LFA
LEGISLATIVE FISCAL ANALYST

INTERIM REPORT: PROPRIETARY AND OTHER FUND TYPES

EXECUTIVE APPROPRIATIONS COMMITTEE OCTOBER 14, 2008

EXECUTIVE SUMMARY

The purpose of this report is to examine and make recommendations regarding significant fund types used by the State of Utah. Previous 2008 Interim reports have already examined fees, restricted funds, special revenue funds, and nonlapsing balances. This report will focus on proprietary funds and miscellaneous other governmental funds.

This report examines four fund types: Internal Service Funds, Enterprise Funds, Capital Projects Funds, and Debt Service Funds. The report makes the following recommendations:

Recommendations for Internal Service Funds

- Consider formalizing the policy that internal service funds may reduce rates in the interim between legislative general sessions and require notification to the Legislature of any rate changes and potential cost savings to agencies.
- Consider requiring ISFs to report contractor positions in their annual budget submissions and/or change statute to include contractor positions in the annual FTE appropriation by the Legislature.
- Consider changing the make-up of each of the three internal service fund rate committees.
- Consider changing the policy from "acquisition" to "purchase" when describing the requirement for lapsing capital outlay authority.

Recommendations for Capital Projects Fund

- Consider requiring that interest on former Education Fund dollars in the Capital Projects Fund be returned to the Education Fund.

Recommendations for Debt Service Funds

- Consider dividing the debt service line item into two line items: one for general obligation bond debt service, the other for State Building Ownership Authority lease revenue bond debt service.

INTRODUCTION

Proprietary and governmental funds are groups, each containing various fund types. The fund types examined in this report include:

Fund Group	Fund Type
Proprietary Funds	Internal Service Funds
	Enterprise Funds
Governmental Funds	Capital Projects Fund
	Debt Service Fund

Proprietary fund types contain multiple funds; that is, the state maintains various internal service funds and enterprise funds.

This report reviews each fund type in depth and provides definitions, explains purposes, lists programs or funds under each fund type, explains unique circumstances, and provides recommendations.

INTERNAL SERVICE FUNDS

Purpose and Operation of Internal Service Funds

Internal service funds (ISFs) are funds created by the state to account for services provided by one state agency to another. ISFs employ business practices and are set up on a cost-reimbursement basis to take advantage of economies of scale. The purpose of an ISF is to avoid duplication of effort and to accurately identify costs of services. Internal service funds do not accrue interest (with the exception of Risk Management which accrues interest earnings on reserves for self-insurance purposes).

An internal service fund sets its rates to recover the full cost of providing a particular service. A rate committee meets annually to approve rates for each of the six statewide internal service funds. The Legislature then deliberates on and gives final approval of the rates through an appropriations bill.

Internal service funds operate more like businesses than government agencies. The statewide ISFs maintain balance sheets, income statements, and cash flow statements. They may also borrow from the General Fund, repay loans to the General fund, accrue retained earnings, and post losses.

The Governor and the Legislature build the costs of the statewide internal service funds into the base budgets of user agencies. As rates increase or decrease each year, the Governor and Legislature typically add or subtract the rate impact from the user agencies' budgets.

State of Utah Internal Service Funds

The State of Utah maintains six statewide internal service funds that operate as divisions within the Departments of Administrative Services (DAS), Human Resource Management (DHRM) and Technology Services (DTS):

- *Purchasing and General Services* (DAS) provides mail and distribution, print, and electronic purchasing services to state agencies.
- *Fleet Operations* (DAS) manages vehicles statewide including fuel, maintenance, repair, and replacement.
- *Risk Management* (DAS) self-insures the state for liability, property, and auto insurance; and contracts for Workers' Compensation.
- *Facilities Management* (DAS) operates and maintains over 190 state facilities
- *Human Resource Management* (DHRM) provides human resource services including classification, recruitment, and performance management.
- *Technology Services* (DTS) provides all information technology services to state agencies including application maintenance and network administration.

The following table compares the state's six internal service funds as related to revenue, profit or loss, General Fund (GF) borrowing, retained earnings, working capital, number of Full-Time Equivalents (FTEs), and capital outlay expenditures.

Internal Service Fund Financials FY 2007							
	Revenue	Profit/Loss	GF Borrowing	Retain. Earn.	Working Cap.	FTE	Cap. Outlay
General Services	13,811,300	2,500	2,779,300	1,449,100	(2,869,000)	50.1	1,399,300
Fleet Operations	61,671,700	4,367,500	19,460,300	10,599,400	(11,421,900)	35.1	13,018,600
Risk Management	38,313,500	(784,000)	2,664,200	7,211,000	42,428,400	25.4	7,211,000
Facilities Management	20,586,300	(698,100)	0	166,500	65,300	122.3	49,800
Human Resource Mgt	11,297,100	390,800	0	390,800	374,800	152.5	0
Technology Services	124,132,500	(3,702,000)	9,960,500	7,153,800	1,247,200	839.6	4,583,500

Table 1

In addition to the six statewide ISFs, the following agencies use an ISF to manage certain services internal to the agency:

- the Department of Human Services (General Services) – which DHS plans to dissolve soon;
- the Department of Natural Resources (Central Warehouse); and,
- the State Board of Education (General Services).

Legislative Oversight of Internal Service Funds

In order to control the size, mission and fees charged to state agencies, the Legislature imposes statutory controls (UCA 63J-1-306(3)) that require ISFs to respond to the legislative budget process. No ISF can bill another agency for its services unless the Legislature has:

- approved the ISF's budget request;
- approved the ISF's rates, fees, and other charges, and included those rates and fees in an appropriations act;
- approved the number of FTEs as part of the annual appropriation process; and,
- appropriated the ISF's estimated revenue based upon the rates and fee structure.

