

Introduction to the Capital Budget

The Commonwealth's capital budget invests significant resources in the construction and maintenance of public assets that are critical to our quality of life, the strength of our economy and the efficient functioning of our government. Through the capital budget, the Commonwealth funds a wide range of public assets, including:

- thousands of miles of state highways and thousands of bridges
- public safety facilities and equipment
- state parks and playgrounds
- affordable housing
- courthouses and prisons
- convention centers
- state office buildings
- local economic development, public works and library projects
- protection of valuable open space resources
- higher education facilities at the University of Massachusetts, state and community colleges

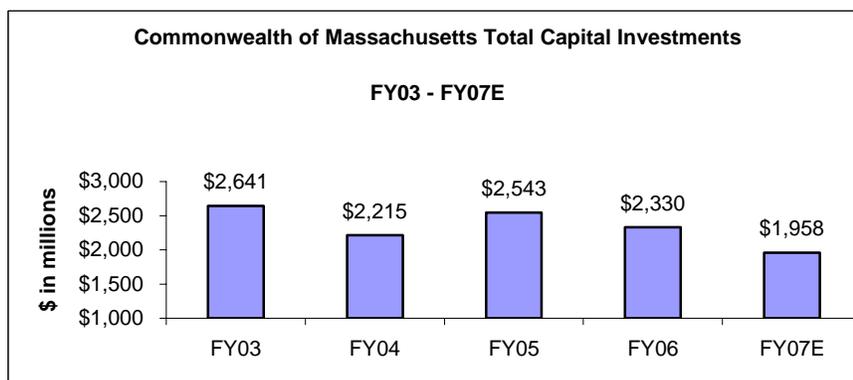
It is imperative that the Commonwealth maintain its existing capital assets. In addition, it needs to take advantage of opportunities to make new capital investments that will yield vast improvements in the quality of life and economic vitality of the state. These capital investment demands are significant, however, and the Commonwealth has limited resources to fund them.

For the reasons described above, the management of the Commonwealth's capital budget is one of the most important functions of the executive branch. The Patrick-Murray Administration is determined to manage the capital budget in a transparent and fiscally responsible manner that ensures the efficient and effective use of the state's limited resources to address our capital needs and further capital investment priorities that best serve the interests of the Commonwealth.

Historical Information

Capital Spending

In the past five years, budgeted capital spending declined from \$2.6 billion in FY03 to just under \$2 billion in FY07. The following chart summarizes the Commonwealth's total budgeted capital spending since FY03. (This chart does not reflect non-budgeted capital spending funded from surplus operating revenues.)



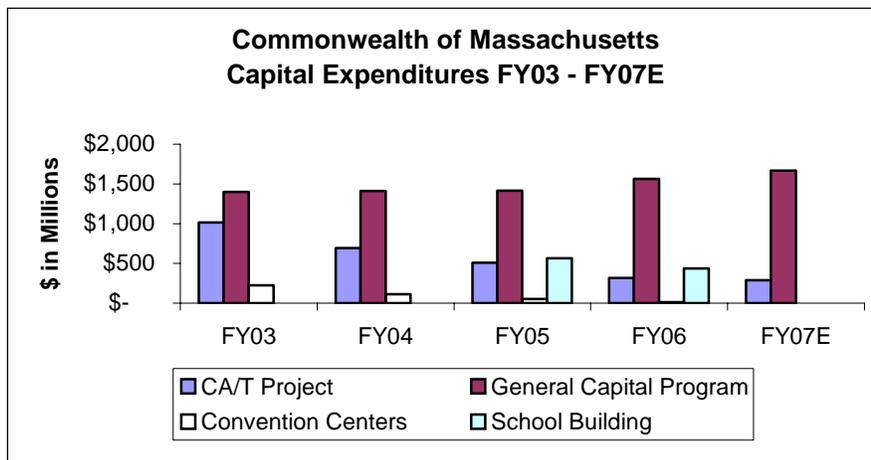
The \$600 million decrease in budgeted capital spending over the last five fiscal years is due to a reduction in spending on the Central Artery Tunnel Project (CA/T Project) as the project has neared completion. In FY03, the Commonwealth spent approximately \$1 billion on the CA/T Project, while the FY07 costs are expected to be only \$288 million.

A temporary increase in capital investments occurred in FY05 and FY06 as a result of \$1 billion expended by the Commonwealth to fund grant obligations for the new Massachusetts School Building Authority (MSBA) inherited from the Department of Education's waitlist of school construction projects. The Commonwealth's funding for this program is now complete and the MSBA's project funding is entirely supported by a dedicated portion of the state sales tax.

The Commonwealth's overall budgeted capital program for the current and prior four fiscal years has been divided into the following four spending categories.

