DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

ARNOLD SCHWARZENEGGER, GOVERNOR
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September 18, 2008

Little Hoover Commission
925 L Street, Suite 805
Sacramento, CA 95814

RE: Bond Oversight Hearing on September 25, 2008

Dear Commissioners:

Thank you for the opportunity to address you on this very important subject. In your letter to me inviting comments on bond oversight, you requested I address six specific topics. My responses to your questions are as follows:

1. *How has the Department of Finance (Finance) implemented Executive Order (EO) S-02-07?*

   On January 24, 2007 Governor Schwarzenegger signed EO S-02-07. The Executive Order (EO) directed all state agencies, departments, boards, offices, commissions, universities and other entities (herein after referred to as "departments") authorized to spend infrastructure bond proceeds to be accountable for ensuring that those proceeds are expended in a manner consistent with the provisions of either the applicable bond act and State General Obligation Bond Law, or laws pertaining to state lease revenue bonds, and all other applicable state and federal laws. It further ordered those departments to ensure that bond proceeds are spent efficiently, effectively and in the best interests of the people of the State of California. The EO also directed the Department of Finance (Finance) to establish a website to provide the public with readily accessible information on how the proceeds of State General Obligation bonds and lease revenue bonds are being utilized.

   Among its other provisions, the EO required each department authorized to expend infrastructure bond funds to establish a three-part accountability structure. The three-parts are:

   - *Front-end accountability:* Documenting the processes or criteria that will be used for deciding what projects, grants or programs receive funding. These processes and criteria must be consist with all relevant laws and regulations and must be consistent with any applicable strategic plans or other guidelines or requirements for selecting and prioritizing which projects, grants or programs are funded. All funding decisions must be publicly enumerated.

   - *In-progress accountability:* Providing oversight to ensure that projects stay within their approved scope, schedule and budget.

- *Follow-Up Accountability:* Conducting close-out audits to ensure that the expenditures were made according to the established front-end process and criteria, were consistent with all legal requirements and achieved the intended purposes.

Upon signing the EO, Finance called together the effected departments to review their obligations under the Governor's directive and to share a vision for the website. The departments involved included departments of Transportation, Water Resources, Parks and Recreation, Corrections and Rehabilitation, Housing and Community Development, and the Resources Agency, California Housing and Financing Authority, Air Resources Board, University of California, California State University, Chancellor's Office of the California Community Colleges, and Office of Public School Construction. These departments and Finance formed a workgroup to develop standards and expectations for implementing the EO and for designing the website. The workgroup members were uniformly collaborative and earnest in their efforts to achieve these ends. The tasks, however, were not simple.

The sheer diversity of purposes of the bond funds and multitude of processes for allocating the bond funds overwhelms the effort to succinctly and simply lay out for public examination the mechanics and outcomes of the bond expenditures. The November 2006 bonds provide funding to over 30 departments and in excess of 100 different programs or projects. Voluminous bodies of statutory and regulatory language govern these departments and their bond-funded programs. In most instances, processes are already in place governing decision making procedures, but in some instances, new statutes need to be enacted and guidelines adopted. The decision-making processes vary widely from project-specific appropriations made by the Legislature to pots of money provided to boards to spend according to their statutorily mandated missions and from formula-driven grant programs to competitive grant programs. The purposes for which the bond proceeds are to be spent cut across the breadth of state and many local government functions, from building correctional facilities to modernizing schools, from rehabilitating levees to cleaning up the air, and from subsidizing low-income housing to reducing highway congestion. The recipients of the funds are also broadly varied, including state departments, local governments, private non-profit organizations, for-profit corporations, housing developers, individual citizens and Indian tribes. The differences in terminology and accounting conventions alone, among these programs, presented a challenge in the effort to design a uniform approach to bond accountability and oversight.