Furthermore, no capital acquisitions or transfers can be made by an ISF without legislative approval.

General Fund borrowing (long-term debt) is authorized as long as the debt is repaid over the useful life of assets and borrowing does not exceed 90 percent of the ISF's capital assets. Working capital should come from the following sources in priority order:

1. operating revenues;
2. long-term debt; and,
3. legislative appropriations.

Utah statute (UCA 63J-1-306(4)) specifically prohibits internal service funds from increasing rates without legislative approval unless a new service or product is established in the interim between general sessions. The statute does not, however, address approval for lowering the rates. Internal service funds interpret the statute to allow them to lower rates in the interim between general sessions. The Legislature may want to formalize this policy in statute and require ISFs to notify the Legislature and the Governor of any rate changes and potential cost savings in agency budgets resulting from such changes.

The current statute requires ISFs to request and report FTE counts and increases to the Legislature; which then appropriates an annual FTE count for the ISF. The statute, however, does not require the reporting of contractor FTE positions. In practice, many ISFs contract out positions for short-term projects instead of hiring state employees. Using contractors increases flexibility for short-term projects; however, it could also be a way to get around legislative FTE caps. The Legislature may wish to have ISFs include contract

employees in their annual budget submissions and may even wish to go so far as to include them in the appropriated FTE count.

Internal Service Fund Rate Committees

Three rate committees, one for each department (DAS, DHRM, and DTS), oversee the six statewide internal service funds. Each of the three rate committees consists of at least six members: three user agencies, the director of Finance, the director of the Governor's Office of Planning and Budget, and the director of the department that manages the internal service fund. The rate committees hold annual hearings where the internal service funds present their accomplishments, budgets, and requested rates for the coming budget year. Agencies have commented that they see a potential conflict of interest in having the directors of the managing departments as members of the rate committees. In some cases the agency director actually chairs the committee and creates the perception that he or she is voting for and encouraging other committee members to vote for his or her own agency rates.

The Legislature may wish to consider changing the make-up of each of the three rate committees. One option is to replace the department director of the internal service fund with a fourth user agency. A second option is to make the ISF department director an ex-officio member of the committee that can neither chair the committee nor vote on the rates. A third option is to simply enlarge the committee to include four or more user agencies.

Internal Service Fund Challenges

Internal service funds have a large time lag between when rates are set and when they take effect. The rate committees meet to set rates in August of the year previous to when the rates go into effect. The Legislature officially approves the rates through legislation; usually in the last weeks of general session (February). Rates become effective July 1 and are set for the entire fiscal year (until June 30). Few private businesses could operate on prices set more than one year before goods or services are sold or on the inflexibility of prices set for an entire year regardless of cost increases. Internal service funds must manage these challenges with retained earnings and the ability to borrow from the General Fund.

As mentioned previously, the Legislature approves an annual amount of capital outlay authority that internal service funds may use to acquire capital assets. As per the Budgetary Procedures Act, this authority lapses at the end of a fiscal year if the "acquisition" does not occur in the fiscal year for which the authorization was given. In general this policy works for most internal service funds. The Division of Fleet Operations, however, faces a unique difficulty in the purchase of vehicles. Due to the volume of vehicles purchased by the state, the state contracts directly with the vehicle manufacturer to actually build (not just buy off of a lot) a specified number of vehicles. The delivery of those vehicles often occurs after the next fiscal year (July 1), which cuts into the division's capital outlay for the next fiscal year. One possible option the Legislature may wish to pursue is to change the statute from "acquisition" (which implies delivery) to "encumbrance" when describing the requirement for lapsing capital outlay authority.

Recommendations for Internal Service Funds

- Consider formalizing the policy that internal service funds may reduce rates in the interim between legislative general sessions and require notification to the Legislature of any rate changes and potential cost savings to agencies.
- Consider requiring ISFs to report contractor positions in their annual budget submissions and/or change statute to include contractor positions in the annual FTE appropriation by the Legislature.
- Consider changing the make-up of each of the three internal service fund rate committees.
- Consider changing the policy from "acquisition" to "purchase" when describing the requirement for lapsing capital outlay authority.

ENTERPRISE FUNDS

The state has various classifications of enterprise funds, including revolving loan funds, alcoholic beverage control funds, Utah Correctional Industries funds, housing loan programs, and State Trust Lands Administration funds. This report will focus on the most prevalent, revolving loan funds. The other classifications receive thorough review during each general session.

Revolving Loan Funds have been established by the Legislature to assist the public with water management, clean fuel vehicle uses, healthcare workforces, transportation programs, agriculture, and petroleum storage tanks.

Current state sponsored loan funds include:

Utah Rural Rehabilitation Fund (UCA 4-19-3): Established as a lender of last resort used for real estate, farm operations, youth and educational loans, and irrigation/water conservation. This program is managed by the Department of Agriculture and Food. Funded through a one-time federal appropriation in 1937 and replenished by repayments and interest collections.

Agriculture Resource Development Fund (UCA 59-12-103(5)(b)): Created for rangeland improvement, watershed protection, flood prevention, soil and water conservation, and energy efficient farming. Individuals involved in agricultural pursuits can apply for loans within this loan program. The program is managed by the Department of Agriculture and Food. Funding sources include $525,000 from sales taxes, loan repayments and interest collections.

Water Resources Revolving Construction Fund (UCA 73-10-8): Created in 1947 to finance projects that will conserve water resources and may include engineering and construction of irrigation facilities. This loan fund is managed by the Department of Natural Resources. The Funding sources include legislative appropriations, loan repayments, water user assessments, interest collections, and loan fund revenues.

