

# Utah State Capital Resource Allocation

## A Proposal for Increasing the Transparency of Capital Expenditures, Including Facilities

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Capital Expenditures are a unique challenge in state budgets because subdivisions of the state are rarely charged for using the state's debt or equity for facilities, equipment, and other investment needs. In an effort to take advantage of the current resource allocation process, state subdivisions lobby for capital expenditure appropriations. The result is an inefficient distribution of resources for capital expenditures within state budgets where the most connected, best funded lobbying efforts frequently win. This paper proposes changing the capital resource allocation processes by attaching a cost to state appropriated capital expenditures in an effort to increase accountability and efficiency while improving the long term credit strength of the state.

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## DCFS Overstates Lease Savings

In July of 2011, the State of Utah on behalf of the Division of Child and Family Services (DCFS) signed a new lease to occupy the former Washington County Justice Center. The Spectrum reported that the lease rate was to be \$180,000 per year.<sup>1</sup> DCFS indicated that the transaction was a good deal because it would realize savings of nearly \$500,000 over the next five years compared with their old lease on River Road.

The savings were calculated from the difference between the old lease rate and the new lease rate. DCFS entirely ignored tenant improvements at the State's expense of \$700,000 that were incurred before DCFS could take occupancy. DCFS incurred no direct expense for the tenant improvement cost, which is why it was not included in the DCFS evaluation. Even though DCFS failed to include the tenant improvement cost, the taxpayers of the State of Utah still paid for the tenant improvements on behalf of DCFS. In this example, the savings associated with moving from one space to another were substantially overstated.

Why did DCFS ignore the \$700,000 in tenant improvement costs spent by the State of Utah? Because the actual cost to DCFS was zero.

## DSU Increases Operating Cash by Securing Capital Appropriation

In July of 2015, Dixie State University's endowment sold University Plaza to Dixie State University.<sup>2</sup> This transaction was the end of an acquisition that began in 2008. Dixie State wanted to acquire University Plaza (formerly Dahle Plaza) and a nearby property referred to as the Larkin property, but the State of Utah would not appropriate the funds. Dixie State moved forward anyway and used its endowment to purchase the properties.

Because the endowment holds assets for investment, Dixie State was required to lease the properties from the endowment in order to use them. The lease payment was designed to offset the debt service from the transaction, provide management, and indemnify the University Foundation against liability. In the 2014 Dixie State Annual Financial Report it states that the University hopes to secure funds from the State of Utah to acquire University Plaza and the Larkin property from its own endowment.<sup>3</sup>

Now that DSU has acquired the property from its endowment using state appropriated capital facilities funds, the University is no longer required to make lease payments. This resulted in a savings to the University's operating expenses by the amount of the lease payment, or \$459,202 annually. This was the equivalent of the Legislature giving DSU a \$459,202 increase in its annual appropriation.

Why did DSU engage in this seven-year transaction? Securing this appropriation reduced the university's operating expenses, giving them the ability to spend that money elsewhere. While there was no cost to the university, there was a very real and direct cost to the State of Utah when it paid for a building it already owned in one of its university's endowments.

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<sup>1</sup> Ahern, Brian "Washington County Leases Out Old Justice Building" *The Spectrum*. July 12, 2011 Section A p. 1.  
Editorial Board "Justice Center" *The Spectrum*. July 14, 2011 Section A p. 5

<sup>2</sup> Washington County Utah Recorder Warranty Deed Entry Number 20150026456

<sup>3</sup> Dixie State University Annual Financial Report for the Year Ended June 30, 2014 by the Office of the Utah State Auditor Note 6, 12, and 13. An entirely different question not considered here is whether or not the endowment's purchase of a facility leased to the University was an appropriate use of the endowment funds.

## Higher Ed Capital Assets Are Allocated by Influence, not Need

Utah State budgets are dominated by education. Within the education budgets, there is fierce competition between K-12 and higher education for funding. When comparing funding, it is important to note that the two systems are funded very differently.

K-12 receives appropriations from the state, plus property taxes. The property tax component is very important because school districts fund their facilities through bonding secured by property tax revenue. When school districts bond for facilities, they must pay back the money borrowed, show the asset and liability on their balance sheet, and recognize the interest and depreciation expenses. School districts must fund all property, plant, and equipment costs out of cash and debt. Their facilities expenditures are constrained by their cost of capital and credit capacity.