- **General Capital Program.** A wide range of capital investments managed by the Executive Office for Administration and Finance through several state agencies.
- **Central Artery/Third Harbor Tunnel Project.** Managed by the Massachusetts Turnpike Authority.
- **Boston Convention and Exhibition Center and the Springfield Arena and Convention Center Projects.** Managed by the Massachusetts Convention Center Authority.
- **School Building Projects.** Managed by the MSBA.

The following table shows the level of spending in each of the four budgeted capital spending categories in the current and each of the prior four fiscal years. The table does not show non-budgeted capital spending funded from surplus operating revenues.



Sources of Capital Funds

The primary source of funding for capital projects is the issuance of bonds. The bond proceeds are used to pay for project costs, and the principal and interest due on the bonds is paid over time from appropriations in the Commonwealth's annual operating budget (line items 0699-0015 and 0699-2044). The Legislature must authorize the issuance of bonds to fund capital projects, the Executive Office for Administration & Finance (EOAF) controls capital spending against bond authorizations, and EOAF works with the State Treasurer to issue bonds against bond authorizations when needed to pay for such capital spending.

Certain capital projects are also funded from federal grants, operating revenues and third-party payments. Statewide road and bridge projects receive significant federal grant reimbursements. The CA/T Project is supported not only by federal grants, but also by operating revenues in the Commonwealth's Transportation Improvement Fund and by payments from the Massachusetts Turnpike Authority and the Massachusetts Port Authority. Surplus operating revenues have also been appropriated by the Legislature on occasion to fund capital projects.

A breakdown of the sources of funding for budgeted capital expenditures in the current and each of the last four fiscal years is presented below. (As in the chart on capital expenditures, this table does not include non-budgeted capital expenditures funded from surplus operating revenues.)

Source of Funds (in Millions)	FY03		FY04		FY05		FY06		FY07 E	
	\$	% of total								
Commonwealth Bonds	1,726	65%	1,404	63%	1,914	75%	1,659	71%	1,373	70%
Federal Reimbursements	509	19%	615	28%	336	13%	353	15%	483	25%
Operating Revenues (From Transportation Improvement Fund)	354	13%	133	6%	194	8%	44	2%	54	3%
Third-Party Payments (From MA Turnpike and Massport)	52	2%	63	3%	99	4%	274	12%	48	2%
Total	2,641	100%	2,215	100%	2,543	100%	2,330	100%	1,958	100%

Administrative Bond Cap

In recent years, EOAF has limited the amount of annual capital budget spending for the portion of the general capital program funded by the issuance of bonds. This capital spending limit is known as the "administrative bond cap".

The budgeted administrative bond cap was \$1.25 billion per year between FY03 and FY07, plus any unexpended funds that were carried forward into the next fiscal year. The rationale for the administrative bond cap is to limit the Commonwealth's debt to affordable levels. It should be noted, however, that a significant amount of debt was issued over the last few fiscal years to pay costs of the CA/T Project and school building assistance grants that were in excess of the administrative bond cap. In addition, the FY 07 spending estimate includes \$50 million of spending above the original budgeted amount to pay costs of the recent repairs to the Central Artery tunnels following the collapse of a ceiling panel on a motorist last summer.

General Capital Program Spending

EOAF has traditionally divided the general capital program budget among seven capital spending agencies. The following table shows the expected breakdown of the FY07 capital budget among the capital spending agencies.

Capital Spending Agency	FY07 Expected Level (in Millions)
Transportation	600
Division of Capital Asset Management	361
Environment	150
Housing & Community Development	143
Public Safety	24
Administration & Finance	50
Information Technology	45
Total	1,373

A brief description of the types of projects funded by each of the capital spending agencies is set forth below.

Transportation

The Massachusetts Highway Department carries out most of the transportation capital spending on projects such as bridge repair, roadway reconstruction, guardrail maintenance, sign and street lighting replacement and general safety improvements. Chapter 291 of the Acts of 2004 requires the Commonwealth to spend at least \$450 million each year on statewide road and bridge projects.

The Commonwealth also provides funding for local transportation related projects, including municipal road and bridge improvements ("Chapter 90" awards), public works economic development grants ("PWED" awards) and transportation support for towns with populations less than 3,500 ("STRAP awards").

Division of Capital Asset Management

Major state building construction and renovation projects are carried out by the Division of Capital Asset Management (DCAM). State government buildings, courthouse renovations, county correction repairs and improvements to our higher education facilities are just a few examples of the work done by DCAM each year.

