Senate Budget and Fiscal Review— Mark Leno, Chair

SUBCOMMITTEE NO. 4 Agenda

Senator Richard Roth, Chair
Senator Tom Berryhill
Senator Norma Torres

Thursday, March 20, 2014
9:30 a.m. or Upon Adjournment of Session
Room 2040

Consultants: Farra Bracht

AGENDA - PART A

STATE FINANCE AND ADMINISTRATION

California's Five-Year Infrastructure Plan

Presentation by the Department of Finance

Commentary provided by:
Legislative Analyst's Office

Background. The Administration released its 2014 Five-Year Infrastructure Plan along with the January budget. The plan identifies total statewide deferred maintenance costs of $64.6 billion ($59 billion, or 91 percent, is for the state's roads). The plan proposes to invest $56.7 billion in capital funding over the next five years and, of this amount, $32.3 billion is from federal funds, $12.1 billion from various special funds, $6.1 billion from bond funds, and $5.9 billion from other funds. Most (94 percent) of the capital investments proposed are for the state's transportation system.

The budget proposes to spend, on a one-time basis, $815 million ($800 million General Fund) to address critical deferred maintenance needs in the following areas:

- $337 million for Caltrans
- $188 million for K-12 Schools Emergency Repair Program
- $175 million for California Community Colleges
- $43 million for Parks and Recreation
- $20 million for Corrections and Rehabilitation
- $15 million for Judicial Branch
- $10 million for Developmental Services
- $10 million for State Hospitals
- $7 million for General Services
- $5 million for State Special Schools
- $3 million for Forestry and Fire Protection
- $3 million for Military
- $2 million for Food and Agriculture

The expenditure proposal does not include specific deferred maintenance projects for these departments. Instead, for most of these departments (excludes Caltrans, K-12 Schools, Community Colleges, and the Judicial Branch), in order for these funds to be allocated, departments would provide a list of proposed deferred maintenance projects to the Administration, who would approve or reject the projects, and then notify the Legislature of its approved list of projects 30 days prior to allocating any funds.

LAO Comments. The plan serves an important role by raising some key policy issues for legislative consideration. In particular, the plan raises questions about (1) the appropriate roles of state versus local governments in funding some infrastructure, (2) whether the state is overly reliant on bond financing for infrastructure, and (3) how to address large backlogs of deferred maintenance in state facilities.

The LAO also points out that the plan does not include some important information required by state law. Specifically, the plan does not include the list of infrastructure needs reported by departments. The purpose of this information is to help the Legislature understand the full scope of the state's infrastructure demands and to make judgments about whether it agrees with the Administration's choices about which project should receive funding. The plan also does not identify K-12 school facility needs or the infrastructure needs of the University of California system and California State University system after 2014-15.

The LAO proposes that the Legislature establish infrastructure committees to promote active and coordinated legislative involvement on the issue.

Staff Comments. The five-year plan is a step in the right direction of beginning to identify the magnitude of the state's outstanding capital and deferred maintenance needs. Moreover, while deferring annual maintenance needs avoids expenses in the short run, it often results in substantial additional costs in the long run.

The Administration's plan has some shortcomings. As noted by the LAO, it does not include K-12 and higher education infrastructure projects. The plan also does not include details to help the Legislature prioritize which projects to fund or a well-articulated long-term funding plan. The Legislature may wish to obtain additional information about the analysis used to identify capital and deferred maintenance projects in the appropriate budget subcommittees. Given the state's existing debt burden and General Fund constraints, the Legislature may want to have the Administration provide an analysis of the use of General Fund-backed debt that explores alternatives to the reliance on voter-authorized General Obligation (GO) bonds. In addition, a well thought out plan would also include a discussion of the ease of implementation of various projects, and associated risks, and how those were taken into consideration in the development of the plan. Finally, it will be important for the Legislature to understand how the Administration plans to incorporate this plan into the annual budget process in the future.

Questions for DOF:

(1) How does the Administration intend to move forward with addressing the state's infrastructure needs in future budget proposals?

(2) What funding is currently available for the projects identified in the plan?

(3) Why doesn't the Five-Year Infrastructure Plan propose additional borrowing as a way to fund the state's significant infrastructure needs?

Questions for LAO:

(1) How should infrastructure projects across various state departments be prioritized?

(2) What should be considered when determining what types of funding sources, such as bonds, user fees, or special funds, to use to fund infrastructure projects?

Overview of Debt Financing

Presentation by the State Treasurer's Office

Commentary provided by:
Department of Finance
Legislative Analyst's Office

Presentation from the State Treasurer's Office on California's use of general obligation bonds—primarily for infrastructure and other capital investments, the state's current and future projections of the repayment of bond debt, and the state's overall debt capacity.

Questions:

1) *What is the right amount of debt for the state to carry? How much is too much? How does the state's debt service ratio compare to other states?*

2) *What factors influence the state's credit rating?*

3) *What budget actions are more likely to result in the state's credit being upgraded?*

ITEMS PROPOSED FOR VOTE-ONLY

0950 State Treasurer's Office

Department Summary: The Governor's budget includes stable funding for the State Treasurer's Office (STO) and the 13 related boards, committees, and authorities. None of the proposals below include General Fund costs. In addition, no concerns have been raised with these proposals, and they are recommended for approval as "vote-only issues."