Higher education also receives operating funds from the State, similar to school districts, but without taxing authority, they cannot issue debt on their own. As a result, higher education addresses most of its facilities and equipment needs by asking the Legislature for one-time capital appropriations. Once the appropriation for a building is secured, unlike school districts, it is never paid back and there are no market constraints on capital investment.

Funding comparisons between higher education and K-12 are not complete without including the capital appropriations to higher education. Failure to include these appropriations would be the rough equivalent of eliminating all of the municipal bond debt service associated with school districts.

Within higher education, the facilities appropriations process is inefficient. The evidence is in the following comparisons used from audited financials from eight institutions of higher education in the State of Utah. The data is from the respective institution's annual financial report for 2014, the most recent available as of this writing. For the complete analysis table, see Exhibit 1.

Institution (A)	State Appropriations/FTE (B)	CANP/FTE (C)	CANP/FTE Debt Service Equivalent (D)	Total State Support (B + D)
U of U	\$10,240	\$56,895	\$2,873	\$13,113
UVU	\$3,341	\$12,282	\$620	\$3,961
USU	\$8,241	\$25,527	\$1,289	\$9,531
WSU	\$4,207	\$13,619	\$688	\$4,895
SLCC	\$4,709	\$14,204	\$717	\$5,426
SUU	\$5,128	\$17,327	\$875	\$6,003
DSU	\$4,054	\$17,443	\$881	\$4,934
SC	\$5,357	\$20,745	\$1,048	\$6,404

CANP is Capital Assets less Depreciation less Total Bonds, Notes, and Contracts

Capital Asset Net Position is capital assets less accumulated depreciation less total bonds, notes, and contracts. This reflects the cumulative capital investment in property, plant, and equipment at the historical cost adjusted for depreciation. The final adjustment for total bonds, notes and contracts recognizes that universities do receive authorization for revenue bonds and other funding for specific use facilities construction. By subtracting the commitments associated with these debt issues, it

approximates the capital that the state has contributed to the campus—net of depreciation. Last, this has been converted to a per student and FTE metric.

Note that the University of Utah has approximately \$57,000 in capital assets per full time equivalent compared with Utah Valley University at only \$12,282. This suggests that the U has receive 4.6 times the facility funding that UVU has received over time.

Referring to Exhibit 1, as of the fiscal year ended 2014 the U has \$4.368 billion in capital facilities on its balance sheet, compared with \$463 million for UVU. This is a difference of nearly 10 times to the disadvantage of UVU while the enrollment numbers are similar and FTE numbers are 26,742 for the U and 21,335 for UVU. A portion of the substantial discrepancy is due to the medical school, the primary research activities, and other programs unique to the University of Utah.

The University of Utah should have more resources at it's disposal, but ten times is a wide discrepancy. Further, after adjusting for depreciation and for the debt service associated directly associated with the U's special programs and services, the U is still receiving FTE equivalent funding that is 4.6 times UVU's funding level for capital facilities.

Why the discrepancy? Because the University of Utah is better at securing facilities appropriations. When there is a shortage, the only way to distribute capital is through rationing. Rationing is an inefficient way to allocate resources in any economy. In this context, those who have the most influence receive the most resources. When the cost to the institution for the facility is zero their appetite for facilities is nearly unlimited and there is a tendency to overconsume. This problem occurs wherever prices are set artificially low.

## Facilities are not Free

The problem in all three of the above scenarios is the same. State subdivisions perceive the cost of using the state's capital for facilities is zero. Any one-time money that can be secured from the State of Utah for facilities is treated as though it were essentially free.

This is not a problem unique to the examples described. Any agency or subdivision of the State that can secure an appropriation for a capital expense (buildings, land, equipment, IT, etc) will never have to pay for it in today's capital budgeting processes. This extends to current proposed projects such as water development, prison relocation, and transportation.

Consider the irony. If the subdivision of the state secures the use of a real estate through a lease agreement, which has monthly or annual lease payments, it must make the payments out of its operating expenses. If it can purchase the real estate all at once with a one-time appropriation from the state, it will never have to realize the cost. It is free. Similarly, if a subdivision of the state leases a server, it must pay for it out of its operating budget. If the same subdivision secures an appropriation, it is free.