In our joint efforts, the departments and Finance quickly came to the conclusion that while the fundamentals of what constitutes bond accountability and oversight are essentially universal, the specifics of that concept vary considerably and cannot be condensed into a one-size-fits-all website or process that perfectly accommodates all bond expenditure activity. Consequently, the strategy pursued by the group was to achieve as much consistency as practical in the format, look and feel of the website across programs with the primary objective being transparency in complying with the principles of the EO. The workgroup agreed upon certain common features and functionality across the website and then were given the responsibility and flexibility to develop the specific information and features for their individual components of the site. . (At this point, I should note that Bond Accountability website is not really one site at all. While it appears on its face to be a single site, once past the first screen, viewers are taken to the individual websites of the various bond-implementing departments.)

I believe that the work group's strategy has been successful. The site has a link for each of the bonds from 2006. At that first link, the viewer is presented an overview of the bond and the programs it funds, the total amount of money available for the program under the bond, how much as been committed to date and the amount remaining for allocation. By clicking on successive links within the site, a user can find more and more detail about what projects or grants were funded. Also consistent among the programs is an articulation of the front-end accountability—that is the processes or criteria followed to make funding decisions; a link to in-progress accountability were a user can learn the status of program or project implementation; and a link to follow-up accountability, where a user can learn what the outcome of a program or project was. As noted, the details vary depending upon the program. For instance, if one were to visit the Proposition 84 link and view expenditures for State Parks, the viewer could find a specific construction project and its implementation status. Because the project is "bricks and mortar", it is relatively easy for Parks to disclose and describe whether the project is within scope and cost and provide other details as well. In contrast, if a viewer were to go to the Proposition 1C link and then to a first-time home buyers program administered by the Department of Housing and Community Development, details on loans to individuals would be somewhat less "concrete". That is because the money is granted to local governments, which then dispenses it to individuals. This sort of program is not as amenable to being measured in straight forward scope-cost-and-schedule terms like a construction project. Nevertheless, the purpose of the loan program is articulated, the process and criteria for awarding grants delineated and the recipient entities listed.

The key to the bond accountability site and the approach to accountability in general is *transparency.* Never before has the public had so much accessibility to both the big picture and the details of how public money is being spent. The public is also afforded even more accessibility to transparency by being provided contact information for people involved in administering the programs who are available to answer questions or provide additional information

2. *What is Finance's perspective on how well the agencies and departments have implemented EO S-02-07?*

There are two main components to implementing the EO, adherence to the three-part accountability process and development of the website that displays that adherence. Let me first address the later component, the website.

The departments have provided a vast amount of information on the site. To a greater or lesser extent (depending in large part upon what information systems they already had in place), departments have devised and implemented new methods for cataloging and displaying their bond expenditure activity. Many of the departments have included graphs, charts or maps on the site to provide viewers with aggregate statistics or other information that would give them a fuller understanding of program accomplishments or a deeper understanding of individual projects or programs. All of the departments have made significant efforts to meet the spirit of the Governors' executive order. Some, like the Resources Agency, already had a similar site in existence, but they have redesigned and improved the depth and features of their site to match the expectations of the EO. Others, like the Chancellor's Office for the Community Colleges had to build their portion of the site

from scratch. Most of the departments are continuing to develop and improve their portions of the site.

All of the departments have implemented their portions of the bond accountability website within their existing resources. This is a reflection of their belief that providing this kind of transparency is an integral part of their responsibility to the public. Many departments have dedicated staff to continually develop and keep the website up to date. I believe all of the departments are to be commended for their efforts to make this leap forward in governmental transparency.

With respect to implementing the three-part accountability model, I believe the departments are also adhering well to the spirit of the EO. Under the terms of the EO, all of the departments were required to submit their plans for implementing the three-part accountability model to Finance for review. Departments were afforded some latitude in how they approached their efforts because of the differing nature of the programs. However, all departments were required to have plans for addressing all three of the accountability process components, and Finance staff reviewed those plans for reasonableness. Eventually, all of the departments submitted acceptable plans, the last of which were approved by late spring 2007.