Budget Summary: The STO's budget calls for 236.4 positions and $29.8 million. This is an increase of three positions and nearly $400,000 from the 2013-14 funding level.

Issue 1: Debt Management System (Governor's Budget BCP # 1)

The STO proposes $1.1 million in expenditure and reimbursement authority from the interest on undisbursed bond proceeds to continue implementation of the debt management system project that was originally authorized in the 2013-14 Budget Act. The amount includes funding for a procurement consultant and related vendor, oversight costs of the California Department of Technology, and funding for four positions. The system is necessary for debt administration, including duties associated with trustee, registrar and paying agent responsibilities, payment of debt service, disclosure and analysis of debt issuances. Given the increased legal and financial complexities in the debt markets, the STO indicates a need for a new system to administer outstanding debt, track and pay debt service and fees on outstanding debt, and track and validate the issuance of new debt. The existing system dates to 2004.

Staff Comment. Staff has no concerns with this proposal.

Staff Recommendation. Approve the budget proposal for $1.1 million increased expenditure and reimbursement authority for contractors and four staff positions.

Vote:

0968 California Tax Credit Allocation Committee

Department Summary: The California Tax Credit Allocation Committee (CTCAC) allocates federal and state tax credits used to create and maintain affordable rental housing for low-income households in the state by forming partnerships with developers, investors, and public agencies. The CTCAC works with public and private entities to assist with project development and monitors project compliance. The CTCAC coordinates its functions with state and local housing fund providers and with private fund investors in the provision and maintenance of affordable housing. The CTCAC consists of seven members from state and local governments, with the State Treasurer serving as chair. Other members are the Governor or Director of Finance, State Controller, Director of the Department of Housing and Community Development, Executive Director of the California Housing Finance Agency, and two representatives from local government.

Budget Summary: The CTCAC budget calls for $6.7 million and 40 positions for 2014-15. This represents a slight increase from the 2013-14 funding level of $6.4 million and 40 positions. The CTCAC is funded through fees generated by the issuance of debt and reimbursements, with no General Fund support.

Issue 1: Compliance Monitoring Operating Expense Augmentation (Governor's Budget BCP #1)

The Governor's budget proposes an augmentation of $200,000 to address increased costs for in-state travel related to an increased number of on-site file and physical inspections; and $100,000 to contract out for the collection of demographic data for every household member that occupies a low-income housing tax credit (LIHTC) unit. The CTCAC has not requested an increase in travel funding in over ten years despite travel costs increasing from $65,000 in 2002-03 to $266,000 in 2012-13.

In addition, an augmentation of $50,000 in reimbursement and expenditure authority is requested for fees collected from compliance training workshops provided by CTCAC to users of the LIHTC program.

Staff Comment: Staff has no concerns with this proposal.

Staff Recommendation: Approve the request for an expenditure augmentation of $300,000 and increased reimbursement and expenditure authority of $50,000.

Vote:

0971 California Alternative Energy and Advanced Transportation Financing Authority

Department Overview: The California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) is housed within the STO and is tasked with the authority to provide financing assistance to entities that wish to develop and commercialize advanced transportation and alternative energy technologies intended to reduce air pollution and conserve energy. The CAEATFA consists of five members and is chaired by the State Treasurer.

Budget Overview: The Governor's budget proposes $27.5 million and 19.5 positions for 2014-15. This represents a net increase of $17.5 million over the estimated current year. The CAEATFA's programs are primarily funded through the California Energy Commission.

Issue 1: Residential PACE Loss Reserve Fund Implementation and Administration (Governor's Budget BCP #2)

The CAEATFA requests a re-appropriation of $10 million for a loss reserve fund (local assistance) to provide credit enhancements for the financing of home energy efficiency project and energy upgrades. This program was originally approved and authorized in the 2013 Budget Act. However, the enabling legislation was not enacted until September 2013, resulting in a delay in program implementation.

Staff Comment. The $10 million re-appropriation would allow for program development and implementation.

Staff Recommendation. Approve the $10 million re-appropriation.

<u>Vote:</u>

0984 CA Secure Choice Retirement Savings Investment Board

Department Summary. The California Secure Choice Retirement Savings Investment Board (SCIB) was established by SB 1234, (de León), Chapter 734, Statutes of 2012, to study the feasibility of implementing a state-administered retirement savings program for private sector employees in California with no access to workplace retirement savings plans. The SCIB consists of nine members: the State Treasurer (Chairperson), the Director of the Department of Finance, the State Controller, a retirement savings and investment expert, an employee representative, a small business representative, a public member and two other members appointed by the Governor.

Budget Summary. The SCIB budget calls for a re-appropriation of $750,000 (or the remainder) of the existing expenditure authority of the $1.0 million provided in the 2013 Budget Act and no staff positions. These funds would be used to conduct a market analysis for a private pension plan consistent with SB 1234.

