FINANCING STUDY OF THE VERMONT ECONOMIC DEVELOPMENT AUTHORITY LOAN FUND

February 1998

The Vermont Business Roundtable is a non-profit, non-partisan organization of 115 chief executive officers representing geographic diversity and all major sectors of the Vermont economy. The Roundtable is committed to sustaining a sound economy and preserving Vermont's unique quality of life by studying and making recommendations on statewide public policy issues.

CONTENTS

INTRODUCTION

In the fall of 1997, the Vermont Business Roundtable published *Vermont's Economic Future: Opportunities for New Strategies* which affirmed its commitment to identify, evaluate, and make policy recommendations on critical economic development enabling factors. As part of that continuing work, the Roundtable has undertaken this examination of the Vermont Economic Development Authority (VEDA) to determine the appropriateness of an additional investment of state funds to provide rate relief to perspective borrowers. In order to make a valid assessment of that proposal, we have examined the national trend in state-sponsored loan funds, assessed the current status of the VEDA loan fund, and sought additional recommendations which would insure a vital VEDA loan program consistent with sound economic development policy.

BACKGROUND

VEDA was created by the General Assembly of the State of Vermont in 1974 for the purpose of promoting economic prosperity in the State by directly financing eligible businesses and projects, including manufacturing, agricultural, travel and tourism enterprises, and operating programs which provide eligible borrowers with access to capital.

The Authority is governed by a twelve member board which includes the State Treasurer, the Commissioner of Agriculture, the Secretary of the Agency of Commerce and Development, and nine people appointed for six-year terms by the Governor.

VEDA administers a variety of programs through the following six independent funds:

- Vermont Jobs Fund administers Subchapter 3--Assistance to Local Development Corporations; Subchapter 4--Industrial Revenue Bonds; and Subchapter 5--Direct Loan Program.
- Agricultural Development Fund administers the Agricultural Finance Program which aids family farmers with loans at below market interest rates.
- Insurance Fund administers the Subchapter 2--Mortgage Insurance Program which insures bank mortgages up to $10 million.
- Debt Stabilization Fund aids family farmers by making available below market, variable rate loans with funds borrowed from participating Vermont banks.
- Vermont Job Start Fund is an economic development program which provides technical assistance and access to loan funds to increase business opportunities for low and moderate income Vermonters.
- Financial Access Fund designed to stimulate lending which may be used to reimburse participating banks.

In addition to the six independent funds, VEDA is involved in the Export Finance Program with Export-Import Bank of the United States. VEDA also created the Vermont 503 Corporation to promote economic growth by financing a variety of industrial and business projects and the Vermont Small Business Development Corporation.

VEDA OPERATIONS

VEDA currently has a staff of 15 people including the current Manager/Executive Director, Jo Bradley. Job creation is measured by occasional employment surveys and VEDA generally relies on the certification of the applicant in the application process as to what level and quantity of jobs are created.

VEDA's staff is responsible for maintaining a healthy portfolio. The health of the portfolio is dependent on financing feasible projects and the state's bond rating is at risk if projects and their loans fail.

Transactions between VEDA and the State of Vermont occur in several forms. Advances are made from the State of Vermont to pay Subchapter 2 insured loans on which the borrower has defaulted. Appropriations represent funds legislated and transferred between the State and the Authority to support the Authority's operating budget.

The Authority also has bonds outstanding to the State of Vermont which were used to cover the full faith and credit advances for losses incurred under the Subchapter 2--Mortgage Insurance Program. Liquidation and repayments from the insurance accounts together with amounts provided by the General Fund of the State of Vermont meet the debt service on these bonds. VEDA is not legally obligated to repay the State of Vermont for the advances made to service the bond debt. Previously, the Authority also borrowed funds from the State Treasurer to finance loans under Subchapter 3, Subchapter 5, and AFP programs.

During FY 1996, legislation was enacted that terminates the Authority's ability to borrow for the Vermont Jobs Fund from the State Treasurer and enables the Authority to borrow in the capital markets. This change was effective July 1, 1997 and led to the current recapitalization program for the Vermont Jobs Fund, by borrowing from the capital markets.

Some VEDA programs borrow from other lenders. For example, DSP funds were borrowed by the Authority pursuant to participation agreements with 30 participating Vermont banks. The Job Start Program also borrowed funds from a Vermont bank. The State of Vermont pledges its full faith and credit to secure payment of DSP obligations.

