HIGHWAYS STATE SPECIAL REVENUE ACCOUNT UPDATE

A Report Prepared for the

Legislative Finance Committee

By

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INTRODUCTION

The highways state special revenue account (HSSRA) provides the state funding match for more than $300 million annually of federal transportation funding for a total of $500 million of annual transportation spending to maintain and expand the state transportation infrastructure. The HSSRA has historically experienced imbalances between revenues and expenditures. It is because of the significant impact on the state economy and the historical instability of the account that the Legislative Finance Committee (LFC) pays particular interest to the fiscal condition of this account. This report is prepared for the LFC to provide awareness of the fiscal condition of the account going into the 2007 legislative session.

This report presents the latest working capital analysis for the account as of the end of FY 2006 and explains: 1) the difference between this analysis and the "Legislative Fiscal Report 2007 Biennium;" 2) the assumptions used in the analysis; 3) the analysis results; 4) the impacts on Department of Transportation funding from high oil prices and construction material cost increases and supply shortages; and 4) legislative options for strengthening the account.

The most recent analysis, based on actual revenue and expenditure activity through FY 2006, shows a $10 million improvement from the report presented in the "Legislative Fiscal Report 2007 Biennium" that was based on appropriations through FY 2006. The report also shows that if all appropriations valid through FY 2007 are expended, the account would be fully depleted partway through FY 2007 and end the 2007 biennium with a negative balance of $17.6 million. However, if agencies revert appropriations at the average levels that occurred between FY 2000 and FY 2006 the fund would end the 2007 and 2009 biennia with positive balances of $17.6 million and $48.6 million, respectively.

THE HIGHWAYS STATE SPECIAL REVENUE ACCOUNT

Applicable Funds

HSSRA is used, among other purposes, to fund the major activities of the Montana Department of Transportation (DOT). Two funds are combined to form this account, the constitutionally restricted fund (fund 02422) and the non-restricted fund (fund 02349). The department records revenues in the fund most appropriate to the constitutional and statutory directions for the revenue source. However, all expenditures are made from the restricted fund, with the balance from the non-restricted fund transferred to the restricted fund.

Account Uses

HSSRA funds the operations of five programs of the DOT that administer, enforce, and support the construction, maintenance, and safe operations of Montana highways. HSSRA also funds Long-range Building Program projects for DOT facilities and those of the Department of Fish, Wildlife and Parks (FWP) related to roadway activities, and for programs of the Department of Justice (DOJ) that support highway or motor vehicle activities. Programs of DOJ that are partially funded with HSSRA are: 1) Legal Services Division; 2) Motor Vehicle Division; 3) Montana Highway Patrol; 4) Central Services Division; and 5) Information Technology Services Division. Appendix A shows the funding profiles for the programs of the DOJ funded with HSSRA.

For the 2007 biennium, the legislature appropriated HSSRA funds to the Department of Commerce for the Main Street Program and DOT for the Rail Service Competition Advisory Council. The Rail Service Competition Advisory Council funds were subsequently transferred to the Governor's Office to administer the council.

HSSRA also funds statutory appropriations that totaled $21.7 million[1] in FY 2006, transfers of $0.1 million per year to the noxious weed trust fund, alcohol production incentives capped at $6.0 million per year, and ethanol consumption incentives. The report assumes no changes in the allocations of the funds in future biennia.

REPORT SUMMARY

Working Capital

The analysis identifies the combined working capital for all funds of the account. Working capital is the difference between current assets and current liabilities, and provides some indication of the ability of the account to meet its current obligations. Current assets are cash and other resources that are reasonably expected to be realized in cash within one year. Likewise, current liabilities are obligations that are reasonably expected to be paid from existing current assets or through the creation of other current liabilities within one year. The adequacy of the working capital balance to sustain the operating costs of the department provides an indicator of the need for potential adjustments of revenues or service levels so the department can satisfy its mission in the long-term.