Issue 1: Market Analysis for the CA Secure Choice Retirement Savings Trust Act (Governor's Budget BCP #1)

The Governor's budget proposes to re-appropriate the remainder of the $1.0 million (estimated to be $750,000) expenditure authority included in the Budget Act of 2013. Budget language is also requested allowing for additional expenditure authority, if additional funding is provided by a nonprofit, or private entity, or from federal funding. This is consistent with the language included in the budget act last year. At this time, no money has been spent, but is it anticipated the work will begin in April 2014 and be completed in October 2014. It is possible the market analysis could begin in 2014-15, if sufficient funds are not received in the current year.

Staff Comment: Staff has no concerns with this proposal.

Staff Recommendation: Approve the request for a re-appropriation of the balance of the existing expenditure authority and related budget language.

Vote:

ITEMS PROPOSED FOR DISCUSSION AND VOTE

9600 Debt Service, General Obligation Bonds, and Commercial Paper

Item Overview: Expenditure of bond proceeds is reflected in the budgets of individual departments, with the payment of bond debt service consolidated in Item 9600 in the Governor's budget. It is the repayment of bond debt that is reflected as a General Fund expense. Some bond costs are offset by special funds or federal funds. Other bonds are 'self-liquidating,' or have their own dedicated revenue source for debt service. For example, the Economic Recovery Bonds (ERBs) receive a quarter-cent of the sales tax as a component of the 'triple flip' enacted as part of the 2004 budget package.

Budget Overview: The Governor's budget includes $5.3 billion in General Fund costs for GO bond debt service and related costs, or a total of $6.8 billion when the debt service costs of the ERBs are included. This amount does not include the proposed supplemental payment of $1.6 billion for ERBs that would result in them being paid off by the end of 2014-15. In addition, $1.1 billion in debt costs are scheduled to be funded from special funds. Finally, federal bond subsidies, through the Build America Bonds (BABs) program, will provide $327 million in 2014-15, allowing for a reduction in General Fund expenses. The Governor's proposed budget includes $106.8 billion in General Fund available resources (not including carry-over balances), so the net General Fund bond debt service as a percentage of General Fund resources is about 5.0 percent.

Governor's Budget for General Obligation Bond Debt
(Dollars in Millions)

Category	2012-13 Actual Cost	2013-14 Estimated Cost	2014-15 Forecasted Cost
General Fund Cost	$3,997	$4,916	$5,298
Other Funds Cost	788	1,052	1,133
Federal Subsidy (Build America Bonds Program)	340	324	327
Total Debt Service	**$5,125**	**$6,292**	**$6,758**
Economic Recovery Bonds (ERBs, not included above because indirect GF cost)	$1,313	$1,539	$1,614

The ERBs are not included directly in General Fund costs for bond debt service. As noted above, repayment of these bonds is financed from a quarter cent sales tax that was temporarily redirected from local government. Local government revenue is backfilled through a diversion of property tax revenues and an increase from the state General Fund in Proposition 98 education funding. The Governor's budget reflects special fund expenditures of $1.6 billion for ERB debt service in 2014-15, and the Proposition 98 budget reflects increased General Fund expenditures of $1.6 billion. Paying off the ERBs in 2014-15 will reduce the state's General Fund expenditures for Proposition 98 by roughly $1.5 billion in 2015-16.

Background: The state uses general obligation bonds (GO bonds) to borrow funds for spending—primarily for infrastructure and other capital investments. The use of bonds to accelerate capital projects is a commonly-used practice of government entities. Bonds must be approved by voters and bond proceeds are either continuously appropriated (immediately available for expenditure) or require an appropriation from the Legislature. All bond debt service is continuously appropriated and, therefore, not appropriated in the annual budget bill. The state has $80.7 billion in outstanding GO bond debt (including self-liquidating bonds such as the Economic Recovery Bonds [ERBs]). Another $28.3 billion in bonds are authorized, but remain unissued. In most instances, bonds are sold at different lengths of maturity such that repayment is spread over about 30 years. The chart below indicates the authorized, but unissued, reservoir of bonds.

General Obligation Bonds Authorized and Not Issued
(Dollars in Millions)

Authorized Bond Program	Unissued Amount
Prop 1A of 2008: High-Speed Rail	$9,244
Prop 1B of 2006: Transportation	7,023
Prop 84 of 2006: Safe Drinking Water	2,958
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,819
Prop 71 of 2004: Stem Cell Research	1,560
Prop 46 of 2002 & Prop 1C of 2006: Housing	1,392
Prop 55 of 2004 & Prop 1D of 2006: Education Facilities	1,201
All other	3,134
Total	**$28,331**

The state generally goes to market to sell GO bonds twice annually—once in the spring and once in the fall. Bond structures are often tailored to meet market demand and investor appetite. This tailoring includes tinkering with variables such as fixed and variable rates, call features and premiums, and various security enhancements. Bonds are sold in amounts necessary to meet expenditure needs, plus an additional cash cushion to account for flexibility regarding how fast projects will expend funds and uncertainty about the timing of the next bond sale.