Zero is a particularly problematic price. In economics, price is the primary mechanism for allocating goods and services in an economy. Price generally functions well both in the private sector as well as the public sector. We know that setting prices too low increases demand and creates a shortage. Prices of zero are an extreme version of the shortage problem where demand is nearly insatiable.

In the public sector, there are many examples where price effectively allocates resources. Labor markets influence the number of employees hired by the state. Budgets and the cost of supplies constrain purchasing activities. The Laffer Curve has long depicted the interaction between tax rates and tax revenue.

In public finance, operating budgets tend to receive more scrutiny than capital budgets. The decision to allocate part of an operating budget creates a real sense of the opportunity cost associated with that allocation. The decision maker realizes that spending the money on a facility lease means that he or she cannot hire additional staff with the same funds.

Currently, we treat capital expenses differently. Instead of employing price to assist with the allocation of demand for multiple year assets (capital expenditures), subdivisions and their representatives lobby the executive and legislative branches of government for a piece of the resource with an artificially low price of zero. Appropriations are made based on a combination of the perceived need and the persuasiveness of the argument. This is in contrast with other large organizations with strong capital budgeting procedures and an established cost of capital or hurdle rate.

## What Are the Costs?

When the state appropriates funds for capital expenditures, there is always a cost. At a minimum, opportunity cost represents the foregone benefit of the next best alternative. Take the DCFS example. When DCFS moved locations, they reduced the lease rate by \$100,000 per year, but they spent \$700,000 in tenant improvements to do it. What if they had renegotiated the existing lease and not spent the \$700,000? They could have purchased new equipment, they could have hired two staff at \$50,000/year for seven years, they could have leased even more space, or maybe they could have invested in new training that would allow them to reach more kids.

What about in DSU's example—they saved money, right? When DSU received funds from the state to purchase the facility, they reduced their expenses by eliminating the lease payment in the operating budget. DSU saved money, but the savings came at an equivalent cost to State of Utah. It is reasonable to assume that the state may now have to service debt equal to the amount of the facility acquisition. Even if the acquisition was funded with cash, it was cash that could have retired interest bearing obligations for the State.

## Charge a Cost of Capital to Subdivisions of the State

Consider a hypothetical example. Assume that a subdivision of the state needed \$50 million for facilities expansion. If the state's cost of capital were 4% and the asset has a life of 40 years then the subdivision of the state should pay \$2,526,000 per year back to the state for use of the funds.<sup>4</sup> This is a reasonable argument because the subdivision transferred the cost of the asset acquisition to the state. The costs of

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<sup>4</sup> See Exhibit 2. \$50 million amortized over 40 years at 4% interest works out to an annual payment of \$2,526,000.

funding the \$50 million investment to the state are realized both in the form of the state's debt service as well as reduced credit capacity.

This is not a new concept. In many instances, revenue bonds are used to fund projects where the revenue is committed to service the project specific debt. This proposal is not to force every capital expenditure to be a revenue bond, but the proposal is to require subdivisions to pay for their capital consumption as though they were revenue bonds.

Although the state may or may not issue debt in a specific case, this treatment would make it easier to compare funding levels across state budgets. Both the opportunity cost and the actual costs associated with the debt service and credit capacity have been considered and are reflected in each subdivision's annual financial report.

## Proposed Solution

Determine the state's cost of capital and charge that cost of capital to the subdivisions that are using the funds. This could be done in one of three ways. The Treasurer could determine the cost of capital, the Legislature could determine the cost of capital, or third, the interest rate on the most recent state debt issue of over \$50 million could determine the cost of capital.

Subdivisions using state funds would pay an amortized payment into a capital replacement fund that would help service the state's debt and new capital expenditures. The capital charge would show up on each subdivision's respective Statement of Activities, much like a lease payment currently does, and better reflect the equivalent annual funding provided by the State. It would be important to work with the Auditor's office to determine a methodology around the accounting.

Exhibit 2 provides an illustration of the accounting treatment of the proposed solution. Note that the Statement of Activities is actually improved relative to current treatment and the Statement of Net Position more accurately reflects both the asset and the liability associated with the state's capital expenditure on behalf of the subdivision.