THE STATUS OF VERMONT'S VEDA LOAN FUND

The Vermont Business Roundtable surveyed a number of people familiar with VEDA from differing perspectives. (See *Appendix 3: Survey Recipients*.) The results of that survey combined with the extensive policy work which the Roundtable has completed in regard to state economic development policy, were the basis of the conclusions and recommendations reached in this report.

VEDA's loan fund received a favorable rating from most constituencies. Under the leadership of its new Manager, both process and documentation improvements are being implemented. The data and operating systems are also scheduled for upgrade which will give the Authority and its Board better information on which to judge the effectiveness of the various loan programs.

The change in VEDA funding from a state appropriation to a capital market funding mechanism involved two steps:

- <u>First Step</u>: Long-term bonds (10 years) were issued backed by the high quality loan part of the VEDA portfolio and the moral obligation. This created a cash reserve.
- <u>Second Step</u>: The cash reserve was pledged to support the quarterly issuance of commercial paper backed by the reserve and the moral obligation or the guarantee of the state.

The projected amount to be raised annually under this program is $10 million per year for lending and approximately $700,000 per year to cover VEDA's administrative expenses. For Phase I, the bonds were issued at an interest rate of 7%.

Both steps in the recapitalization of VEDA have been completed and the agency has funds available to lend at variable rates of 5.95% for tax exempt projects meeting the IRS definitions and 7.95% for those not qualifying. However, demand for loans as measured in new loan applications has dropped off at VEDA in the past 12 months due to the uncertainty of rate. Direct loan volume in the Subchapter 5 loan fund was over 30% below FY 1996 levels. VEDA is currently experiencing significant demand risk; money is available to lend yet the demand for productive placement of these funds is declining resulting in an immediate need for VEDA to stimulate demand.

A factor in the slow demand for funds is that banks in Vermont this year have plenty of funds to lend and are doing so at very discounted and competitive rates, even for start-up businesses and small businesses. VEDA is considering direct advertising of its loan fund programs with a goal of financing approximately $10,000,000 in loans per year.

The survey conducted for this report resulted in the following conclusions regarding the status of the VEDA loan programs:

- The major benefit of the VEDA loan programs is the provision of low cost capital that enables Vermont based companies to compete nationally and internationally. These programs encourage local economic development and provided access to capital for start-up and small companies, keep jobs in Vermont, help attract new employers to Vermont, and enable funding of projects by RDC's and banks that would not be feasible with a single traditional lender.
- The major drawbacks of the current VEDA loan programs are the higher variable rates VEDA is forced to offer under the self sustaining market capitalization of its portfolio, the lengthy and often complex process of loan approval, and the general lack of strong economic development support from the state.
- Survey participants ranked the current VEDA loan programs from most important (1) to least important (10) in relation to the State's overall economic vitality as follows:

    1. Direct Loan Program
    2. IRB Program
    3. LDC Loan Program
    4. Mortgage Insurance Program
    5. Agriculture Finance Program
    6. Debt Stabilization Program
    7. Vermont Financial Access Program
    8. Vermont Job Start Program
    9. Export Financing Program
    10. Technical assistance (not a program, but a side benefit of VEDA loan application process)

- Survey recipients identified the following as the most important benefits of VEDA's loan programs:

    1. Below market interest rates
    2. Flexible repayment terms
    3. Extended repayment terms
    4. Access to capital
    5. Created comfort for other lenders to lend
    6. Market interest rates
    7. Fixed rates and flexibility in the approval and terms of each loan transaction

- When asked if the terms, conditions, and qualifying criteria were largely beneficial or detrimental, the process and rules were identified as the negative aspects of the process. "Given current rates, conditions, and terms that are overly restrictive, most banks will do the deal without VEDA"; respondents question the effort required for market rate loans when highly competitive bank offerings are available.

- Respondents still felt that VEDA loan programs were needed even in today's competitive banking environment because VEDA financing helps banks make higher risk loans, makes loans available for non-bankable projects, and is basically perceived as a enabler of viable but difficult projects. VEDA financing is also seen as a positive signal to out of state business that Vermont wants their business and will take steps to welcome business in Vermont.
- Most survey respondents agreed or strongly agreed with the statement: "Without the VEDA loan fund program, my business or my community would not enjoy the economic benefits it does today."