Paying GO bond debt is a significant General Fund expense. State and federal tax exemptions for interest income received by investors ensure that GO bond debt is a low-cost financing alternative. To the extent bond costs do not exceed a government's long-term ability to fund other commitments; bonds allow the public to enjoy the benefits of infrastructure investment more quickly than would otherwise be the case. The LAO indicates that the state's debt service requirements for infrastructure will climb steadily over the next several years, to about $7.1 billion in 2019-20. As a percent of General Fund revenues, debt service is estimated to remain at about 5.9 percent.

Voters approved over $40 billion in new bonds on the 2006 ballot, just prior to the national recession. The bonds have allowed the state to invest in infrastructure while the need for economic stimulus is most acute, while borrowing costs are low, and while construction procurement is favorable. Despite the benefits of bonds, they come with the cost of many years of debt service. Assuming that a bond carries an interest rate of 5 percent, the cost of paying it off with level payments over 30 years is close to $2 for each dollar borrowed—$1 for repaying the amount borrowed and close to $1 for interest. This cost, however, spread over a 30-year period, after adjusting for inflation is considerably less—about $1.40 for each $1 borrowed. That bond cost crowds out alternative expenditures over the life of the bond. The Legislature can prioritize or limit bond funding through the budget process as overall expenditures are prioritized. This question may be particularly acute as the economy begins to recover and interest costs climb as a result of increased demand for capital.

Issue 1: Bond Sale and Cash Plan for 2014-15 (Governor's Budget Proposal)

The budget plan includes an assumption that $2.8 billion in GO bonds will be sold in the spring of 2014, and that $2.1 billion more will be sold in the fall of 2014. Among these planned sales are $2.7 billion for transportation and related capital facilities, $1.4 billion for various education facility bonds, and $618 million for various natural resources bonds.

Detail: As the state's cash situation deteriorated with the most recent recession, the Administration changed the methodology for managing bond cash. Prior to the recession, reserve cash funded project costs in advance of bond sales, and then bond sales replenished cash reserves. When reserve cash declined, the state had to instead sell bonds in advance of expenditures. Due to project expenditures occurring slower than anticipated at the time of bond sales, large bond cash balances developed—about $9.7 billion as of December 2011. The Administration recently implemented a plan to utilize commercial paper to aid cashflow, and reduce the need to carry large bond cash balances, as well as requiring GO bond programs to demonstrate an immediate need for additional bond proceeds prior to issuing new bonds. As of December 2013, about $4.5 billion in bond cash was on-hand from prior bond sales, as shown in the table below. At budget hearings, the Administration could be asked to discuss their management of bond proceeds, forecasts of project expenditures, and the optimal level of cash balances.

General Obligation Bonds Current Cash Proceeds
(Dollars in Millions)

Authorized Bond Program	Bond Proceed Cash Remaining as of Dec. 2013
Prop 1B of 2006: Transportation	$921
Prop 1E of 2006: Disaster Prep and Flood Prevention	896
Prop 84 of 2006: Safe Drinking Water	567
Prop 1C of 2006: Housing	293
Prop 1D of 2006: Public Education Facilities	354
Prop 50 of 2002: Water Security	447
Prop 13 of 1996: Clean Water and Watershed	204
All others	817
Total	**$4,499**

Staff Comment. While funding for bond debt service is continuously appropriated, a broader discussion on GO bonds may be useful to understand the Administration's priorities and help inform future discussion on individual bonds and expenditure plans. The Administration should be prepared to discuss their overall plan for GO bonds in 2014-15. Individual bonds will be discussed in more detail by subject matter in this subcommittee and other subcommittees as hearings progress this spring.

Question:

1) *Is bond cash sufficient to fund all bond projects appropriated by the Legislature, or are any projects on hold due to insufficient bond cash or other reasons?*

Staff Recommendation: Informational item. Bring the issue back at a future time if the Administration substantially revises their bond plan as part of the May Revision.

Issue 2: Infrastructure Financing and Debt Service Capacity (Governor's Budget Proposal)

The Governor's budget proposes bond sales in the spring and fall of 2014. The issuance of authorized bonds on a consistent basis over the next few years would keep debt service requirements in the range of 6-7 percent of General Fund revenues. In recent years, debt service has been one of the fastest growing segments of the budget and debt service on infrastructure bonds is expected to increase to $8.6 billion by 2017-18. In addition, significant infrastructure needs are apparent throughout the state which must be addressed through additional bond authorizations, on a pay-as-you-go basis, or some alternative means of financing.

Detail: The Administration released its 2014 Five-Year Infrastructure Plan along with the budget as summarized earlier in this agenda. The plan focuses on using existing revenue streams—mostly federal funds, special funds, and already authorized bond funds—for its funding proposals. The plan does not propose the addition of any new taxes or new general obligation bonds. The plan notes that to the extent the state undertakes additional borrowing, it will affect the state's debt-service ratio, which is the portion of the state's annual General Fund revenues that must be set aside for debt-service payments and are, therefore, not available to support other programs.

