasurer's Office to alleviate the increasing pressures in the administration of the State and Teachers' Systems because of the aging workforce and increase in retirement rates. Future savings to the State can be expected through the deferral of new positions and resulting costs necessary to address these increasing demands in those two systems.