This treatment has precedent. For example, the DSU financial statements show a capital lease obligation for bonds issued by the Board of Regents.<sup>5</sup> DSU was in fact incurring a charge for the proceeds raised by the bonds issued by the Regents. Similar treatment is found in other university annual reports. Instead of reflecting a charge for the use of capital only when there is a special situation, the practice should be to charge for the use of the capital all the time. This will prevent a discrepancy resulting from having a cost of funds in the "free" pool of money provided by the state and the "not free" pool of capital provided through the Regents' bond.

Where would the funds come from to make the payments? Either the legislature would have to fund the payments or the application would be merely an accounting treatment. Actually funding the payments would make the program more effective. Further, it wouldn't increase funding requirements

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<sup>5</sup> Dixie State University Annual Financial Report for the Year Ended June 30, 2014 by the Office of the Utah State Auditor Note 6

at the Legislature. The state is already funding the capital expenditures and servicing the debt. The final step is to transfer the obligation to the subdivision that requested it.

## Benefits of Charging for Capital

Implementing the proposed solutions creates distinct benefits for the resource allocation processes and by extension the citizens of the state.

1. Lease versus buy distortions would be reduced or eliminated—If in fact it was cheaper to lease a capital asset, there would no longer be an incentive to ask for an appropriation to purchase. Purchasing would no longer be treated as though it were free.
2. Credit rating and credit capacity are protected—Requiring projects to meet cost of capital requirements will help eliminate unnecessary projects and allow more viable projects to receive needed funds. Further, the capital replacement fund will increase the state's ability to service its debt. Last, because the capital replacement fund is returning capital to explicitly service debt, the state's credit rating and credit capacity are maximized.
3. Annual Financial Reports will better reflect resource allocation—Annual Financial Reports from the Office of the Utah State Auditor will be more representative of the resources directed to a subdivision of the state in any given year. Having a more accurate picture of the resources being used will make comparisons among competing interests more accurate and transparent.
4. Better aligned incentives between the state and its subdivisions—Eliminating the incentive to create one-time capital appropriations out of ongoing expenditures will result in less brinkmanship in budgeting and fewer games.
5. Accounting treatment for subdivisions without taxing authority will more closely match those with taxing authority—Making the change will narrow the funding discrepancy that currently exists where cities, counties, and school districts must pay for their own capital expenditures out of cash or through debt service, while other subdivisions benefit from accounting treatment that does not require them to recognize the true cost of their facilities and other capital expenditures.

Some of the mechanisms the state is currently utilizing to help reduce distortions need not change. For example, frequently the state requires subdivisions to fundraise or otherwise contribute a portion of the capital expenditure as a form of down payment. This policy does not have to change. If it is deemed effective, then it could continue without negatively impacting the preceding recommendations.

There will always be valid exceptions to the process. The challenge will be to avoid the exception becoming the de facto rule.

Some might want to take the recommendations one step further and implement a more corporate style capital budgeting process complete with NPV and IRR analysis. While this may be a valid discussion point, it introduces additional questions such as, who calculates the NPV, what is the process of



determining cash flows for the NPV analysis, what is the review process, etc. These questions should be answered clearly prior to implementing a more rigorous capital budgeting process.

Even though the recommendations included do not require explicitly calculating NPVs and IRRs, the proposed process of assigning a capital charge will require subdivisions to consider taking on the incremental costs associated with using the state's capital to purchase assets for its balance sheet. This should result in more efficient capital expenditure allocation, enhanced credit quality, and continued oversight and engagement through the existing legislative processes.

## About Neil Walter

Chief Operating Officer and principal at Brokers Holdings, which transacted over \$2 billion in residential and commercial real estate sales and leasing over the past 10 years. Licensed real estate broker in Utah, Nevada, and Idaho. Brokers Holdings' two firms are NAI Utah South and ERA Brokers Consolidated.

UT GOP State Central Committee Member from 2011-2015 representing Washington County and 2010 candidate for US Congress in Utah's 2nd Congressional District. Vista Charter School board chair/board member since 2011.

Part-time/Adjunct instructor at Dixie State University in Finance and Economics since 2006. Courses taught include Investments, Macroeconomics, Intro to Economics, Financial Modeling and Decision Making, Statistics, Real Estate Finance, and Entrepreneurial Finance.