LAO Comment. The LAO in its analysis of the 2014 California Five-Year Infrastructure Plan notes that the state's funding approach is an important consideration for the Legislature. It finds the Legislature may want to determine whether it agrees with the Governor's cautious approach to taking on new General Fund commitments, including debt obligations. In addition, the Legislature may wish to explore other funding sources, besides the General Fund, such as special funds and user fees.

Staff Comment: The Administration should be prepared to discuss the affordability of the state GO bond plan and the ability of the state's General Fund to continue at the current level—or any future increased level—of debt service requirements given the other demands on it. This additional debt could include a possible water bond to address the reliability of the state's water supply. The Administration should describe options for infrastructure and include a discussion of things that it considers when weighing financing options such as financing costs, ease of implementation, project flexibility, and assumed risk.

Questions:

(1) *What is the state's capacity for more GO bonds, especially to fund infrastructure projects?*

(2) *How does the Administration determine how to fund infrastructure projects? What options does it weigh?*

Staff Recommendation: Informational item.

9620 Cash Management and Budgetary Loans

Item Overview: This budget item appropriates funds to pay interest costs on General Fund borrowing used to overcome cash flow imbalances during the fiscal year. Because receipts and disbursements occur unevenly throughout the fiscal year, the General Fund borrows in most years, even though each budget is balanced when enacted, and funds are repaid within the fiscal year. Interest is paid on both internal borrowing, such as short-term loans from special funds, and for external borrowing, such as Revenue Anticipation Notes (RANs). This item additionally pays interest costs for budgetary borrowing by the General Fund from special funds. Budgetary borrowing is across fiscal years and is scored as a budget solution, whereas cashflow borrowing is not counted as a budget solution, but conducted in order to maintain adequate cash reserves.

Budget Overview: This item appropriates funds for interest costs associated with cashflow and budgetary borrowing. The budget includes $120 million General Fund for the interest costs associated with two cashflow borrowing methods—$60 million for the RAN and $60 million for internal borrowing costs. The proposed amounts are conservative and based on budgeting sufficient funds to cover the uncertainty in interest rates and other factors. In addition, the budget includes $54 million in interest costs associated with the repayment of internal budgetary borrowing from special funds.

Issue 1: Cashflow Borrowing (Governor's Budget Proposal)

The Governor's Budget proposes both internal and external cashflow borrowing. Generally, internal sources are assessed first, and external borrowing is used to supplement internal sources. In order to supplement the state's internal borrowing within the budget year, the Administration has proposed a RAN initially sized at $3.5 billion. This provides an additional cashflow cushion to the existing availability of internal resources. Without the external borrowing, there would be insufficient cash reserves and other funds during the months of October, November, December, and March.

Background and Detail: The state's receipts and disbursements of cash occur unevenly throughout the fiscal year. As a consequence, the General Fund borrows for cashflow purposes in most years, even though each budget is balanced when enacted and funds are repaid within the fiscal year. Given that the state receives revenues on an uneven basis throughout the year, the state's cash position varies, with the typical low points occurring in July, October, and November. Maintaining an adequate cash balance allows the state to pay its bills in a timely fashion. Interest is paid on both internal borrowing (such as cashflow loans from special funds) and for external borrowing (such as Revenue Anticipation Notes [RANs]). For the current year, the state issued RANs in August of 2013 of $5.5 billion. The RANs are payable in May and June and carry an expected interest cost of $16 million.

Total monthly borrowable internal resources from some 700 plus funds are typically in the range of $20 billion. The state also established a new cashflow tool in the form of the Voluntary Investment Program (VIP) in 2012. This measure provided an additional means to assure cashflow continuity by establishing a new account for voluntary participation by local governments. Another cash management tool of the state is the State Agency Investment Fund (SAIF), which attracts deposits from entities not otherwise required to deposit funds with the state. The VIP and SAIF were not used in the current year.

An additional tool in managing cash is deferrals of payments within the fiscal year to K-12 and higher education, local governments, and other entities. In recent years, flexible deferrals have been enacted in statutes that allow specified deferrals if necessary to maintain a prudent balance for bond debt and other priority payments. For the current year, there were deferrals allowed for K-12 education, higher education, and local government payments. The fiscal impact of these deferrals varies from entity to entity, depending upon their own cash positions.

Based on the cashflow statements of the Administration, the cash low-points will occur in October, December, and March, when unused borrowable cash resources are estimated to be $4.5 billion, $4.2 billion and $5.0 billion respectively. By way of comparison, and reflective of the uneven flow of receipts and disbursements, the cash and borrowable resources in June of this year are estimated to be $20.8 billion.

LAO Comment. The LAO finds that the estimated interest cost related to budgetary loans ($54 million) is reasonable given the loans proposed to be repaid.

Regarding internal cash-flow borrowing, costs were $50 million in 2012-13 and are estimated to be $40 million in 2013-14. The LAO finds the $60 million budgeted in 2014-15 will probably prove to be too high given that the state's cash position appears better than in recent fiscal years.