JUSTIFICATION FOR PROVIDING STATE FUNDS FOR RATE RELIEF TO PROSPECTIVE VEDA BORROWERS AS AN ECONOMIC DEVELOPMENT STRATEGY

Survey respondents presented a wide array of reasons for State funding of an interest rate buydown program including saving and creating jobs in the State; increasing tax revenues; keeping Vermont competitive with other States; signaling State support of economic development; and helping Vermont companies with a predictable, lower, fixed blended rate.

Half of the respondents felt that all borrowers should have access to reduced rates from a buydown program while the other half felt targeting the reduced rates to borrowers who create or maintain quality jobs was the way to maximize value to the state. Small businesses and start-ups were often mentioned of as good targets for reduced rates.

Regarding which rate buydown option would have the greatest positive economic value statewide, the clear preference was to buydown and fix the rate on loans rather than offer deep interest rate discounts in the early life of the loan.

VEDA has run several scenarios to map the impact of a one-time capital appropriation on the agency's ability to buydown and fix the interest rate paid by VEDA borrowers. Without an appropriation, the VEDA directorate is correct in not accepting the interest rate risk. VEDA as a lender always accepts credit risk (risk of not getting principle repaid) and earnings risk (risk of not earning the interest budgeted). Interest rate risk refers to the risk of lending to customers through fixed rate loans and financing that loan internally with variable funding, in VEDA's case, supported by 90-day variable commercial paper.

OTHER IDEAS TO INSURE A VITAL VEDA LOAN FUND PROGRAM CONSISTENT WITH SOUND ECONOMIC DEVELOPMENT POLICY

The survey interviews resulted in a variety of new ideas including:

- Link loan approval to state economic strategy; when a project meets the criteria, be flexible on loan rate and terms.
- Separate business loan programs from social programs and narrow the focus concentrating on programs that provide quality, value added high tech and manufacturing jobs.
- Discontinue older, less effective programs before adding any new ones.
- Develop expertise as the State's bank and manage all lending programs.
- Implement a pre-approval process to test loan applications before all the work is done and fast-track the approval process.
- Simplify the process, reduce the paperwork, standardize the loan documentation, and therefore reduce the legal costs to the borrowers.
- Implement risk based pricing/incentive pricing.
- Establish new positions: Senior Credit Officer with the authority to approve most loans and modifications, and Senior Credit Administrator to manage the quality of the portfolios and protect the bond rating.
- Target growth in depressed areas such as the Northeast Kingdom.
- Advertise the program.
- Focus on emerging companies and avoid being the lender of last resort. Add line of credit loans and working capital loans to the direct loan program.
- Create new funds such as: Venture Fund, Development Capital Fund, Equity Investment Fund, and Micro Business Loan Fund.

CONCLUSIONS

The State of Vermont needs a comprehensive long-term economic development strategy and actions taken regarding VEDA should be consistent with this strategy. The Department of Economic Development's new strategic plan *Building Competitive Advantage in Vermont* and the Roundtable's recent report *Vermont's Economic Future: Opportunities for New Strategies*, are important initial steps in establishing a vision and motivating stakeholders throughout the state to build a consensus strategy. The dynamics of our diverse regional economies present opportunity for both synergy and flexibility in a proactive strategy.

As a result of other state priorities, there are limited resources committed to economic development. Now, while the economic and state fiscal indicators are positive, is the time to invest in Vermont's economic vitality. Investing in programs that help protect, retain, and attract quality jobs for Vermonters that pay at or above the national average must become a priority reflected in our strategy and voiced at every opportunity. Jobs should be targeted at original local residents as well as skilled in-migrants. This will require a wide range of investments by both the public and private sectors.

The states that compete with Vermont for attracting or expanding quality wage employers have more loan fund programs, more tax abatement programs, more process fast-track programs, and more flexibility to customize and combine programs for highly desirable employers. Vermont needs “more tools in the tool box” of economic development to retain and create these jobs.