Comparison to Legislative Fiscal Report 2007 Biennium

The ending working capital balance for FY 2006 is the known starting point in this analysis for the estimates of succeeding fiscal years. Figure 1 shows the most recent working capital analysis for the HSSRA from FY 2006 through FY 2009. The ending working capital balance for FY 2006 is $10.0 million higher in this analysis than that shown in the "Legislative Fiscal Report 2007 Biennium." The improvement in the FY 2006 ending balance is due mostly to the net of the following:

- Gasoline tax revenues were $2.6 million lower, while diesel tax revenues were $2.8 million higher than estimated
- Indirect cost recovery was $4.3 million lower than estimated
- Other revenues were $8.6 million higher than estimated
- Alcohol production incentives were expected to be $3.0 million in FY 2006, but due to delays starting production facilities, the incentives are now not expected to begin until FY 2007
- Expenditures were $2.7 million lower than appropriations

Summary of Results

The analysis shows that the expenditures from the account continue to exceed revenues and the balance continues to decline. In FY 2006 expenditures exceeded revenues by $15.8 million, or 5.9 percent. The revenue deficit grows to $44.8 million and the ending balance goes to negative $17.6 million in FY 2007 due primarily to inclusion of all unexpended appropriations available to be appropriated by the 2007 Legislature. Historically, agencies have reverted portions of their appropriations. After applying the average reversions for the period from FY 2000 to FY 2006 for DOJ and DOT, the FY 2007 ending balance is projected to be $17.6 million and the 2009 biennium begins with a balance equivalent to the account imbalance that occurred in FY 2006. Since this relatively low balance going into the 2009 biennium only includes adjustments for the pay plan of the 2005 Legislature, an increase for federal-aid highway construction equivalent to the growth of published federal apportionment levels, and relies on agencies reverting appropriations at the historical levels, there is little room for the 2007 Legislature to provide further increases of agency funding from the account.

[1] In FY 2006, an accounting change increased statutory appropriations by $3.8 million in association with distribution of gasoline tax refunds to tribal governments in Montana. Prior to FY 2006, the refund was accounted for as a revenue abatement. For consistency with HJR 2, the working capital analysis shows the refund as a revenue abatement, so revenues and expenditures shown on Figure 1 are both lower by $3.8 million than shown on the statewide accounting system.

Other Pressures

In addition to pressures from a state fund with questionable financial stability, the legislature will also be faced with pressures imposed by worldwide factors impacting the price and availability of construction materials and a federal trust fund with a questionable financial stability, both of which will impact the projects that can be undertaken.

Figure 1

Working Capital Analysis - Highways State Special Revenue Account
Fiscal Years 2006- 2009 Legislative Budget
(in Millions)

Description	FY 2006 Actual	FY 2007 Approp.	FY 2008 Forecast	FY 2009 Forecast
Beginning Working Capital Balance	$43.6	$27.2	-$17.6	-$35.3
Revenues				
Gasoline tax (net of refunds)	$125.6	$128.8	$129.3	$129.9
Diesel tax (net of refunds)	$67.8	$68.7	$71.5	$74.5
Gross vehicle weight fees (GVW)	$27.6	$27.4	$27.4	$27.4
Indirect cost recovery (based on agency input)	$30.2	$35.1	$36.4	$36.7
Other revenues	$15.6	$16.6	$17.2	$17.7
Revenue deductions				
Gasahol tax reduction (based on agency input)	-$0.3	-$0.5		
Alcohol production incentives (15-70-522, MCA)	$0.0	-$2.0	-$6.0	-$6.0
Total Revenues	$266.5	$274.1	$275.9	$280.3
Expenditures				
Department of Transportation (includes annualized pay plan)	$255.1	$287.7	$264.0	$267.0
Governor's Office (Rail Service Competition Council)	$0.0	$0.1		
Department of Commerce (Main Street Program)	$0.1	$0.1		
Department of Justice (includes annualized pay plan)	$24.4	$26.1	$26.1	$26.2
Long-Range Building Program				
Maintenance and repair of MDT buildings	$1.7	$3.1	$2.5	$2.5
Department of Fish, Wildlife & Parks	$0.8	$1.7	$0.8	$0.8
Total Long-Range Building Program	$2.5	$4.9	$3.3	$3.3
Transfer for noxious weeds (80-7-823, MCA)	$0.1	$0.1	$0.1	$0.1
Total Expenditures	$282.3	$318.9	$293.5	$296.5
Revenues less expenditures	-$15.8	-$44.8	-$17.7	-$16.2
Adjustments	$0.7			
Ending Working Capital Balance	$27.2	-$17.6	-$35.3	-$51.5
Average reversions (FY 2000 through FY 2006)		$35.2	$32.2	$32.6
Ending Working Capital Balance (with average reversions)		$17.6	$32.2	$48.6