Lastly, external borrowing costs were about $48 million on a $10 billion RAN in 2012-13 and are estimated to be about $16 million on a $5.5 billion RAN in 2013-14. For planning purposes, the budget proposes a RAN of $3.5 billion for 2014-15. The LAO finds that external borrowing costs associated with the 2014-15 RAN will probably prove to be significantly below the Administration's current estimates. In total, Item 9620 costs likely will prove to be less than the Administration now estimates—probably by an amount in the low tens of millions of dollars. The Administration's January estimates are provided for planning purposes, and these are typically updated with the May Revision, at which time we will be able to reassess the scoring.

The LAO also notes that unlike most items in the annual budget plan, Item 9620 interest costs will automatically be paid if interest costs prove to be higher than budgeted. Both Items 9620-001-0001 and 9620-002-0001 include provisional language appropriating "any amount necessary" to pay required internal borrowing and budgetary loan interest costs. For RAN costs, Section 17310 of the Government Code also provides for payment of any amounts necessary for interest costs. The LAO advises the Legislature to score interest costs based on the best estimate available at the time the budget is passed. In the event that costs exceed (or are below) this estimate, the General Fund reserve will be less (or more) than budgeted.

In addition, while it is unlikely that there will be substantial new special fund budgetary loans in the near future, the LAO recommends a change in the way interest is calculated for *future* special fund budgetary loans. Specifically, a blended interest rate that accounts for changes in the Pooled Money Investment Account rates over time would more appropriately compensate special funds for their reduced balances. To implement this recommendation the LAO suggests that the Legislature could direct DOF to work with the State Controller's Office to propose appropriate statutory language to implement this change.

Staff Comment: Maintaining an emphasis on cashflow borrowing from internal sources is sound fiscal policy that reduces the need for more expensive external borrowing. The LAO finds that some of the estimated borrowing costs may be too high based on past costs. At the time of the May Revision, the Administration's proposal will likely be updated and at that time should be reassessed to ensure that the estimated borrowing costs are appropriate.

Questions:

1) *Please explain the basis for the estimated internal cashflow borrowing costs of $60 million for 2014-15.*

2) *What is the basis for the estimated borrowing cost of $60 million for the RAN?*

Staff Recommendation: Hold open and reassess at the May Revision.

Issue 2: Budgetary Borrowing Repayment Plan (Governor's Budget Proposal)

The Governor proposes to pay down $11.0 billion of the remaining $24.9 billion "wall-of-debt" by the end of 2014-15. In addition, the Governor's multi-year budget plan proposes to fully repay wall-of-debt obligations by the end of 2017-18. Assuming this plan is adhered to, the 2018-19 budget and ongoing budgets would be increasingly free of these debt pressures and expenditures would be more in line with annual revenues. The estimated wall-of-debt repayment schedule is presented in the following table.

Governor's Wall-of-Debt and Proposed Repayment (Dollars in Millions)

Item	Current Wall Amount	Payments 2013-14	Repayment Proposed in 2014-15	Repayment Proposed in 2015-16	Repayment Proposed in 2016-17	Repayment Proposed in 2017-18
Deferred Payments to Schools and Community Colleges	$6,164	$3,690	$2,474	$0	$0	$0
Economic Recovery Bonds	3,914	0	3,165	0	0	0
Loans from Special Funds	3,880	0	927	2,021	932	0
Mandate Payments to Local Governments	5,382	0	0	1,993	1,752	1,637
Underfunding of Proposition 98	2,391	598	0	1,793	0	0
Deferred Medi-Cal Costs	1,773	0	60	40	0	1,637
Deferral of State Payroll Costs	783	0	0	0	783	0
Deferred Payments to CalPERS	411	0	0	0	411	0
Proposition 42 Borrowing from Transportation Funds	168	0	83	85	0	0
Total	**$24,866**	**$4,288**	**$6,709**	**$5,932**	**$3,878**	**$3,310**

The planned payments for ERBs and Proposition 42 borrowing are constitutionally required or dictated by bond debt service. However, the Governor's proposal to retire ERBs a year early by making a one-time supplemental payment of $1.6 billion, is discretionary, as is the payment of loans from special funds. The Administration indicates that repayment of roughly half of the special fund loans allows the state to make critical investments in maintaining the state's highways and roads, and addressing climate change. The amount of special fund loans proposed for repayment in the Governor's budget is $927 million, plus total interest costs of $54 million. Interest is required on most special fund loans and is paid when the principal is repaid.

Governor's Proposal for Repayment of Special Fund Loans
(Dollars in Millions)

Affected Department and Special Fund	Principal Amount
Transportation—Highway Users Tax Account Loan Repayment	$328.3
Trial Courts—State Courts Facility Construction Fund	130.0
Air Resources Board—Greenhouse Gas Reduction Fund	100.0
Resources—California Beverage Container Recycling Fund	82.3
Public Utilities Commission—California High Cost Fund B Administrative Committee Fund	59.0
Transportation—State Highway Account, State Transportation Fund	56.0
Resources—Electronic Waste Recovery and Recycling	27.0
Health—Hospital Building Fund	20.0
General Services—Public School Planning, Design, and Construction Review Revolving Fund	20.0
Consumer Affairs—Vehicle Inspection Repair Fund	14.0
Justice—False Claims Act Fund	12.7
Health—Health Data and Planning Fund	12.0
Emergency Services—Victim-Witness Assistance Fund	10.1
Consumer Affairs—Enhanced Fleet Modernization Subaccount	10.0
Secretary of State—Victims of Corporate Fraud Compensation Fund	10.0
Other Departments, Funds and Accounts	35.6
Total	**$927.0**

