OVERVIEW OF DIVISION OF FLEET OPERATIONS GENERAL FUND BORROWING

INFRASTRUCTURE AND GENERAL GOVERNMENT APPROPRIATIONS SUBCOMMITTEE
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ISSUE BRIEF

Summary

The Division of Fleet Operations (Fleet or the division) has incurred debt to the General Fund of approximately $33 million since FY 1995. The debt is due largely to three issues: Fleet's lease rates have not been sufficient to cover the purchase cost of replacement vehicles, and Fleet has under recovered on fuel charges and on maintenance costs. The division is taking measures to reduce its need to borrow when purchasing replacement vehicles, and it has addressed undercharging for fuel and maintenance. This report concludes with four options for the Legislature to consider regarding Fleet's General Fund borrowing and accumulated debt: (1) maintain the status quo, (2) appropriate $8 million ongoing from the General Fund for five years to eliminate the current debt, (3) build an inflationary factor into lease rates, and (4) continue the current lease rate model and add an annual appropriation to cover inflation. Each option has pros and cons that are explained in the concluding section of the report.

Background

The Division of Fleet Operations was established as an internal service fund (ISF) in FY 1997. As an ISF, Fleet does not receive a General Fund appropriation; rather, it receives Dedicated Credits by charging customer state agencies for its services. Rates that Fleet charges for an upcoming fiscal year are established annually by the Legislature in the "State Agency Fees and Internal Service Fund Rate Authorization and Appropriations" bill. Ideally, Dedicated Credits recovered through each rate would offset Fleet's cost of providing a particular service. However, because rates are set in advance of the time services are provided and because costs vary throughout a fiscal year, it is impossible for the division to exactly cover its costs. Consequently, an ISF may overcharge or under recover and rules govern the ISF's obligations in either scenario. This brief discusses some reasons that Fleet has under recovered historically.

Statute allows ISFs to incur long-term debt from the General Fund to eliminate negative working capital and to acquire capital assets, and borrowing is capped at 90 percent of the net book value of the agency's capital assets (see Utah Code 63J-1-410(8)(d)-(e)). In the event that Fleet's costs exceed Dedicated Credits revenues, the division borrows from the General Fund to purchase vehicles and this allows the division to make up any shortfall. Fleet is required to "repay all long-term debt borrowed from the General Fund … by making regular payments over the useful life of the asset according to the asset's depreciation schedule" (63J-1-410(8)(d)(ii)).