Cities Water Loan Fund (UCA 73-10-22): Established in 1974 to assist cities, towns, and other municipalities to provide adequate and safe water supplies. The Fund provides financing for construction of culinary water systems. The loan fund is managed by the Department of Natural Resources. The fund was originally capitalized by legislative appropriations with ongoing funds provided through loan repayments and interest collections.

Water Conservation and Development Fund (UCA 73-10-24): Created in 1978 to finance multipurpose dams and large water systems. The program is under the supervision of the Department of Natural Resources. Funding sources include General Fund appropriations, sales tax revenues, loan repayments, and interest collections.

Health Care Workforce Financial Assistance Program (UCA 26-46-102): Created to increase the number of health care professionals providing health care services to medically underserved areas of the state. The program offers educational loan repayment grants and nursing educator scholarships in return for providing services for and obligated period of time. The program is managed through the Health Department. The primary funding source is from General Fund appropriations by the Legislature.

Transportation Corridor Preservation Revolving Loan Fund (UCA 72-2-117): Established to allow highway authorities to acquire real properties for state, county, and municipal highway corridors. Purchasing properties in a designated corridor increases the possibility to purchase raw ground before development has occurred thus increasing the final right of way expenditure for the highway corridor. Oversight of the program is from the Department of Transportation. Funding sources include legislative appropriations, sales tax revenues, motor vehicle rental taxes, rental revenue, interest collections, and sale of excess lands.

Aeronautics Construction Revolving Loan Fund (UCA 72-2-122): Established to help finance county and municipal airport facilities. The Department of Transportation is responsible for this program. Funding for this program is not yet available.

Transportation Infrastructure Loan Fund (UCA 72-2-202(3)): Created to provide infrastructure loans to build or rehabilitate existing infrastructure. The Department of Transportation manages this program. The fund was originally capitalized by the federal government with a loan to the Centennial Highway Fund and was interest free. That loan was paid off in FY 2005. In FY 2007 there was a loan made to Logan City. There have been no additional loans made to date.

Drinking Water Loan Funds (UCA 73-10c-4): Established to help finance drinking water facilities for political subdivisions in the state. The Fund provides financing for construction of culinary water systems. The Department of Environmental Quality provides oversight of this program. Funding sources include legislative appropriations, federal grants, sales tax revenues, interest collections, and loan repayments.

Waste Water Loan Funds (UCA 73-10c-4.1): Established to help finance waste water facilities for political subdivisions statewide. The program provides financing for approved waste water disposal facilities. This loan program is under the supervision of the Department of Environmental Quality. Funding sources include legislative appropriations, federal grants, sales tax revenues, interest collections, and loan repayments.

Petroleum Storage Tank Loan Fund (UCA 19-6-405.3): Established to upgrade petroleum storage tanks and associated piping with corrosion protection, or spill and overflow prevention equipment. The fund is available to persons and business that have petroleum storage facilities that are covered by federal laws. Program oversight is through the Department of Environmental Quality. Funding sources include loan repayments and interest collections.

Clean Fuels and Vehicle Technology Fund (UCA 19-1-403): Created to assist with retrofitting or purchasing of vehicles that use clean fuels. Individuals or government agencies can participate in the program. The Department of Environmental Quality manages this program. Original funding was provided by legislative appropriations. Current funding sources include loan repayments and interest collections.

Energy Efficiency Fund: House Bill 198, "State Agency Energy Efficiency" (Hunsaker, 2008 G.S.) created the "State Facility Energy Efficiency Fund" and transferred $3.65 million from the Stripper Well-Petroleum Violation Escrow Fund to capitalize the revolving loan fund. The State Building Board makes loans from the fund to state agencies to finance energy efficiency measures.

All of the above programs are managed by state agencies' personnel with oversight of appointed boards. Unaudited examination of each of these programs by the Legislative Fiscal Analyst showed that they are being managed properly and are serving their statutory purposes. Unless the Legislature desires to implement policy changes no changes to these loan programs are recommended at this time.

Appendices A and B show the sources of funding and outstanding balances in each of the above discussed revolving loan programs for FY 2008 and FY 2007 respectively.

CAPITAL PROJECTS FUND

UCA Title 51 Chapter 5, Funds Consolidation Act, specifically establishes Capital Projects Funds as one of the major fund types in state government.

> *Capital Projects Funds account for financial resources to be expended for the acquisition or construction of major capital facilities, except when financing for the acquisition or construction of a major capital facility is obtained from a trust fund or a proprietary type fund* (UCA 51-5-4(5).

The Capital Projects Fund was created on July 1, 1981. The Division of Facilities Construction and Management (DFCM) is responsible for fund accounting, with oversight from the Division of Finance. Revenue sources include legislative appropriations and institution or agency funding for capital facilities.

The Capital Projects Fund accounts for three broad categories of capital facilities projects:

1. State funded capital developments
2. Non-state funded capital developments
3. State funded capital improvements

"Capital Developments" include any remodeling, site, or utility project costing $2,500,000 or more, new construction costing $500,000 or more, or any property purchase where an appropriation is requested to fund the purchase. "Capital Improvements" include any remodeling, alteration, site, or utility project costing $2,500,000 or less, or any new construction costing $500,000 or less (UCA 63A-5-104).