Background and Detail: Through budget actions over the last decade, the state has borrowed from special funds and deferred various payments in order to close budget deficits. By the close of 2010-11, the DOF indicates that a total of $34.7 billion in loans and deferrals has accumulated and remained unpaid. The Governor defines this as the wall-of-debt, and includes in his definition adjustments related to his budget proposals. This amount largely represents the debt overhang from prior year budgets adopted under the previous Administration. By the end of the current year, this amount is expected to be reduced to $24.9 billion.

Some obligations included in the wall-of-debt have required repayment in specified years due to constitutional requirements or due to scheduled bond debt service. An example of a rigid remittance requirement is the annual Economic Recovery Bond (ERB) payment of approximately $1.5 billion through 2016-17. Other debt payments are more flexible and can be repaid over time as the budget situation allows, such as school payment deferrals, and as long as borrowing does not interfere with the activities that a special fund loan supports. In either case, the wall of debt represents a budget challenge, as payments on these accumulated debts restrict legislative discretion and displace funding for ongoing or expanded program costs.

Staff Comment: The Governor's continued emphasis on repaying budgetary debt, specifically the ERBs and special fund loans, is sound fiscal policy and would continue California's progress towards strong fiscal footing. The plan to repay the wall-of-debt over the next four years is timed to coincide with the expiration of the state's receipt of revenues from temporary taxes established by Proposition 30 in November 2012. In addition, paying off the ERBs early would free up sales tax resources now dedicated to General Fund bond repayment, most likely beginning in 2015-16. Overall, the rate of repayment is somewhat more aggressive in 2014-15 and 2015-16, about $6.7 billion and $5.9 billion respectively, than in the final two budget years of repayment, which are about $3 billion in 2016-17 and 2017-18.

Generally, actions regarding special fund loans will be made in the budget subcommittees by subject-matter area, although the 9620 Budget Item should be made to conform.

Some of the loans proposed by the Administration for repayment are necessary to make, some of the loans could be repaid earlier to help meet the desired program objectives, and some of the proposed loan repayments are unnecessary at this time, as the programs have been operating for many years without these funds.

In order to assess which loans justify repayment, it will be important to apply specific criteria to each loan proposed for repayment. One way to do this during budget hearings is to ask key questions of departments that have outstanding special funds loans such as:

- Do expenditures consistently exceed revenues?
- Are special fund programs cost-effective?
- What is an appropriate fund balance?
- Is a substantial, one-time cost anticipated, such as deferred capital projects or maintenance?
- Are reductions in fees justified?
- Does the department, board, or bureau have performance targets?
- What interest rate is the General Fund paying to borrow from this special fund?
- How would the repayment funds be used by the program?

In addition, the Legislature can scrutinize the current and budget year spending projections to determine if the fund balance, as presented by the Administration, is accurate. One way to do this is to request that the Governor provide updated fund condition statements, at the time of the May Revise, for those loans that are proposed for repayment. This is not the current practice and more up-to-date information would help the Legislature to better examine the expenditure needs of the affected departments and programs, assess the projected trend of spending, and the need for repayment.

Our analysis of a selection of loans from a variety of program areas found that one of the loans proposed for repayment could be delayed and two other special funds could benefit from an early loan repayment as described below. These are examples only and it is possible that a more comprehensive review of all outstanding special fund loans could find additional loan repayments that could be delayed or advanced.

The committee may want to hold final determination on loan repayments until the May Revision when final revenue forecasts are known. The Administration should be prepared to discuss their overall plan for special fund loan repayment for the remainder of 2013-14 and for 2014-15 through 2017-18.

Questions:

1) *How are decisions made about which special fund loans to repay? What criteria did the Administration use to determine which special fund loans to pay off and when?*

2) *When a decision was made to repay a certain special fund, how was the repayment amount determined?*

Staff Recommendation: Hold open.

Control Section 6.10 Funding for Deferred Maintenance Projects

Item Overview: Budget Control Section 6.10 gives the Department of Finance the authority to allocate $100 million General Fund in the amounts identified below for deferred maintenance projects:

- Department of Parks and Recreation $40,000,000
- Department of Corrections and Rehabilitation $20,000,000
- Department of Developmental Services $10,000,000
- Department of State Hospitals $10,000,000
- Department of General Services $7,000,000
- State Special Schools $5,000,000
- California Military Department $3,000,000
- Department of Forestry and Fire Protection $3,000,000
- Department of Food and Agriculture $2,000,000

Under this proposal, departments would provide DOF a list of deferred maintenance projects for which the funding would be allocated. The DOF would review and provide the approved list to the Chairperson of the Joint Legislative Budget Committee (JLBC) 30 days prior to allocating any funds. The amounts specified above would be available for encumbrance or expenditure until June 30, 2016. If a department makes a change to the approved list after the funds have been allocated, DOF's approval is required and the JLBC would be notified 30 days prior to the change being approved.