The benefits of economic development loan fund programs include the creation and protection of jobs, improved infrastructure to support economic growth, and ultimately, tax revenue growth from corporate profit increases, sales and use taxes, property taxes, and personal income tax. There are a wide variety of state-sponsored loan fund programs and other economic development programs that are successful in other states. State programs with the highest potential of success have a long-term strategy based on the principles of leveraging resources, collaboration, capacity building, and partnering. They invest in workforce education, technological capability, infrastructure, and a business/regulatory climate conducive to quality employment opportunities.

VEDA, as the state economic development loan fund program, has a role to pay as part of this new strategy. Because VEDA is a political and social program of the State and a critical economic development tool, it cannot be judged on the same criteria applied to traditional for-profit lenders such as banks.

VEDA will benefit from a clearly articulated State and Agency economic mission statement and strategic plan. This could lead to a clear statement of expected quantifiable outcomes for each of the loan fund programs VEDA manages. However, VEDA needs an improved operating system that would allow information management to measure and support the desired outcomes. Since the current operating system is very limited in data quality and CIS opportunities, a cost/benefit model for evaluating projects has merit.

The State of Vermont would be well served if it financed the creation of a Senior Credit Administrator position at VEDA to insure that loan quality is measured and managed to protect our bond rating as well as the integrity of the ongoing programs. The current performance of each program should be tracked, measured, and reported. VEDA should consider risk adjusted pricing to gain the most from limited financial resources.

Streamlining the application and closing processes for VEDA loans must be undertaken. The business cost of VEDA participation could be reduced if some loan programs were allowed to “participate” in another lender’s loan rather than create a stand alone loan that gets layered into a project. This would reduce the cost burden on borrowers and VEDA.

Generally, the VEDA loan funds are well managed and well utilized. The primary benefit of VEDA loan funds is the provision of low cost capital. As the ability to continue this benefit is lost and VEDA now charges variable market rates, the funds are experiencing a reduction in their attractiveness as a result of market funding of VEDA. The most popular program, Subchapter 5--Direct Loans, is experiencing the most decline in demand.

Without an interest rate buydown program, VEDA's loan funds will loose their self-sustaining (and funding) ability within 2 to 3 years. Investing in an interest rate buydown program for VEDA would contribute to a "long-term vision and sustaining political leadership that results in a long-term, systematic public and private commitment to economic development" and "adequate public resource commitment to economic development designed to leverage private sector efforts" both of which were identified as enabling factors for economic development in the Roundtable's September 1997 report *Vermont's Economic Future: Opportunities for New Strategies*.

Many of the long list of suggestions to insure a vital VEDA loan fund program consistent with sound economic development policy have merit and should be considered for implementation. Among the most attractive ideas are:

- Flexible rates and terms for projects that meet pre-defined criteria for contribution to the statewide economic goals.
- Focus VEDA on economic development programs and move the social subsidy programs to another agency.
- Implement a pre-approval (go/no go) process.
- Seek process improvements for every program and process.
- Evaluate an equity investment fund for new ventures or expansion of business for existing business.

RECOMMENDATIONS

The Vermont Business Roundtable supports an interest rate buydown program as described below in conjunction with a series of equally important recommendations regarding the structure, operations, and processes involved in the management of VEDA programs. Therefore, the following actions steps are recommended:

- Execute a process of consensus building and action around a statewide economic development strategy as started by the Department of Development.
- Commit some of our state surplus to investment in long-term economic infrastructure and development programs using collaboration and leveraging resources wherever possible.
- Explore "fast-track" as a part of continuous process improvement for VEDA and other economic and regulatory programs. Streamline the VEDA application and closing process with a goal of reducing the business cost of VEDA participation. A thorough review of

the role of the Board and the empowerment of VEDA employees should be part of process improvement. Consideration of flexible rates and terms, a pre-approval go/no go program, and new loan fund programs experiencing successful outcomes in other states with similar agendas.