Because capital projects frequently take multiple years to complete, funds appropriated for these projects frequently stay in the Capital Projects Fund for multiple years. For the most part, interest earned on the Capital Projects Fund flows to the General Fund. The only exception is when a project is funded by revenue bonds. In that case, interest stays in the Capital Projects Fund to be applied to the revenue bond funded project. When the project is completed and closed out, any remaining funds flow to the debt service line item to help retire the debt. Any interest earned on general obligation bond proceeds is transferred to the General Fund in a year-end transaction by the Division of Finance.

Project Financed By	Interest Goes to	At Close-Out, Any Excess Goes to
General Fund	General Fund	Project Reserve Fund
Education Fund	General Fund	Project Reserve Fund
General Obligation Bonds	General Fund	Project Reserve Fund
Revenue Bonds	Capital Project Fund	Debt Service
Agency/Institution Funds	N/A - Billed at Actual Cost	N/A - Billed at Actual Cost

Table 2

The State Treasurer's Office estimates that cash balances in the Capital Projects Fund generated the following amounts of interest to the General Fund in the last five fiscal years:

	Estimated Interest Earned	Average Cash Balance	Average PTIF Rate
FY 2008	$6,099,500	$144,630,900	4.43%
FY 2007	$5,384,900	$103,271,300	5.21%
FY 2006	$4,038,900	$96,231,000	4.17%
FY 2005	$806,000	$28,640,700	2.40%
FY 2004	$265,500	$17,641,700	1.49%

Table 3

As shown in Table 3, the jump in interest earned between FY 2005 and FY 2006 was caused by an increase in cash balances and interest rates. The Legislature didn't appropriate cash for capital development projects for the three legislative general sessions between 2002 and 2004. During these same three years a slow economy and low interest rates made bonding a more attractive option, and the Legislature authorized an average of $120 million in bonds each of the three years.

DFCM tracks the Capital Projects Fund by project number. Each project receives a unique number that allows revenues and expenses to be tracked separately.

The Capital Projects Fund includes two sub-funds: The Project Reserve Fund and the Contingency Reserve Fund. Each is assigned a unique project number for tracking purposes.

The Project Reserve Fund is governed by UCA 63A-5-209(2). The only time that this reserve fund receives funding is when savings are achieved on a project. Savings are typically identified and transferred into the

Project Reserve Fund when construction has been fully bid and at the end of the project. The only way DFCM is allowed to use funds in the Project Reserve Fund without a specific legislative authorization is to cover construction bids that come in over budget. According to statute, "The Legislature shall annually review the amount held in the project reserve for possible reallocation by the Legislature to other building needs, including the cost of administering building projects."

The Contingency Reserve Fund is governed by UCA 63A-5-209)(1). As provided by this statute, a specified percentage of the construction budget is included in each project budget for contingencies. The percentage applied is set according to a sliding scale. For new construction, the scale ranges from 4.5% to 6.5% depending on the project size. For remodeling, the scale ranges from 6% to 9.5%. The Contingency Reserve Fund is the funding source for unforeseen costs that exceed any of the categories within the budget. According to statute, "The Legislature shall annually review the percentage and the amount held in the statewide contingency reserve. The Legislature may reappropriate to other building needs, including the cost of administering building projects, any amount from the statewide contingency reserve that is determined to be in excess of the reserve required to meet future contingency needs."

As recently as the 2008 Second Special Session, the Legislature appropriated $1 million from the Contingency Reserve Fund to replace General Funds in the DFCM administrative budget. The following table shows legislative appropriations from the Project Reserve Fund and the Contingency Reserve Fund in the last five years.

Appropriations from the Project Reserve Fund and Contingency Reserve Fund

	Project Reserve Fund		Contingency Reserve Fund	
FY 2009	$200,000	DFCM Administration	$1,082,300	DFCM Administration
FY 2008	$200,000	DFCM Administration	$2,000,000	SWATC Land Purchase
			$82,300	DFCM Administration
FY 2007	$200,000	DFCM Administration	$82,300	DFCM Administration
FY 2006	$200,000	DFCM Administration	$694,000	DNR Fire Mgt Facility
			$225,000	Courts Land Purchase
			$1,180,200	DFCM Administration
FY 2005	$0		$0	

Table 4

For purposes of illustration on the workings of the Capital Projects Fund, consider the following example. Suppose the Legislature appropriates $10,000,000 for a new state building. DFCM usually transfers the lowest percentage allowed by law to the Contingency Reserve Fund for new projects costing over $10 million. Therefore, DFCM would transfer 4.5%, or $450,000 to the Contingency Reserve Fund (a sub-fund in the Capital Projects Fund). Suppose that several months into the project the contractor discovers unforeseen soil problems that would cause liquefaction in an earthquake. The contractor and DFCM agree on a change order costing $100,000 to stabilize the soil. These funds would be transferred back from the Contingency Reserve Fund to the project. Two years later, the contractor completes all work and the project is closed out at $9,600,000. As a result, this project came in $50,000 under budget and therefore transfers $50,000 to the Project Reserve Fund to help with other projects where bids are over budget. This project also contributed a net of $350,000 to the Contingency Reserve Fund to help with other projects where unforeseen events (usually change orders) drive up costs after contracts are signed.

Example of Funding Flow in the Capital Projects Fund	
$10,000,000	Legislative appropriation for new state building
($450,000)	4.5% transfer to Contingency Reserve Fund within Capital Projects Fund
$9,550,000	Subtotal
$100,000	Soil problems require transfer of funds from Contingency Reserve Fund
$9,650,000	Subtotal
($9,600,000)	Payout to contractor after successful completion of project
$50,000	Subtotal
($50,000)	Transfer to Project Reserve Fund within Capital Projects Fund
$0	Ending Balance

Table 5

Recommendation for Capital Projects Fund

Most higher education capital projects are funded with appropriations from the Education Fund. Once education fund dollars are transferred to the Capital Projects Fund, they begin generating interest for the General Fund. The Analyst recommends that interest on former Education Fund dollars in the Capital Projects Fund be returned to the Education Fund.