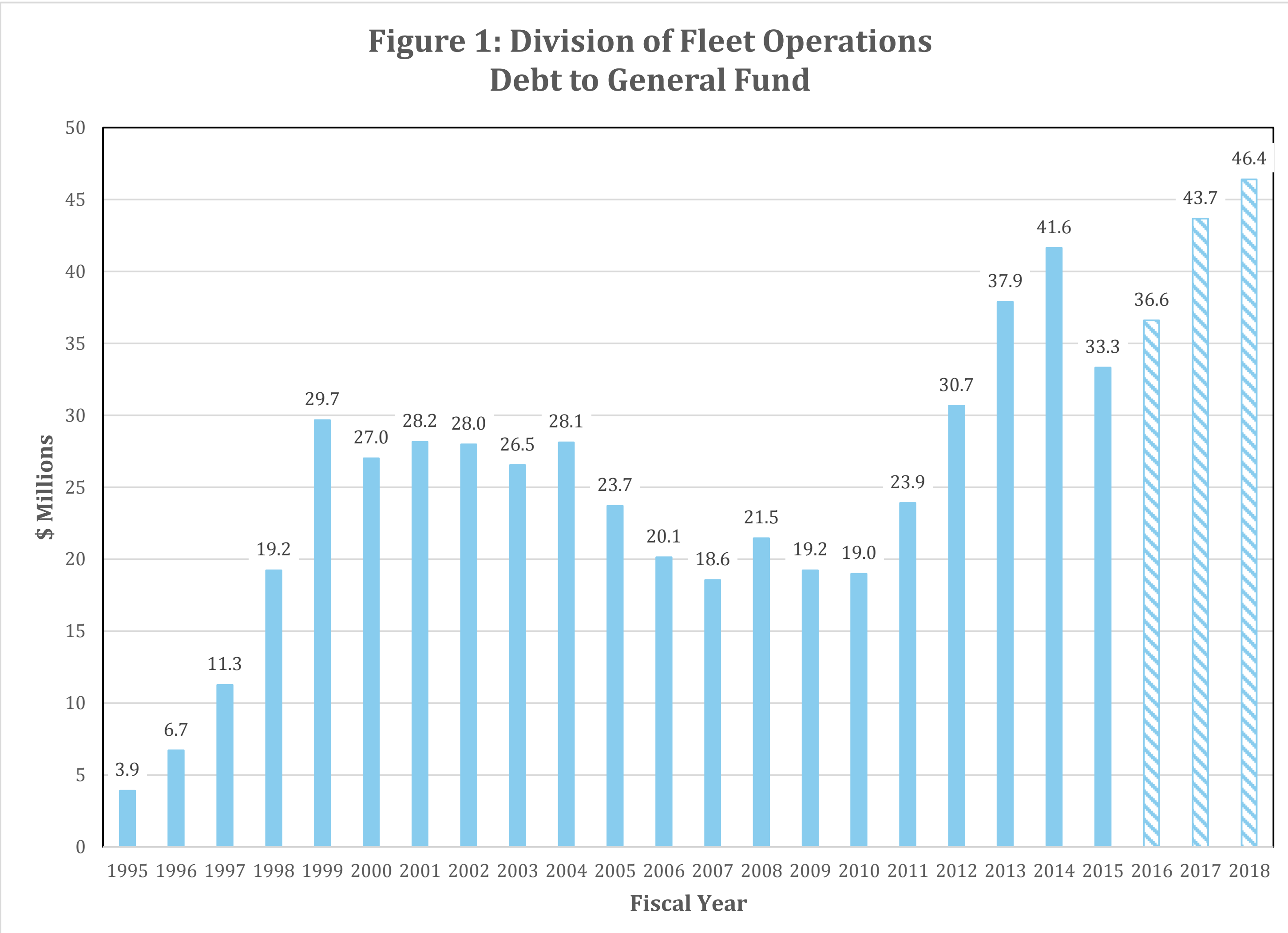
Specific duties of Fleet are listed in Utah Code 63A-9-401. Some primary responsibilities of the division that have direct impact on its General Fund borrowing include:

- coordinating all purchases of state vehicles;
- creating standard use and rate structures for state vehicles;
- establishing requirements for disposal of vehicles; and
- administering a fuel dispensing services program.

History of Fleet's General Fund Debt

The predecessor to the Division of Fleet Operations was $3.9 million in debt to the General Fund in FY 1995 and $6.7 million in debt in FY 1996. At its inception, Fleet inherited its predecessor's debt and additional debt was added; Fleet's total indebtedness in FY 1997 was $11.3 million. Debt grew rapidly in the next two years reaching $29.7 million in FY 1999. From FY 1999 to the present, Fleet's debt to the General Fund has seen periods of decline and increase, and the current debt is about 12 percent higher than the FY 1999 level. Figure 1 below depicts Fleet's (and its predecessor's) debt from FY 1995 through FY 2015. It also shows the division's projection of debt for FY 2016, FY 2017, and FY 2018.

The increase in projected debt is due primarily to timing of purchases. The division has purchased an average of 660 vehicles per year since FY 2000. In FY 2015, the division purchased just 325 vehicles, but in the ensuing three years Fleet projects that it will purchase an above average number of vehicles.