Fortune 50 corporate experience in risk management and security pricing at ConocoPhillips. Priced security portfolios of over \$3 billion dollars and built custom risk metrics and systems.

MBA from Carnegie Mellon University, BS in Finance from BYU. Chartered Financial Analyst (CFA) charter holder and member of the CFA Societies of Salt Lake and Las Vegas. [Click to learn more about the CFA program.](#)

Southern Utah boy married to a Utah County girl. Fortunate enough to have experience with and be educated about Utah's role in a global economy while maintaining an important connection to my roots through our working family ranch in Garfield County.

## Why This Paper?

I love economics. Economics is the study of the allocation of resources. In most industrialized nations, governments are the single largest allocator of resources either through direct expenditures, third party contracts, or transfer payments. Politics and economics are deeply interrelated.

My training and interests are in improving resource allocation through financial modeling and creative restructuring for both government and private enterprises. My interests are generally related to these disciplines whether it be from a local, national, or global perspective.

I enjoy discussing portfolio construction and management, capital structure, lease vs buy decisions, real estate feasibility and market analysis, and opportunity cost analysis for both private and public entities. My custom models are set up for pro-forma cash flow analysis, portfolio analysis, and incremental cash flow analysis.

If you are interested, check me out on [LinkedIn](#) or [download my CV](#).

**Exhibit 1: Higher Education Capital Asset Appropriations by Institution.** Data from 2014 Annual Financial Reports for select Higher Education Institutions.