DEBT SERVICE FUND

Debt Service is made up of interest and principal due on the state's bonded indebtedness. This debt service includes the money required to pay the current outstanding principal and interest payments on existing obligations according to the terms of those obligations. The state uses long-term debt to finance large capital expenditures including new construction, major remodeling and highway projects.

The state issues two main types of debt instruments: General Obligation (GO) bonds and State Building Ownership Authority (SBOA) revenue bonds. General Obligation bonds are secured by the "full faith and credit" of the state and its ability to collect taxes. SBOA revenue bonds, used to construct buildings, are secured by: (1) a revenue stream of annually appropriated lease payments from agencies occupying those buildings and, (2) a lien placed against the building that is cross-collateralized with other state-owned buildings.

GO bond debt is limited by the State Constitution (see Article XIV, Section 1 and Article XIII Section 5(3) of the State Constitution) and by statute (see State Code UCA 63-38c-402v, UCA 63B-1-201, UCA 63B-1-202, UCA 63B-1a, UCA 63B-1a-101(4), UCA 63B-1a-301, UCA 63B-1a-303, UCA 63B-1a-601) whereas SBOA bond debt is limited only by statute (see State Code UCA 63B-1-304, UCA 63B-1-307).

General Fund (GF) and Education Funds (EF) are typically used to pay the debt service on the building portions of the GO bonds. Centennial Highway Funds (CHF) and other transportation restricted funds are used to pay the debt service on the highway portions of the bonds.

The State of Utah has maintained a "Triple A" rating for credit worthiness for the past several years. National rating agencies, such as Moody's Investor Service, Fitch Ratings, or Standard and Poor's provide these ratings on all states. Utah has maintained an "AAA" rating for many reasons, since ratings factors are complex, but in large part because of the commitment to good management shown by both the executive

and legislative branches. Utah's track record of showing willingness to manage its debt seems to be as important as its ability to pay its debt.

Unlike standard loans individuals may use, bonds are issued in numbered series by year. Whereas a typical loan is often a lump sum amount that an individual borrows that can be repaid at any time, each bond series has multiple principle amounts that mature in various years. For example, a bond offering statement issued by the state may contain $75 million of GO bonds that really includes seven different bonds whose principal amounts mature in different years. Each separate bond issuance is assigned its own debt service fund by State Finance. However, appropriations to debt service are made in a lump sum to one line item rather than multiple appropriations to each account. This method gives the state more flexibility in paying the bonds.

Bonding Agencies Outside Debt Service Line Item

Two agencies—Utah Higher Education Assistance Authority (UHEAA) and Utah Housing Corporation (UHC)—both engage in bonding activities with different missions. As part of their general purpose, "UHEAA's mission includes comprehensive outreach and information to assist citizens in planning for and financing postsecondary education, and special programs to keep student loans affordable and help borrowers avoid delinquencies and defaults" (UHEAA website). As of August 31, 2008, UHEAA reported $593,553,346 outstanding principal balance as their total for the 1988 Trust Estate Revenue Bond. As of the same date, it was reported for the 1993 Trust Estate Revenue Bond $1,398,260,325 outstanding principal balance.

Utah Housing Corporation (UHC) was developed as a public corporation by the State of Utah in order to generate funding to assist in the creation of affordable housing within the state. Families with lower incomes in Utah can benefit from services provided by UHC as well as developers building or renovating affordable apartment projects. UHC does not receive any state funding but is a self-sustaining organization. As of June 30, 2008, financial statements reported by UHC showed approximately $1,750,000,000 in both current maturities and non-current bond payables. On average, over the past three calendar years, UHC has bonded for approximately $245,000,000 per year.

Bonding: Advantages and Disadvantages

The state incurs several advantages and disadvantages by issuing general obligation bonds as noted below:

Advantages:

- Since the state pledges its full taxing power and its full faith and credit, in addition to having an excellent credit rating, general obligation bond issues are considered to be secure investments. This fact makes general obligation bond offerings attractive both to underwriters and other investors while interest rates are lower than other bond types.
- When interest rates are low, bonding allows the state to pay back present value with future dollars. Long-term bonds may offer value in excess of present value.
- General obligation bonding allows non-revenue producing projects to be financed over long periods of time.
- Projects funded through the sale of these bonds generally benefit the community for long periods of time.
- The outstanding debt is retired over the life of the asset by residents who benefit from the asset.
- Revenue in the sinking fund may be invested and used to retire the debt prior to final maturity.

Disadvantages:

- If a state issues long-term bonds every year it may ultimately find that debt service will become a driving force for all budget decisions.

- Bonds require additional expense to analyze, underwrite, and place on the market.
- The interest portion of debt service payments would be better used on state projects than paying off indebtedness.
- All residents are taxed to pay off the bonds although some of them may not directly use the asset. However, paying with cash offers the same disadvantage. Revenue bonds only impact users of the asset.
- Though chances of default are small, general obligation bonding may result in additional tax increases if necessary to pay off the bonds.

Call Provisions and Early Payment (Defeasance)

Certain bonds are issued with a call provision which allows the issuer (the State) to redeem the bonds prior to maturity. While bonds without a call provision require the payment of all principal and interest until maturity, bonds with a call provision allow the issuer to pay off the remaining principal on the bonds at the call date. Any such bond can be legally defeased earlier than its final maturity date depending on the provisions for that particular bond.