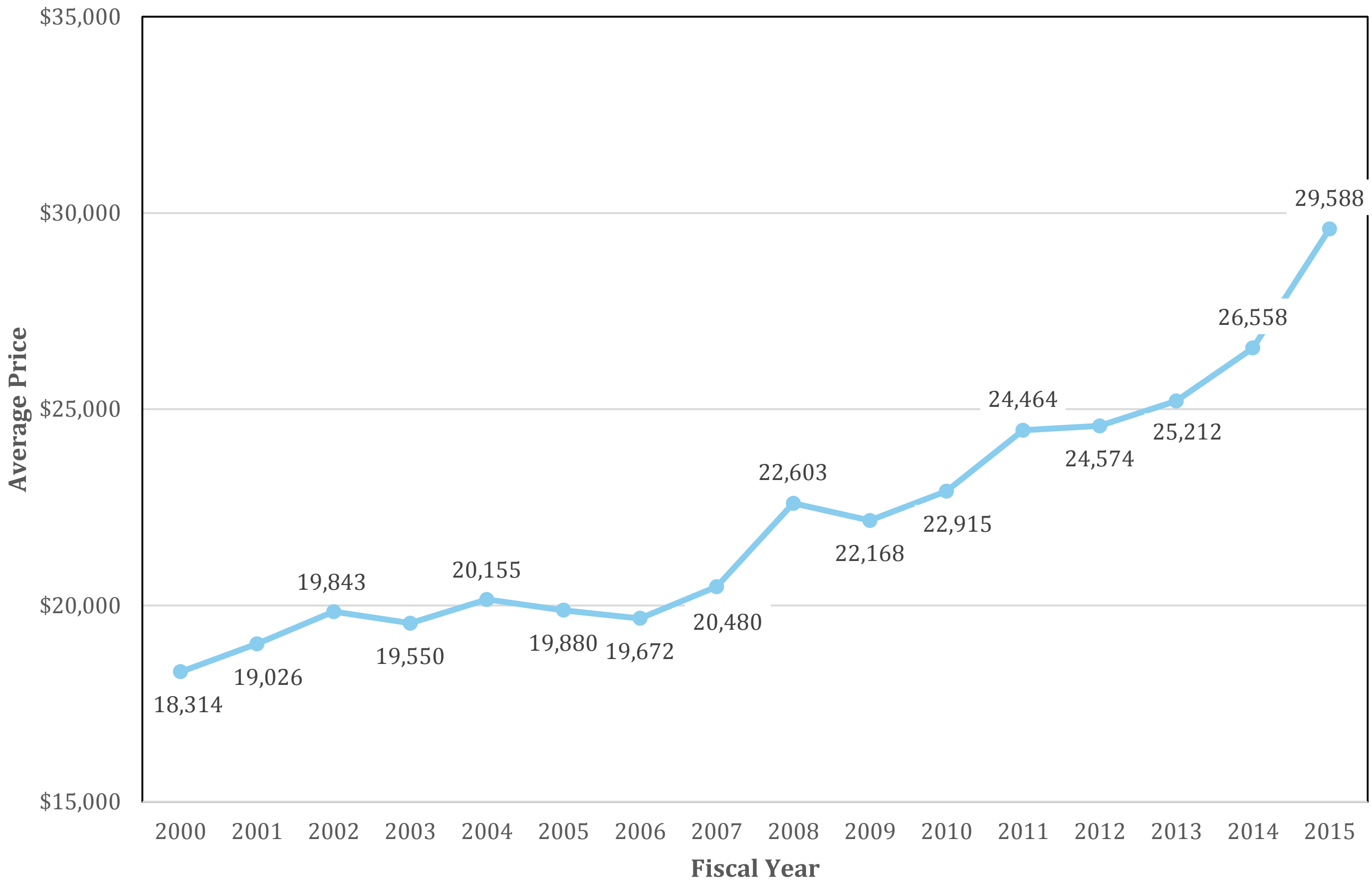
Factors Contributing to Fleet's General Fund Borrowing

Two major factors have led the Division of Fleet Operations to borrow from the General Fund. First, the division has charged customer agencies a lease rate on vehicles that is calculated to recover the purchase price of the vehicle less an expected salvage (or resale) value. Second, until the current fiscal year, Fleet charged customer agencies a bundled mileage rate that was intended to recover its cost for fuel and maintenance of the vehicle.

Lease rates. Fleet retires and purchases a large number of vehicles of various types each year. Revenue from lease rates and from sales of retired vehicles are applied toward the purchase of new vehicles, but revenue is insufficient to fully cover the cost of new purchases.

The division has not included an inflationary adjustment in lease rates. The major reason for this is that Fleet wants to avoid overcharging the federal government as it allows collection based on a vehicle's purchase price. A typical passenger vehicle remains in the state fleet for approximately seven years, and other vehicle types are in state service for various lengths of time. Regardless of vehicle type, it is evident from Figure 2 below depicting the average vehicle purchase price that Fleet's practice of collecting lease payments based on the contract purchase price of a particular vehicle's class does not generate enough money to fund the purchase of the replacement vehicle in the future.

Figure 2: Division of Fleet Operations Average Vehicle Purchase Price



Mileage rate. Until FY 2016, Fleet charged a fixed rate to agencies for each mile driven in a state-owned vehicle. Maintenance costs were covered by the rate. Problematically, the rate also covered customer agencies' fuel usage. In most years, the division ended up subsidizing customer agencies as the market price for fuel (that fluctuated throughout the year) exceeded the expected cost that Fleet had built in to the mileage rate.