	U of U	UVU	USU	WSU	SLCC	SUU	DSU	SC
Enrollment	31,515	31,332	27,662	26,266	29,537	7,656	8,570	4,779
FTE	26,742	21,335	20,899	15,989	15,932	6,150	6,405	3,746
Tuition Rev	\$ 291,184,000	\$ 106,684,620	\$ 109,763,378	\$ 78,578,065	\$ 66,839,102	\$ 46,346,728	\$ 29,905,185	\$ 7,047,754
State Appropriations	\$ 273,839,000	\$ 71,279,595	\$ 172,237,348	\$ 67,266,600	\$ 75,022,429	\$ 31,538,161	\$ 25,963,029	\$ 20,066,231
Capital Assets (PP&E)	\$ 4,367,500,913	\$ 462,734,267	\$ 1,191,082,497	\$ 460,829,025	\$ 358,259,049	\$ 215,489,820	\$ 183,646,086	\$ 159,817,659
Depreciation	\$ 1,954,771,766	\$ 127,273,988	\$ 509,610,790	\$ 182,993,618	\$ 125,466,671	\$ 89,318,939	\$ 55,709,171	\$ 64,924,810
Net Capital Assets	\$ 2,412,729,147	\$ 335,460,279	\$ 681,471,707	\$ 277,835,407	\$ 232,792,378	\$ 126,170,881	\$ 127,936,915	\$ 94,892,849
Current Bonds, Notes, and Contracts	\$ 139,930,000	\$ 3,888,429	\$ 8,413,390	\$ 2,233,388	\$ 1,691,249	\$ 1,663,554	\$ 1,256,826	\$ 609,044
Noncurrent Bonds, Notes, and Contracts	\$ 751,316,000	\$ 69,529,329	\$ 139,561,435	\$ 57,845,542	\$ 4,800,994	\$ 17,943,604	\$ 14,960,720	\$ 16,573,072
Total Bonds, Notes, and Contracts	\$ 891,246,000	\$ 73,417,758	\$ 147,974,825	\$ 60,078,930	\$ 6,492,243	\$ 19,607,158	\$ 16,217,546	\$ 17,182,116
<b>Capital Asset Net Position (CANP)</b>	<b>\$ 1,521,483,147</b>	<b>\$ 262,042,521</b>	<b>\$ 533,496,882</b>	<b>\$ 217,756,477</b>	<b>\$ 226,300,135</b>	<b>\$ 106,563,723</b>	<b>\$ 111,719,369</b>	<b>\$ 77,710,733</b>
Capital Asset Net Position is Net Capital Assets less Total Bonds, Notes and Contracts								
Tuition/Student	\$ 9,240	\$ 3,405	\$ 3,968	\$ 2,992	\$ 2,263	\$ 6,054	\$ 3,490	\$ 1,475
Tuition/FTE	\$ 10,889	\$ 5,000	\$ 5,252	\$ 4,915	\$ 4,195	\$ 7,536	\$ 4,669	\$ 1,881
State Appropriations/Student	\$ 8,689	\$ 2,275	\$ 6,226	\$ 2,561	\$ 2,540	\$ 4,119	\$ 3,030	\$ 4,199
<b>State Appropriations/FTE</b>	<b>\$ 10,240</b>	<b>\$ 3,341</b>	<b>\$ 8,241</b>	<b>\$ 4,207</b>	<b>\$ 4,709</b>	<b>\$ 5,128</b>	<b>\$ 4,054</b>	<b>\$ 5,357</b>
Capital Assets/Student	\$ 138,585	\$ 14,769	\$ 43,058	\$ 17,545	\$ 12,129	\$ 28,147	\$ 21,429	\$ 33,442
Capital Assets/FTE	\$ 163,320	\$ 21,689	\$ 56,992	\$ 28,822	\$ 22,487	\$ 35,039	\$ 28,672	\$ 42,664
Net Capital Assets/Student	\$ 76,558	\$ 10,707	\$ 24,636	\$ 10,578	\$ 7,881	\$ 16,480	\$ 14,928	\$ 19,856
Net Capital Assets/FTE	\$ 90,222	\$ 15,723	\$ 32,608	\$ 17,377	\$ 14,612	\$ 20,516	\$ 19,975	\$ 25,332
Capital Asset Net Position/Student	\$ 48,278	\$ 8,363	\$ 19,286	\$ 8,290	\$ 7,662	\$ 13,919	\$ 13,036	\$ 16,261
<b>Capital Asset Net Position/FTE</b>	<b>\$ 56,895</b>	<b>\$ 12,282</b>	<b>\$ 25,527</b>	<b>\$ 13,619</b>	<b>\$ 14,204</b>	<b>\$ 17,327</b>	<b>\$ 17,443</b>	<b>\$ 20,745</b>
CANP/Student Debt Service Equivalent	\$ 2,438	\$ 422	\$ 974	\$ 419	\$ 387	\$ 703	\$ 658	\$ 821
<b>CANP/FTE Debt Service Equivalent</b>	<b>\$ 2,873</b>	<b>\$ 620</b>	<b>\$ 1,289</b>	<b>\$ 688</b>	<b>\$ 717</b>	<b>\$ 875</b>	<b>\$ 881</b>	<b>\$ 1,048</b>
CANP/FTE Debt Service Equivalent is Capital Asset Net Position/FTE amortized at 4% interest over a 40 year term								
<b>Total State Support</b>	<b>\$ 13,113</b>	<b>\$ 3,961</b>	<b>\$ 9,531</b>	<b>\$ 4,895</b>	<b>\$ 5,426</b>	<b>\$ 6,003</b>	<b>\$ 4,934</b>	<b>\$ 6,404</b>
Total State Support is State Appropriations/FTE + CANP/FTE Debt Service Equivalent								

## Exhibit 2: Sample Accounting Treatment for Proposed Capital Charge

<b>Assumptions</b>	<b>As Proposed</b>	<b>Current</b>
Cost of Capital	4%	0%
Project Size	\$50,000,000	\$ 50,000,000
Project Life	40 Years	40 Years
Annual Payment	\$2,526,174	\$ -
<b>Statement of Activities</b>		
Revenue		
State of Utah	\$ 2,526,174	\$ -
Expenses		
Depreciation	\$ 1,250,000	\$ 1,250,000
Interest Expense	\$ 2,000,000	\$ -
Change in Net Position	\$ (723,826)	\$ (1,250,000)
<b>Statement of Net Position</b>		
Assets		
Capital Assets	\$50,000,000	\$ 50,000,000
Liabilities		
Notes Payable	\$50,000,000	\$ -
Net Position	\$ -	\$ 50,000,000

Note that the payment of \$2,526,174 would be paid back into a designated Capital Replacement Fund. The Capital Replacement Fund is designated for debt service or for future capital projects. As this fund builds, the State is better prepared for future capital expenditures and it has revenue committed to service its debt. This improves the creditworthiness of the State.