Defeasance refers to the method of rendering outstanding bonds null and void. Typically bond defeasance is both legal and financial—meaning that the debts are taken off of the accounting books and the state is no longer legally obligated to the debts. Whether a bond can be defeased and the state's debt paid early is dependent upon the stipulations that accompany the bond issuance and legal agreements.

Bonds can also be "refunded" through the practice of using proceeds from the issuance of new, lower interest rate bonds to pay the principal and interest on old, higher interest rate bonds until maturity.

Whereas refunding simply refinances bonds at a lower rate, there is an option to actually take the debt completely off of the books. That option is to set up an escrow account with cash that will be sufficient to pay all of the principal and interest on the bonds until they are callable or mature. There are federal limits as to the types of investment options for such an escrow account, but the account is allowed to accrue interest off of those investments to offset some of the principal and interest payments. Federal arbitrage regulations limit the amount of interest that may be earned.

Which Bonds should be Paid Off First?

- *High Coupon Bonds.* Typically, bonds with the highest interest rates are the most likely candidates for defeasance. The higher the coupon rate on the bonds, the more the state will pay in interest costs over the life of the bonds.
- *Bonds with Call Provisions.* As previously mentioned, call provisions enable the state to pay off bonds early without having to pay the associated interest payments to maturity. Assuming the coupon rates on the bonds with a call provision are not substantially lower than other bonds, the callable bonds would probably be defeased at a lower cost.
- *General Obligation Bonds.* Of the two types of debt instruments the state currently uses, GO Bonds are the more likely candidates for defeasance. SBOA revenue bonds, for the most part, are paid for through dedicated revenue streams whereas GO Bonds are paid with appropriations of state funds.

FY 2009 Debt Service Funding Mix

Figure 1 below shows the funding mix of General and Education Funds, Dedicated Credits and other funds that go into servicing the state's debt obligations. General and Education Funds pay for buildings while Dedicated Credits are lease payments from state agencies to pay off lease revenue bonds. The "Other" funds are made up of the Centennial Highway Fund (CHF), County of the First Class Sales Tax and the beginning and closing fund balances for Debt Service as a total.

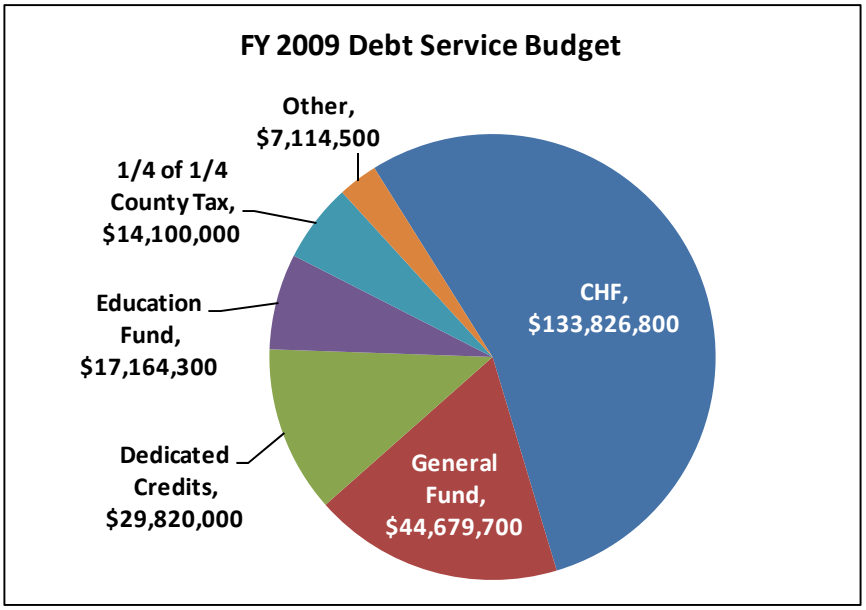

Figure 1

The table below explains the state's outstanding GO Bond indebtedness as of October 1, 2008.

Outstanding GO Bond Indebtedness

Series	Purpose	Original Amount	Final Maturity Date	Outstanding as of Oct. 1, 2008
2001B*	Highways	$348,000,000	July 1, 2009	$37,650,000
2002A*	Various	$281,200,000	July 1, 2011	$18,075,000
2002B	Refunding	$253,100,000	July 1, 2012	$221,125,000
2003A*	Various	$407,405,000	July 1, 2013	$234,125,000
2004A	Refunding	$314,775,000	July 1, 2016	$314,775,000
2004B	Various	$140,635,000	July 1, 2019	$101,660,000
2007A	Various	$75,000,000	July 1, 2014	$66,400,000
Subtotal Prinicipal Amount of GO Debt				$993,810,000
Plus Unamortized Original Issue Bond Premiums				$46,011,200
Less Deferred Amount on Refunding				($11,894,800)
Total GO Debt				$1,027,926,400

*Portions refunded in subsequent bond issues

Table 6

Recommendation for Debt Service Fund

Currently, debt service on SBOA revenue bonds and general obligation bonds is combined into one line item. The Analyst recommends that the debt service on the general obligation bonds be separated from the debt service on the SBOA lease revenue bonds in two line items.

Whereas the debt service on GO bonds comes from appropriations, the debt service on lease revenue bonds comes from lease payments paid by user agencies. Difficulties have arisen when these two revenue sources are combined.

Due to the cyclical nature of bond payments and the desire of agencies for a stable budget, lease payments on SBOA bonds are smoothed over the life of the bonds. This results in some lease payments being more than or less than the actual debt service; which in turn increases or decreases the nonlapsing balance in the debt service line item.