- Ask VEDA to implement outcome based planning and programs. Consider the Vermont Association of Regional Development Directors' recommendation for a cost versus benefit model for evaluating competing program investments. Consider a university-based policy evaluation model for all state policy debates.
- Continue to upgrade the operating system for VEDA and, inherently, the information available on VEDA managed loan funds.
- Create position of Senior Credit Administrator, knowledgeable in credit administration practices.
- Authorize VEDA to implement risk adjusted pricing on projects.
- Fund an interest rate buydown program for the Subchapter 5--Direct Loan Fund Program as a pilot program with consideration of expansion to other funds based on pre-determined performance criteria.
- Continue the VBR research as outlined in *Vermont's Economic Future: Opportunities for New Strategies.*

Appendix 1

VERMONT ECONOMIC DEVELOPMENT AUTHORITY

Members of the Authority:

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President, Getchell Professional Associates

Ned Pike, VEDA Vice Chair
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Monument Farms

William C. Shouldice, IV
Secretary, Agency of Development and Community Affairs

Appendix 2

EXAMPLES OF STATE-SPONSORED LOAN FUND PROGRAMS IN OTHER STATES

Green Industries Initiative (Delaware): A joint project of the Department of Development and the Department of Natural Resources, the criteria for capital access is not lack of other sources but rather the use of the capital for "green" companies.

Nontraditional Loan Insurance Program (Maine): This program provides loan insurance to non-traditional sources of capital including individual, trusts, and other organizations up to 80% of the commercial loan.

SCANA Development Revolving Loan Fund: A joint venture between South Carolina Jobs/Economic Development Authority and the parent company of South Carolina Electric and Gas Company, it provides small loans (under $50,000) at fixed rates for 5-year terms to jump start small businesses.

State of Wisconsin Investment Board--Private Placement Division: This Board makes market rate, long-term investments of pension fund benefits for Wisconsin Retirement Fund System participants. Fixed rate, long-term financing is available for established companies with at least 5 years' operating experience.

The Ben Franklin Partnership (Pennsylvania): This partnership encourages development of new technology through challenge grants, a seed venture capital program, and a program targeted to environmental products.

CAPCO's (Louisiana and Missouri): A CAPCO is a venture capital company that receives investments from insurance companies for equity participation in small businesses that are generally too small to attract the attention of venture capital companies. The insurance company receives a 100% tax credit on premium taxes over 10 years for that investment.

State Pension Investment Fund (Wisconsin and Michigan): Utilizing state pension funds, a venture fund for small businesses was established that offers loans and equity investments.

Job Expansion and Investment Tax Credit (Kansas): This program allows an income tax credit for up to 10 years and up to 50% of a business income tax liability for the creation of qualifying jobs.

High Performance Incentive Program (Kansas): This program provides incentives to companies which pay higher than average wages and invest at least 2% of total payroll costs in employee training and work force training programs.

Kansas Economic Opportunity Initiatives Fund: The fund has a high level of flexibility and allows the state to address the creation/retention of jobs presented by unique opportunities or emergencies.

Appendix 3

VEDA SURVEY RECIPIENTS

Included individuals representing the following categories and/or organizations:

VEDA Board

Banks

Business Owners

Regional Development Corporations

VEDA Borrowers

Cabinet Members

Community Members

Business Organizations

Governor's Council of Economic Advisors

Vermont Economic Progress Council

Sustainable Jobs Fund

Vermont World Trade Office

Vermont Community Loan Fund

Vermont Technology Council

Appendix 4

POTENTIAL BORROWERS
WHO CHOSE NOT TO COMPLETE THE
VEDA APPLICATION PROCESS OR CLOSE AN APPROVED LOAN

- A manufacturer in Bethel seeking funds for capital expansion to purchase machinery and equipment looked at the cost to bring VEDA in as a lender. The application process, legal fees, and the company executive's time at loan committee led the company to ask its bank to finance the entire project. This borrower said he would have pursued VEDA "if the rate was 4%." He disliked the requirement that the owners had to offer a guarantee for a "well established company not a start-up."

- A manufacturer in a neighboring state was considering expansion with a plant in Vermont. This particular deal fell through partially because of the slow Act 250 process. The company liked the way Vermont could finance 100% of the project using a bank, an RDC, and VEDA. Market rate was deemed acceptable in return for 100% financing.

- A manufacturer in Sharon withdrew its VEDA loan application when VEDA refused to waive the personal guarantee of the owners even for a company with a 50-year history. The project was completed and five jobs were created over time with an average wage of approximately $30,000. This company has experience with IRB's in other states and would have considered the loan only with significant rate incentives.

- A Morrisville factory sought 100% bank financing because of the "hoops and high legal bills" that came with VEDA financing.

- Other borrowers placed their projects on hold for other reasons not related to VEDA.

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