Fleet's Measures to Reduce or Eliminate General Fund Borrowing

The Division of Fleet Operations has explored numerous service and pricing models that might reduce or eliminate its need to borrow from the General Fund. Some options have been implemented and others are still under consideration. For example, Fleet has partnered with Enterprise under a vehicle lease program to provide service to agencies at the multi-agency complex near 1950 West and North Temple in Salt Lake City, and early results of the partnership appear promising.

Lease rate. The lease rate is based on Fleet's contract price for the class of vehicle. This has been updated from the 2004 model year contract price to the 2013 model year contract price. Figure 3 below summarizes Fleet's lease rates for FY 2017.

Figure 3: Calculation of Lease Rates

$$Monthly\ Lease\ Rate = \frac{(Contract\ Price - Salvage)}{Lifecycle} + Fees$$

Contract Price	2013 model year contract price for class	
Salvage Value	Light trucks Select sedans Select SUVs All others	21% 18% 21% 17%
Lifecycle	Current lifecycle (in months) based on actual mileage	
Fees	Admin fee; Management Information System fee; Alternative Fuel Vehicle fee	

The division will analyze data regarding the effectiveness of the pricing model in the years ahead, and it may request to modify the pricing model to remove the "model year contract price for class" to the "current year contract price". This may better equate its costs with its revenues.

Discontinuance of mileage rate. Effective July 1, 2015, the fixed mileage rate that Fleet charged to cover maintenance and fuel costs was modified. The 2015 Legislature approved Fleet to charge customer agencies at cost for fuel and so the rate was lowered to cover just the maintenance. Consequently, the division no longer runs the risk of undercharging agencies for fuel, and that will reduce the need for Fleet to borrow from the General Fund.

Options Regarding Fleet's Borrowing and Accumulated Debt

The Division of Fleet Operations is actively pursuing measures to reduce or eliminate its need to borrow from the General Fund. While it is too early to know with certainty that the measures are working as intended, early indications point to an improved position. However, even if Fleet is successful in eliminating its need to borrow from the General Fund, it still owes approximately $40 million to the General Fund for accumulated debt.

The Fiscal Analyst recommends that the Legislature consider the following four options regarding Fleet's borrowing from the General Fund and its accumulated debt.

Option 1 – maintain the status quo. Regulations for ISFs allow the agency to have accumulated debt of up to 90 percent of the net book value of the agency's capital assets, and Fleet's debt is within this allowable limit. Furthermore, if the division were to liquidate its assets, it would be able to repay the debt to the General Fund in full. If the division were to continue its current practices, its debt to the General Fund would grow by the inflationary amount for purchases of replacement vehicles, but the debt would not grow beyond the legal limit.

Option 2 – appropriate to eliminate the current debt. The current debt plus projected additional debt could be retired through an $8 million ongoing appropriation from the General Fund for the next five fiscal years. This option alone would not eliminate Fleet's need to borrow from the General Fund as it does not address the financing gap that results from collecting on contract prices while not factoring in inflation.

The practical implication of this option is that the 2016 Legislature would have $8 million less to appropriate to other priorities. The original $8 million would churn as Fleet would return the money to the

General Fund and it would then be available for the next year's appropriation. Upon the final payment from Fleet, the original $8 million would once again be available to appropriate to other priorities.

Option 3 – build an inflationary factor into lease rates. The lease rates model presented in Figure 3 could be modified to include an inflationary adjustment. A single adjustment could apply to all classes of vehicles, or a class-specific adjustment might be utilized. The benefit of this model is that, given correct adjustment factors, Fleet would have sufficient cash to purchase replacement vehicles without having to borrow from the General Fund. One drawback of this option is that federal rules allow collection based on a vehicle's purchase price, so including an inflationary adjustment would be seen by the federal government as an overcharge, and the State would have to reimburse the federal government the amount of the overcharge each year.

Option 4 – continue the current model and appropriate to cover inflation. The current model does not account for inflation when Fleet replaces vehicles. As explained under *Option 3*, including an explicit inflation adjustment in lease rates would create an overcharge to the federal government. Absent an explicit inflation adjustment, Fleet is knowingly under collecting in terms of financing replacement vehicles, and the under collection could be mitigated through an annual appropriation.

In addition to the options above, the Legislature could combine aspects of the various options. Regardless of the option chosen, the Fiscal Analyst recommends that Fleet report annually on its progress in reducing the debt to the Infrastructure and General Government Appropriations Subcommittee in one of its interim meetings.