Environmental Affairs

The Executive Office of Energy and Environmental Affairs (formerly the Executive Office of Environmental Affairs) distributes capital funds through its agencies (Department of Environmental Protection, Department of Fish and Game, Department of Agricultural Resources, and Department of Conservation and Recreation). Approximately half of the

environmental capital spending is carried out by the Department of Conservation and Recreation (DCR) for dam rehabilitation, beach restorations, infrastructure improvements, maintenance of park and campground facilities, and open space land acquisitions.

Housing and Community Development

Capital spending by the Department of Housing and Community Development falls into three categories: public housing rehabilitation, affordable housing development and community development. Under the first two spending categories, DHED invests in public and private housing programs for low- and moderate-income families and individuals, as well as the elderly and others with specialized residential needs. The Department also spends funds for Community Development Action grants for neighborhood rehabilitation projects (“CDAG”), Urban Revitalization and Development grants that give municipalities funds to stimulate economic development in blighted areas (“UDAG”) and funds for Transit Orientated Development (“TOD”) to promote smart growth near transportation centers.

Public Safety

More than half of the capital program for the Executive Office of Public Safety is used to purchase fleet equipment for the state police, such as patrol cars and mobile data units. A smaller portion is spent on communication and security equipment.

Administration & Finance

EOAF administers a number of miscellaneous capital spending programs on behalf of the Commonwealth. For example, EOAF administers grants for the construction of municipal libraries, grants for off-street parking garages, and grants for the State Revolving Fund to secure federal funds for water and sewer projects.

Information Technology Division

The Information Technology Division (ITD) oversees capital spending for information technology investments. ITD is involved in the planning, design, and operation of information technology systems, and it evaluates and prioritizes information technology capital projects.

Capital Finance under the Patrick-Murray Administration

The Patrick-Murray Administration is engaged in a comprehensive review of the Commonwealth’s capital budget-making process in order to more efficiently target the state’s limited resources toward key capital investment priorities. The results of the comprehensive review will inform the Patrick-Murray Administration’s process for developing and managing its five-year capital spending program. The Patrick-Murray Administration’s objective is to develop a transparent, fiscally responsible capital financing program that more efficiently and effectively uses the state’s limited resources to meet critical needs and further its investment priorities.

Development and Administration of a Five-Year Capital Budget

EOAF plans to engage in a thorough and thoughtful capital budget-making process. Though the details of the process are still in development, the process will include several key elements:

- ***Project-based allocations.*** The Patrick-Murray Administration will move from an agency-focused funding model to a project-focused model. A project-based allocation process will ensure continued support for ongoing efforts and will allow greater flexibility to address emerging project needs. It will also ensure that funding is based on the merits of a project, rather than on historic agency funding levels.
- ***Clearly-established priorities and criteria.*** Capital allocations will be based on a set of priorities that are clearly defined and articulated. Project ranking criteria will favor well-developed projects of appropriate scope that most efficiently and effectively meet the capital infrastructure needs of the Commonwealth and its citizens.
- ***Broad participation in priority-setting.*** The Patrick-Murray Administration will seek information about capital project needs and priorities from a wide range of interested parties. State agencies at the front-lines of service delivery will be asked to help determine capital project needs and priorities. Formal lines of communication will be opened with members of the State Legislature to gain insight into community needs from every corner of the Commonwealth. Public input on capital needs and priorities will be solicited through public hearings and a dedicated capital finance section of the EOAF website.
- ***Integration of capital and operating budgets.*** Capital budget needs and priorities will be evaluated within the context of operating budget needs and priorities to ensure that all of the state's resources work together on common priorities and to ensure that the operating budget impact of capital investments is taken into account.
- ***Fiscal responsibility.*** EOAF will continue to establish an "administrative bond cap" to limit annual capital expenditures funded from the issuance of bonds. Under the Patrick-Murray Administration, however, the administrative bond cap will be based on a transparent and rational determination of affordability intended to maximize our investment in capital infrastructure needs while preserving an affordable debt burden that does not adversely impact our other operating budget needs or the Commonwealth's bond rating.
- ***Timely decision-making.*** Although it is essential that the capital-budget making process be thorough and thoughtful, the Patrick-Murray Administration recognizes that it is just as essential that the FY08 capital project spending decisions be made before the beginning of FY08. EOAF's five-year capital plan will be completed by July 1, 2007, the start of the 2008 fiscal year, to ensure that the agencies have sufficient time to carry out the approved projects. EOAF will re-evaluate the five-year capital plan on an annual basis and make annual project spending allocations at the beginning of each fiscal year.
- ***Project development and oversight.*** EOAF will conduct due diligence on funded projects to ensure that capital funds are used appropriately and effectively. EOAF will also participate in the early stages of planning to ensure that projects have an appropriate scope and address the Commonwealth's needs and priorities.