The up-front accountability is perhaps the most transparent. As noted above, with few exceptions, extensive statutory and regulatory language already guides and governs the decision-making process for allocating bond funds among competing priorities. These decisions, while sometimes purely formulaic, and most of the time guided by pre-established priority-setting principles, are often still essentially value judgments. When that is the case, those value judgments are virtually always made in public forum and open to debate. Whether made by the Legislature or by a board or commission statutorily empowered to make those decisions, the decisions are subject to open meetings laws and public scrutiny. The processes and rules for making these decisions are spelled out on the website. In addition, the openness of the process and competitive nature of various interested parties seeking to obtain their share of limited funding helps ensure accountability in that part of the process. At the risk of stating the obvious, the public nature of the decision-making process does not ensure that all parties will agree and be pleased by the decision itself, but it is clear who made the decision and there was an opportunity for interested parties to be heard.

In-progress accountability has probably been the least visible of the three components in the past. This form of accountability is essentially a matter of applying best practices in project management. At least with respect to construction projects, this should be highly quantifiable and measurable. Of course, the fact that it can be measured does not always mean that it is being measured. The clear expectations of the EO that projects be monitored to stay within cost, scope and schedule, combined with the expectation that such progress will be posted on the website helps ensure that departments implementing bond programs will pay close attention to this aspect of accountability. For some grant programs, however, the concept of in-progress accountability looks a little different than a traditional adherence to scope, cost and schedule, because it is difficult to measure progress until the end of the activity. For example, some grant programs do not award money to a selected applicant until the applicant actually produces a promised outcome (e.g., a housing

development or a local park improvement), and then they are reimbursed for their efforts. Consequently, there is not always a measure of in-progress accountability.

Follow-up accountability is the most familiar kind and is generally thought of as a close out audit. Under the EO, all close out audits must be performed either by Finance audit staff or by another objective party approved by Finance. While some bond-funded projects are now complete, the vast majority of the activity being funded by the bonds is still in progress. Consequently, there are relatively few (given the size of the overall infrastructure bond program) follow-up audits completed to date.

In addition, Government Code section 16724.4 requires departments administering a bond act to submit a report annually that includes a listing of the projects and its location, the cost of each project and its status. The first of these reports were distributed to the Legislature and Finance this past spring.

3. *Are there any additional measures Departments could do to enhance bond oversight?*

Some of the programs are quite mature and have extensive oversight and accountability measures that have been in place for some years. The K-12 school construction program is an example of this. The constituents for this program are very active participants in monitoring the policies and decisions of the board that makes funding decisions and the office that implements those decisions. The administrators of that program have responded to that vigorous constituent interest over the years by developing a substantial body of information about the program and making it readily available to the public, thus providing a high degree of transparency. Other departments are similarly situated to a greater or lesser degree and all have a continuing interest in pursuing additional measures to ensure that bond funds are spent in an accountable and efficient way.

For example, several of the departments are currently evaluating the way that interim financing is carried out for their projects. Interim financing allows a project to be funded on a schedule conducive to program needs, without having to wait for a convenient time to conduct a bond sale. Several departments are analyzing whether there is a more cost-efficient strategy and technique for handling this interim financing than the method they currently use.

In addition, Finance is continuing to work with the departments to refine the website. Efforts are ongoing to provide more consistent presentation of the information, enhance its ease of use and improve navigation within the site.

4. *Discuss the challenges and barriers arising, including the difficulty in assessing the effectiveness of dozens (if not hundreds), of individual bond programs governed by thousands of lines of statutory code.*

Please see response to question 1 above.

5. *Would the addition of a Treasurer's Office web-based accountability system, or auditing resources for Controller's, or a Citizen's bond Oversight Commission in Finance's perspective enhance oversight?*

As discussed above, extensive procedures and requirements are already in place to guide the expenditure of bond funds. Although there are probably procedural improvements that would enhance accountability (nothing is perfect), perhaps the best accountability system is one that ensures *adherence* to the numerous existing procedures and requirements intended to achieve accountability, efficiency and effectiveness in the expenditure of bond funds. By making the activities and decisions of the bond administering departments transparent to the public, the incentive for adherence is increased, as is the opportunity to detect a lack of adherence.

Each of the departments has an accountability plan in place, they are disclosing to the public their bond funded activities on the website, their decision-making processes are publically vetted, and they are required to use independent auditors to evaluate their expenditures. It's not readily apparent what additional value would be achieved by another website or a citizen's commission, but Finance is certainly open to value-added approaches that would further enhance accountability.