Impacts of High Construction Material Costs and Shortages

Based on statistics from DOT, average highway construction costs have increased by 22.5 percent since August 2005. The cost increase is due in large part from higher construction material costs, such as pavement, concrete, steel, and other petroleum based construction materials. A key factor for the higher costs is the high worldwide demand for many construction materials. With higher construction costs, each state dollar buys a significantly smaller amount of highway maintenance and construction than it bought previously. Since federal funding is fixed at the levels apportioned to the state and subsequently appropriated by congress and obligated for distribution, higher costs translates into fewer construction projects. The construction plan that formed the basis for the legislative appropriations for the 2007 biennium has seen projects delayed or reprioritized as the department manages within available funding. The growth of construction material costs appears to be slowing or stabilizing but not declining. As such, the department will need to maintain the state highway network and address highway demand pressures in an environment of higher cost, but the same financial resources that are showing signs of financial stress and instability.

High construction costs may also impact the amount of reversions of the department as the department manages to minimize the impacts of high costs on construction project delivery. Since Figure 1 and the working capital analysis show a reliance on historical reversions to maintain positive account balances, historical reversions may cease to indicate future activity and the balances that result from considering reversions may not come to fruition.

Federal Highway Trust Fund

Federal highway funds are apportioned to states in multiyear federal funding authorizations. The latest authorization was signed into law by the President on August 10, 2005, and is titled The Safe, Accountable, Flexible, and Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU). SAFETEA-LU sets specific annual funding levels for most federal highway programs on the basis of projected receipts to the federal Highway Trust Fund for federal fiscal years 2005 through 2009. According to a published release by the United States Government Accounting Office (GAO) on testimony before a subcommittee of the U.S. House of Representatives[2], the federal Highway Trust Fund balance could go negative as early as 2009. The GAO testimony raised concerns about whether funding for federal highway programs – which were recently authorized by SAFETEA-LU – will continue to be met. The GAO states that "The Highway Trust Fund balance is gradually being depleted because estimated outlays of the Highway Account exceed estimated revenues each year from 2006 through 2011."

The funding for the federal-aid highway program is a "pay as you go" system funded by receipts from highway user excise taxes[3]. In other words, there must be enough money in the fund to make reimbursements. Since the federal-aid program typically obligates reimbursement of funds to capital projects whose reimbursements spread over several years, the calculation for determining how much funds will be apportioned to federal-aid programs considers the current fund balance and revenues anticipated to be collected in the next two years. All existing obligations that have not been reimbursed are then deducted to determine the amount of funds available to be apportioned to states. Because of the current condition of the trust fund, funds available to be apportioned could likely be significantly lower than the apportionment levels published for SAFETEA-LU.

Potential Legislative Options for Strengthening the Account

The stability of the federal trust fund for highways is questionable, the stability of the state highway account is questionable, and construction costs have risen. The impacts of questionable funding and higher costs could have a dramatic impact on the number of highway projects undertaken in Montana and even the condition of Montana's highway infrastructure. If federal funding levels decline below the levels expected in SAFETEA-LU due to federal trust fund balances, the legislature may feel pressures from its constituency to provide state funds to offset federal funding deficiencies. As such, the legislature may wish to consider its options for addressing the potential funding choices for Montana's highways.