Initial Capital Finance Program Objectives

The following are some of the Patrick-Murray Administration's initial capital finance program objectives:

- ***Affordability.*** As described above, the Patrick-Murray Administration's capital budget will be based on a thorough and rational analysis of debt affordability. This analysis will start with rigorous modeling to determine the impact of different "administrative bond cap" levels under various measures of affordability. These affordability measures will be derived from rating agency criteria and from the best practices of other states that are recognized for

excellent debt management policies. The Patrick-Murray Administration will be committed to limiting capital spending to the administrative bond cap unless additional projects can be funded from identified, one-time revenue sources or from an identified, self-supporting stream of new revenues.

- **Appropriate Allocation of Costs.** Paying the personnel costs of capital-intensive agencies through the capital budget misrepresents the true operating costs of government services and irresponsibly funds recurring annual operating expenses with debt. The Patrick-Murray Administration inherited approximately \$170 million of annual personnel and related costs being funded from the capital budget. Although it cannot all be done at once, the Patrick-Murray Administration is committed to working to shift these personnel expenses off of the capital budget and into the operating budget. The FY08 operating budget includes approximately \$10 million of Executive Office of Transportation personnel expenses previously carried on the capital budget, representing the first step toward eliminating this fiscally irresponsible practice.
- **Aligning Debt Duration with Project Life.** The Commonwealth currently issues bonds for a term of not greater than 20 years, regardless of whether the asset being financed has a useful life of longer than 20 years. It is appropriate, however, to finance buildings or other capital assets that last for 30 years or longer with 30-year debt instead of 20-year debt. By more closely aligning the life of the debt and the life of the asset, the Commonwealth would ensure that the current generation of taxpayers does not pay a disproportionate share of the cost of the asset and that future taxpayers who enjoy the asset do not get a free ride. The Patrick-Murray Administration will seek to more closely align the terms of new debt to projects' useful lives.
- **Maintaining Our Assets.** There is currently no formal policy or practice in place to ensure that sufficient funding exists to adequately maintain our state's capital assets. Consequently, the Commonwealth has a significant backlog of deferred maintenance projects. The Patrick-Murray Administration is committed to finding ways to properly fund and manage the maintenance of our capital assets.
- **Coordination of Resources.** The capital budget has contained a number of different local grant programs for economic development, affordable housing, transportation, land conservation, public works and other purposes. The Patrick-Murray Administration will establish formal procedures for coordinating the use of these types of resources to ensure that they are being efficiently and effectively targeted in a coordinated fashion to foster appropriate and productive development.

Innovations and Other Capital Financing in the Commonwealth

To achieve its capital investment priorities, the Patrick-Murray Administration plans to identify and leverage all of the many resources that exist to make sure they are productively used and coordinated. Within the bounds of fiscal responsibility, the Patrick-Murray Administration will seek creative financing mechanisms to fund capital projects in a manner that better leverages new or existing resources. It will also work with the state's independent authorities and quasi-public agencies to coordinate the use of their resources with the use of state resources to make desired capital investments. In addition, the Patrick-Murray Administration will support and promote new financing tools like "I-Cubed", which commits new state tax revenues expected to be derived from a proposed economic development project to pay a portion of the project cost.

With responsible management and creative use of all available resources, the Patrick-Murray Administration intends to expand the scope of the capital investments that can be made and to more efficiently and effectively finance its priorities and initiatives for the Commonwealth.

Requests for Bond Authorizations

Limited Short-Term Bond Bill

The Patrick-Murray Administration will soon be filing a bond bill to obtain limited bond authorization to fund short-term needs. This bond authorization is needed as soon as possible in order to: secure federal grants; address safety concerns and critically-needed repairs; carry on with projects that have already started or were planned to start, and thereby avoid further project cost inflation; avoid significant disruptions that would be caused if standard capital programs were stopped due to a lack of funding; and proceed with legally mandated projects. The bond bill will only seek borrowing authorization for projects that satisfy one or more of the short-term needs identified above. It will not include any projects planned to begin in FY 2008 or later that could start in the second half of FY 2008 or later without significant adverse consequences, and it will not include any new project initiatives. In light of the urgent need for the bond authorization and the limited scope of the bill, the Patrick-Murray Administration is requesting that this short-term bond bill be passed promptly by the Legislature without amendment.

Comprehensive Bond Bill

As described above, the Patrick-Murray Administration will be working over the next few months to develop its five-year capital investment plan by June 30, 2007. In July 2007, the Patrick-Murray Administration will file a comprehensive bond bill requesting the bond authorization needed to fund the five-year capital program. This comprehensive bond bill will reflect the Patrick-Murray Administration's long-term capital investment priorities.