Background. At this time, most deferred maintenance is funded through the baseline support budget provided to individual departments. Departments have some discretion to use these funds for maintenance projects or other higher priority needs within the department.

In response to this proposal, some departments have provided lists of deferred maintenance projects and identified which projects are the highest priorities for completion. However, other departments have not.

Staff Comment: The Governor's proposal to provide funding for deferred maintenance is a positive first step toward addressing the problem. However, the proposed process for the allocation of the $100 million (which in some cases could be for projects costing tens of millions of dollars) may not provide for adequate Legislative oversight and transparency. (The proposals for deferred maintenance funding are also being discussed in the budget subcommittees as part of each department's budget.)

It is unclear why the Administration is proposing an alternative process, to the typical budget process where departments' support budgets include funding for deferred maintenance projects. The JLBC process, that is being proposed, is not transparent and is intended to be an alternative process, not a primary process for allocating state funds. In addition, the proposed allocation of the $100 million would not provide the Legislature with an understanding of how each department prioritized projects. For example, it would be unclear if a department's prioritization process emphasized important factors, such as if the projects could leverage additional federal or local funds, or if they would help to generate revenue for the state. Project prioritization could also be based on whether the project addresses fire, life, and safety issues, or prevents future greater state costs. The proposed process also would not allow the Legislature an opportunity to provide its input on other projects that it considers high priorities. Finally, this process also would not allow the Legislature to consider other potentially appropriate funding sources for deferred maintenance projects, such as using bond funds or user fees, rather than state General Funds.

Given these considerations, the Legislature may want to reject the proposed control section process and direct the Administration to come back with proposals that enable the Legislature to approved funding for deferred maintenance projects through department's support budgets.

Questions:

1) *Why is an alternative process to funding deferred maintenance projects through departments' support budgets being proposed? Why can't these projects be funded within departments' support budgets that are approved as part of the budget process?*

2) *Would the proposed funding be in addition to the baseline funding for deferred maintenance included in departments' support budgets, or would this supplant existing funding?*

3) *What is the distinction between a deferred maintenance project and a project that has had such significant deferred maintenance that the project has become a capital outlay project? Would these types of capital outlay projects be funded under this proposal?*

4) *How would the process work if the Legislature has concerns with the projects submitted and approved by DOF using the Control Section process?*

Staff Recommendation: Reject Control Section 6.10. Direct the Administration to come back with a proposal that allows the Legislature to approve funding for individual department's deferred maintenance projects through the regular budget process.

<u>Vote:</u>

0985 California School Finance Authority

Department Summary. The California School Finance Authority (CSFA) was created in 1985 to oversee the statewide system for the sale of revenue bonds to reconstruct, remodel, or replace existing school buildings, acquire new school sites and buildings to be made available to public school districts (K-12) and community colleges, and to assist school districts by providing access to financing for working capital and capital improvements. Over the last 25 years, the CSFA has developed a number of school facilities financing programs and most recently is focused on assisting charter schools to meet their facility needs. The CSFA is a three-member board comprised of the State Treasurer, the Superintendent of Public Instruction, and the Director of the DOF, and is administered within the Office of the State Treasurer.

Budget Summary. The CSFA budget calls for $126.1 million and 10 positions for 2014-15. This represents a small increase from the 2013-14 funding level of $126.0 million and eight positions. The CSFA is largely funded by General Fund (Proposition 98), federal funds, and other funds that include General Funds (non-98).

Issue 1: Charter School Facility Grant Program (Governor’s Budget BCP #1)

Last year the Charter School Facility Grant Program and the Charter School Revolving Loan Program were transferred from the California Department of Education (CDE) to CSFA. The shift included $175,000 in General Fund (Non-98) and 2.0 positions from CDE to CSFA to support the program transfer in 2013-14 and beyond. The shift was approved because CSFA already administers similar programs and according to the Administration, the proposed shift was intended to improve the efficiency of charter school program administration and disbursement of funds to local charter schools.

The Governor’s budget requests two additional positions and to upgrade an existing position, for a total cost of $167,000 General Fund (non-98), to administer the program.

Staff Comment. The CSFA is requesting additional resources that were not anticipated last year. The CSFA believes that CDE was able to absorb some of the workload that was shifted last year and that is why the resources that were provided were inadequate. According to CSFA, it does not have the capacity to absorb any workload and therefore needs these additional resources. The LAO, in their review of this issue, found that CSFA has not provided a workload analysis justifying the need for the additional staff. This additional information will better enable the Legislature to determine what resources are actually needed to administer the program.

Questions:

1) *When the administration of this program was shifted from CDE to CSFA last year, why was the need for additional resources not anticipated?*

2) *Are there funds other than state General Funds that could be used to pay for these additional staff positions?*

Staff Recommendation. Hold the item open and direct CSFA to provide a workload analysis to the LAO, in the next month, justifying the need for the additional positions. Direct LAO to review the workload analysis and report back at a future subcommittee hearing on their review and recommendation for this item.