Federal funding levels for federal FY 2007 have not been determined and the Executive Budget has not been completed. Without these two key components, the structural integrity of HSSRA is still uncertain and decisive actions by the legislature to address the account stability may be premature. However, Figure 1 indicates that the funding source for the maintenance and operation Montana's highways is tenuous at best. Given the uncertainty, the intent of this report is to inform the legislature that it may be faced with any or all of the following three basic options to strengthen the account to support future biennia operations: 1) continue to rely on the department to manage the account; 2) increase revenues; and 3) reduce or control expenditures of HSSRA funds, while still matching all federal funds.

[2] Testimony by Katherine Siggerud, Director of Physical Infrastructure Issues, United States Government Accountability Office, on April 4, 2006, before the Subcommittee on Highways, Transit, and Pipelines, Committee on Transportation and Infrastructure, U.S. House of Representatives (GAO-06-572T)

[3] Excise taxes on motor fuels, such as gasoline, diesel, and special fuels; and truck related taxes, such as truck and trailer sales, truck tires, and heavy-vehicle use)

Continue to Rely on Montana Department of Transportation Management

The legislature could continue to rely on the department to maintain the account in a condition that would provide for the operations of those programs funded from the account through appropriations of the legislature. The department would have no control over other agencies funded with the account and would have to maintain the account balance by prioritizing the 91 percent of total annual HSSRA expenditures appropriated to the department. As such the legislature would rely on the department and the executive for proposing any legislative initiative to shore up the account.

Increase Revenues

At $0.2775 per gallon for gasoline and $0.285 per gallon for diesel fuel, including the $0.075 per gallon that goes to the petroleum tank cleanup fund, Montana ranks eighth highest in gasoline tax rates[4] and six states now have variable tax rates that are indexed to an economic indicator. Combined, gasoline and diesel taxes provide roughly 73 percent of annual revenues for HSSRA. The legislature could balance expenditures by increasing highway user fees such as gasoline and diesel taxes or gross vehicle weight fees, or it could establish new fees. Any increases of the gasoline or diesel tax rates or gross vehicle weight fees would require legislation. Based on FY 2006 actual revenues, each $0.01 increase of gasoline tax generated roughly $4.8 million revenues for HSSRA.

Reduce or Control Expenditures

For the past several biennia, the legislature has appropriated more from HSSRA than it estimated in revenues. The legislature has relied on the fund balance to balance the HSSRA budget. As stated, HSSRA funds many services in addition to those of the department. To bring HSSRA expenditures in line with revenues, the legislature could reduce expenditures or enhance revenue in any of the following ways:

- Amend statute to reduce or eliminate alcohol production incentives (15-70-522, MCA)
- Amend statute to reduce or eliminate ethanol consumption incentives (15-70-204 and 321, MCA)
- Amend statue to reduce or eliminate the $100,000 annual transfer to the noxious weed trust fund (80-7-823, MCA)
- Amend statute to reduce or eliminate the statutory appropriations to cities, towns, counties, and consolidated city-county governments and to the Montana local technical assistance transportation program (15-70-101, MCA)
- Prioritize services and match appropriations made to the department, Department of Justice, and Long-range Building Program with estimated revenues

Included in the assumptions in the working capital analysis summarized on Figure 1 are past practices of the department[5] that Montana would: 1) expend state funds to match all federal funds available to the state; and 2) expend all federal indirect cost recovery revenues as state funded construction expenditures. These two assumptions could be modified to reduce or control HSSRA expenditures. Perhaps the legislature may wish to reduce HSSRA expenditures for state construction projects funded with federal indirect cost recovery revenue.