Whereas these balances are not free-revenue, but, in fact, future obligations to SBOA bonds, caution must be taken when viewing the nonlapsing balances in the debt service line item. If the GO bonds and the SBOA bonds had their own line items, the nonlapsing balances would be much more straightforward and the transparency of the debt service for each bond type would improve.

SUMMARY OF RECOMMENDATIONS

Recommendations for Internal Service Funds

- Consider formalizing the policy that internal service funds may reduce rates in the interim between legislative general sessions and require notification to the Legislature of any rate changes and potential cost savings to agencies.
- Consider requiring ISFs to report contractor positions in their annual budget submissions and/or change statute to include contractor positions in the annual FTE appropriation by the Legislature.
- Consider changing the make-up of each of the three internal service fund rate committees.
- Consider changing the policy from "acquisition" to "purchase" when describing the requirement for lapsing capital outlay authority.

Recommendations for Capital Projects Fund

- Consider requiring that interest on former Education Fund dollars in the Capital Projects Fund be returned to the Education Fund.

Recommendations for Debt Service Funds

- Consider dividing the debt service line item into two line items: one for GO bond debt service, the other for SBOA lease revenue bond debt service.

APPENDIX A – 2008 REVOLVING LOAN FUND BALANCES

		2008 Fund Balance				
	Revenue Source	Beg Bal	Revenues	Expenses	Transfers	End Bal
Transportation Revolving Loan Funds						
Transportation Corridor Preservation Revolving Loan Fund	1) motor vehicle rental tax, 2) appropriations, 3) contributions public and private, 3) interest, 4) monies collected for repayments and interest on fund monies, 5) monies collected from rents and sales of real property	51,924,300	9,095,800	(13,066,400)	16,000,000	63,953,700
Transportation Infrastructure Loan Fund	1) Appropriations, 2) Federal funds, 3) State grants, 4) Contributions, 5) Repayments of fund monies, 6) Interest, 7) Money available transferred by the Commission	2,582,900	87,300	0	0	2,670,200
Environmental Quality Revolving Loan Funds						
State Revolving Fund for Drinking Water Projects	1) Appropriations, 2) Money from Fund 128 to meet Federal Match, 3) Repayment of loans, 4) Investment income, 5) Federal funds, 6) Interest on loans which goes to this fund or Fund 129 - Hardship Grant	65,817,500	12,867,700	(383,400)	1,645,900	79,947,700
Drinking Water SRF Hardship Fee Account	1) Hardship fees 2) interest	2,933,900	690,200	(723,200)	0	2,900,900
Drinking Water Loan Program Subaccount	1) State appropriation , 2) Principle repayment of loans, 3) Interest from loans which is recorded in Fund 129, 4) Sales tax revenue per UCA 59-12-103	47,389,200	3,566,500	(16,000)	(1,764,000)	49,175,700
Hardship Grant Program for Drinking Water Projects	1) Interest on loans, 2) Hardship assessments, 3) Appropriations, 4) Investment income	2,418,100	1,249,100	(614,000)	0	3,053,200
Drinking Water Origination Fee Subaccount	1) The origination fee for loans made by the Drinking Water Board within the Drinking Water Security Subaccount	0	39,000	(25,000)	0	14,000
Water Quality SRF Hardship Assessment	1) Hardship fees 2) interest	10,066,300	3,769,900	0	(878,200)	12,958,000
Utah State Revolving Fund for Wastewater Projects	1) Appropriations, 2) Federal funds, 3) Transfers from Wastewater Loan Program Fund 135 for state match, 4) Interest on loans	180,333,100	9,343,200	0	2,690,500	192,366,800
Utah Wastewater Loan Program Subaccount	1) State appropriation, 2) Principal repayment of loans, 3) Interest goes to Fund 136, 4) Sales tax revenue per UCA 59-12-103(5)	53,440,900	3,617,200	(16,500)	(2,723,800)	54,317,800
Hardship Grant Program for Wastewater Projects Subaccount	1) Interest on loans, 2) Hardship assessments, 3) Appropriations, 4) Investment income on balances in this fund and the Utah Wastewater Loan Program Subaccount (Fund 135)	9,011,500	1,340,100	(356,700)	0	9,994,900
Water Quality Origination Fee Subaccount	1) The origination fee for loans made by the Water Quality Board within the Water Quality Security Subaccount	0	25,000	0	(25,000)	0
Petroleum Storage Tank Loan Fund	1) Appropriations, 2) Investment income, 3) Principal and interest received from the repayment of loans	5,968,200	249,400	(3,800)	(147,100)	6,066,700
Clean Fuels and Vehicle Technology Fund	1) Appropriations, 2) Public and private contributions, 3) Interest, 4) Loan Repayments	2,631,500	109,800	(300)	(92,900)	2,648,100
Natural Resources and Agriculture Revolving Loand Funds						
Water Resources Construction Fund	1) State appropriation, 2) Interest on loans, 3) Money from sale or management of certain reservoir land, 4) Charges assessed against water and power users, 5) Interest earnings	37,349,500	1,062,000	(3,538,400)	4,278,600	39,151,700
Water Resources Conservation and Development Fund	1) State appropriation, 2) Sales of project water and power, 3) Repayments of loans (principle and interest), 4) Sales tax revenue per 59-12-103, 5) Federal mineral lease funds	203,854,200	21,298,400	(4,385,000)	(5,286,200)	215,481,400
Water Resources - Cities Water Loan Fund	1) State appropriations of liquor control profits, 2) Loan repayments	27,827,100	412,300	0	0	28,239,400
Agriculture Resource Development Fund	1) Appropriations, 2) Sales and use tax receipts 3) Repayments of loans made from the fund, 3) Money made available to the state for agriculture resource development from any source, 4) Interest earned	29,399,800	1,474,700	(453,600)	(1,333,300)	29,087,600
(DAG) Rural Rehabilitation Fund	1) Appropriations, 2) Repayments of loans made from the fund, 3) interest earned, 4) Appropriations from the Agriculture Resource Development Fund (1998-99)	5,604,700	276,500	(36,400)	1,000,000	6,844,800
State Energy Efficiency Revolving Loan Fund						
State Facility Energy Efficiency fund	1) monies appropriated to it by the Legislature, 2) monies received for the repayment of loans made from the fund, 3) monies made available to the state for energy efficiency from any source; and (4) interest earned on the fund	0	0	0	3,650,000	3,650,000