6. *Explain the relationship between state credit rating, investors' perceptions, and the interest rates the state pays on general obligation (GO) bonds for infrastructure projects.*

The state's credit rating is currently A1 from Moody's and A+ from Fitch and Standard & Poors. This puts California as one of the lowest ranked states in the nation. The rating agencies look at a variety of factors in determining these ratings including such things as the vitality of the state's overall economy, the predictability and reliability of its revenue sources, its debt load, its budgetary flexibility and other issues. The major reasons for California's low rating currently are its inability to resolve its chronic budget imbalance, the inflexibility of its budget and the extent of its reliance on a volatile revenue source (high income earners).

Many investors rely heavily on ratings from credit agencies because they either do not have, or do not want to expend, the resources to do their own evaluations of the credit worthiness and risks of potential investments. The interest rates investors are willing to accept on bonds generally follow the ratings. With a low rating, California is paying a higher interest rate by about 0.3% than it would if its bonds were rated triple A.[1]

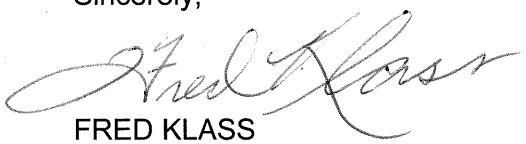
State Treasurer Locker has challenged the rating agencies on their methods for rating states and municipalities. The agencies apply a different set of standards for states and municipalities than they do for corporations. This dual rating system results in some governmental entities receiving ratings much lower than they would if they were a private enterprise. This is the case for California. There is virtually no reason why California should

[1] Nevertheless, the state's bonds typically trade at a better rate than the state's credit rating. This is primarily because of the unusually high ratio of wealthy Californian's in proportion to the amount of bonds issued. This pulls in what is known as the double-barrel investment, where the investor gets to take advantage of tax-free earnings for both state and federal. Because of the relatively high state income tax rates, wealthy Californian's are more likely to invest in California bonds than other states' bonds as the value to them is much higher and therefore, makes the bonds more attractive to the state investors. This, however, is not so much a factor of investor perception—which is what your question addressed—as it is the effect of relatively high demand for a finite product.

not be triple A if the test is the likelihood that the state will make good on its debt service commitment to bond holders. Under the state constitution, after a certain amount of funding is paid to K-12 education, the next call on the state's General Fund revenue is the payment of debt service. This payment is required to be made automatically when due, is not subordinate to any other funding obligations and is not dependent on an appropriation by the Legislature or a policy decision by any other official. In order for the state not to make good on its debt service payments, state revenues would have to decline by approximately 60%. Outside of a massive global depression, the likelihood of this occurring is nil. Although many of the weaknesses the rating agencies point to in California's budget situation are well founded, those problems have little to do with the state's ability or willingness to pay its GO debt. Unfortunately, the rating agencies have yet to be persuaded of this point of view and their ratings are costing state taxpayers a premium in the market.

Finally, you asked for a brief biography of the testifier. Please find my biography attached. Thank you for the opportunity to discuss bond oversight with you. Please feel free to contact me at (916) 445-4923 or Theresa Gunn at (916) 445-9694 if you have any other questions.

Sincerely,



FRED KLASS
Chief Operating Officer

Attachment

Attachment – Biography
Fred Klass

Fred Klass has 31 years of experience in State government. He is currently the Chief Operating Officer for the California Department of Finance, where he has worked, collectively, for 23 years developing and administering budgets for state programs in a variety of areas including natural resources, environmental protection, energy, capital outlay, courts, higher education, local mandates, and information technology. As Chief Operating Officer, Mr. Klass is responsible for coordinating the efforts of the Department's various units and ensuring the efficient functioning of the organization.

Mr. Klass formerly served as a consultant to members of the state Senate Budget Committee. He also served several years as the Vice Chancellor for Governmental Relations for the Chancellor's Office of the California Community Colleges, and spent four years evaluating governmental program effectiveness and efficiency for the Commission on California State Government Organization and Economy (Little Hoover Commission).

Mr. Klass holds a master's degree in public administration from California State University, Sacramento, and a bachelor's degree in political science from the University of California, Berkeley.