One way the legislature could establish controls over how low the account balance went and still allow the department to maximize the amount of construction activity if favorable fund balances exist would be to establish a tiered approach to department appropriations. A tiered approach could be implemented by funding the highest level of expenditures in appropriations for the department and establishing separate appropriation for lower level priorities and placing restrictions and conditions on the lower level appropriations that would allow expenditures for the activities if certain conditions occurred. Conditions to activate an appropriation could be

[4] States with higher total gasoline or diesel tax rates are New York ($0.4577 and $0.4453), North Carolina ($0.299 and $0.299), Ohio ($0.28 and $0.28), Pennsylvania ($0.323 and $0.392), Rhode Island ($0.30 and $0.30), Washington ($0.31 and $0.31), and Wisconsin ($0.329 and $0.329)

[5] A decision package is included in the department submittal to the budget office to reduce state funded construction by $11.3 million per year from the base level. Since this is a policy change not concurred in by the legislature, it is not included in the assumptions for this analysis.

structured around achieving a certain level of revenue or fund balance. The legislature could control expenditure of indirect cost recovery revenues by approving a line item appropriation and restricting and conditioning the appropriation only for expenditures on state funded construction activities under specified conditions, such as maintenance of a minimum ending balance. The legislature could also amend the statute that authorizes the HSSRA to provide a requirement to maintain a minimum ending balance.

CONCLUSION

Current projections of HSSRA indicate that the adequacy of the HSSRA working capital balance is questionable for providing funding through the 2007 biennium without relying on agency reversions. Projections indicate that with current revenue streams and present law spending, the account may not be able to sustain spending in the 2009 biennium. If the projections of this analysis hold true, the legislature may soon be faced with choices for restoring a structural balance between revenues and expenditures of the HSSRA.

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APPENDIX A

Department of Justice -
HSSRA Program Funding Profiles

Department of Justice
Program Funding Percentages
FY 2006

Program	General Fund	HSSRA	Other State Special Revenue	Federal Special Revenue	Other
Legal Services Division	33.8	0.6	3.7	4.2	57.7
Motor Vehicle Division	31.3	20.6	23.1	3.4	21.6
Highway Patrol Division	3.4	82.2	3.9	10.5	0.0
Central Services Division	36.2	48.8	9.0	0.0	6.0
Information Technology Division	68.5	1.8	28.1	1.3	0.3

APPENDIX B

Analysis Assumptions

The following assumptions were used to forecast future revenues and expenditures for the October 2006 update of the working capital analysis for the highways state special revenue account

Revenues:

- FY 2007 estimates for gasoline and diesel taxes and gross vehicle weight fees are HJR 2 estimates (will be updated as estimates for the 2009 biennium are developed)
- FY 2008 and FY 2009 estimates for gasoline and diesel taxes and gross vehicle weight (GVW) fees are FY 2007 HJR 2 estimates adjusted by the corresponding growth rate in HJR 2 from FY 2006 to FY 2007 (0.45 percent for gasoline, 4.2 percent for diesel, and 0.0 percent for GVW)
- Indirect cost recovery revenues are based on Department of Transportation projections published in the Third Quarter FY 2006 department Director's Report
- Gasohol tax reductions and alcohol production incentives are based on Department of Transportation projections published in the Third Quarter FY 2006 department Director's Report
- Other revenues, which accounts for a general fund transfer and numerous miscellaneous revenues that are not estimated by the Legislature in HJR 2, are projections using least squares method and based on actual revenues from FY 2002 through FY 2006

Expenditures:

- FY 2007 expenditures are unexpended appropriations valid for the 2007 biennium (because Long-range Building Program appropriations are continuing appropriations, the FY 2007 appropriation includes unexpended portions of prior biennium appropriations)
- 2009 biennium expenditures, except for Construction Program expenditures, are FY 2007 appropriations adjusted only to annualize the pay plan approved by the 2005 Legislature in HB 447 (includes no inflationary adjustments)
- 2009 biennium Construction Program expenditures, are FY 2007 appropriations adjusted to annualize the pay plan approved by the 2005 Legislature in HB 447 and inflated by 3.0 percent annually to reflect growth in federal construction funding as published in apportionment tables for SAFETEA-LU
- Reversions are the average reversion percentages for the period from FY 2000 through FY 2006 for HB 2 appropriations made to the Departments of Transportation (12.7 percent) and Department of Justice (3.7 percent)