APPENDIX B – 2007 REVOLVING LOAN FUND BALANCES

		2007 Fund Balance				
Fund_Name	Revenue Source	Beg Bal	Revenues	Expenses	Transfers	End Bal
Transportation Revolving Loan Funds						
Transportation Corridor Preservation Revolving Loan Fund	1) motor vehicle rental tax, 2) appropriations, 3) contributions public and private, 3) interest, 4) monies collected for repayments and interest on fund monies, 5) monies collected from rents and sales of real property	2,156,534	5,160,016	17,675,930	10,000,000	(359,380)
Transportation Infrastructure Loan Fund	1) Appropriations, 2) Federal funds, 3) State grants, 4) Contributions, 5) Repayments of fund monies, 6) Interest, 7) Money available transferred by the Commission	2,477,743	105,121	0	0	2,582,864
Environmental Quality Revolving Loan Funds						
State Revolving Fund for Drinking Water Projects	1) Appropriations, 2) Money from Fund 128 to meet Federal Match, 3) Repayment of loans, 4) Investment income, 5) Federal funds, 6) Interest on loans which goes to this fund or Fund 129 - Hardship Grant	54,675,063	10,595,568	1,053,270	1,600,170	65,817,531
Drinking Water SRF Hardship Fee Account	1) Hardship fees 2) interest	2,212,371	695,963	20,000	45,610	2,933,944
Drinking Water Loan Program Subaccount	1) State appropriation , 2) Principle repayment of loans, 3) Interest from loans which is recorded in Fund 129, 4) Sales tax revenue per UCA 59-12-103	45,665,991	3,587,664	51,875	(1,812,557)	47,389,223
Hardship Grant Program for Drinking Water Projects	1) Interest on loans, 2) Hardship assessments, 3) Appropriations, 4) Investment income	2,064,117	1,343,552	1,027,000	37,477	2,418,146
Drinking Water Origination Fee Subaccount	1) The origination fee for loans made by the Drinking Water Board within the Drinking Water Security Subaccount					
Water Quality SRF Hardship Assessment	1) Hardship fees 2) interest	10,085,459	3,028,681	3,926,000	878,182	10,066,322
Utah State Revolving Fund for Wastewater Projects	1) Appropriations, 2) Federal funds, 3) Transfers from Wastewater Loan Program Fund 135 for state match, 4) Interest on loans	169,264,140	10,114,186	0	954,775	180,333,101
Utah Wastewater Loan Program Subaccount	1) State appropriation, 2) Principal repayment of loans, 3) Interest goes to Fund 136, 4) Sales tax revenue per UCA 59-12-103(5)	52,608,476	3,587,500	17,750	(2,737,356)	53,440,870
Hardship Grant Program for Wastewater Projects Subaccount	1) Interest on loans, 2) Hardship assessments, 3) Appropriations, 4) Investment income on balances in this fund and the Utah Wastewater Loan Program Subaccount (Fund 135)	7,324,188	1,489,715	(197,547)	0	9,011,450
Water Quality Origination Fee Subaccount	1) The origination fee for loans made by the Water Quality Board within the Water Quality Security Subaccount					
Petroleum Storage Tank Loan Fund	1) Appropriations, 2) Investment income, 3) Principal and interest received from the repayment of loans	5,802,579	301,447	0	(135,835)	5,968,191
Clean Fuels and Vehicle Technology Fund	1) Appropriations, 2) Public and private contributions, 3) Interest, 4) Loan Repayments	2,575,945	131,348	375	(75,409)	2,631,509
Natural Resources and Agriculture Revolving Loand Funds						
Water Resources Construction Fund	1) State appropriation, 2) Interest on loans, 3) Money from sale or management of certain reservoir land, 4) Charges assessed against water and power users, 5) Interest earnings	37,660,401	1,291,004	5,900,552	4,298,684	37,349,537
Water Resources Conservation and Development Fund	1) State appropriation, 2) Sales of project water and power, 3) Repayments of loans (principle and interest), 4) Sales tax revenue per 59-12-103, 5) Federal mineral lease funds	186,890,783	23,083,419	1,066,343	(5,053,663)	203,854,196
Water Resources - Cities Water Loan Fund	1) State appropriations of liquor control profits, 2) Loan repayments	27,492,005	335,053	0	0	27,827,058
Agriculture Resource Development Fund	1) Appropriations, 2) Sales and use tax receipts 3) Repayments of loans made from the fund, 3) Money made available to the state for agriculture resource development from any source, 4) Interest earned	28,415,639	1,583,077	268,572	(330,300)	29,399,844
(DAG) Rural Rehabilitation Fund	1) Appropriations, 2) Repayments of loans made from the fund, 3) interest earned, 4) Appropriations from the Agriculture Resource Development Fund (1998-99)	5,365,732	247,954	9,000	0	5,604,686