Office of the State Auditor
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State of Mississippi

From the Office of State Auditor

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Bond Management and Capital Projects in Mississippi:

A Performance Audit Report

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- Phil Bryant, MS State Auditor

STATE OF MISSISSIPPI

OFFICE OF THE STATE AUDITOR

PHIL BRYANT
AUDITOR

Bond Management and Capital Projects in Mississippi: *A Performance Audit Report*

Executive Summary

Today Mississippi faces five challenges in bond management, which if addressed, can effect significant change and more importantly, substantial cost savings for the State. Arbitrage penalties, unspent bond proceeds, unreturned interest payments from agencies, unissued but authorized bonds, and other financial and management issues all contribute to the unnecessary increased costs associated with general obligation (GO) bonds.

For example, our State has the opportunity to save almost $13 million each time it issues $100 million in bonds by addressing a few of the recommendations provided within this report. Even greater savings are within reach for Mississippi through changes in our bond and bond project management and oversight process.

- *Reducing the cost of construction change orders by even 15%, Mississippi would have saved a minimum of* ***$2.4 million*** *in FY 2004.*
- *Reducing project development times by even one year could save the State a minimum of* ***$5 million each year.***
- *Each time the State modifies $100 million of bond issues to take advantage of lower interest rates on short-term variable rate debt during the initial 3 years (typical construction phase) and then financing the remaining amount over 17 years, Mississippi could save $10 million. Since this is possible each year, over one 20-year cycle the state could save $105 million—an average of* ***$5.25 million per year.***
- *Construction management and oversight changes could save the State significant amounts as well.*

The Office of the State Auditor (OSA) has developed recommendations to address each of these challenges. They include some needed legislative action, some policy changes, and some procedural changes. While some of them look to the future, many of these recommendations can achieve immediate savings of taxpayer dollars.

As Mississippi's bonded indebtedness has rapidly increased, so has the amount of unspent bond proceeds which the State has on hand. Topping $746 million at the beginning of 2004, these borrowed monies have resulted in millions in IRS arbitrage penalties. The interest payments on these unspent general obligation (GO) bond monies exceed $40 million annually.

While Mississippi's GO bond proceeds management process works, it can still be refined and improved to save taxpayer dollars. Each year, the State faces arbitrage penalties when bond proceeds have earned interest and are unused for too long. As of August 2004, $163 million remained unspent for three or more years. Federal tax penalties issued by the IRS for violation of arbitrage rules cost the State over $10 million in the last four years.

To reduce costs and realize actual savings, legislators must recognize the importance of accelerating the time it takes to implement projects while shortening the time bond proceeds are idle, drawing interest which may end up being paid to the federal government in the form of arbitrage penalties. Among the steps needed are:

- *Legislation prohibiting the issuance of GO bonds for capital outlay until all required preplanning, including regulatory approval* *processes, is completed and the project is ready for final design work or construction;*

- *Sunset provisions to limit both the time new project funds can be authorized, but not issued by the State Bond Commission, as well as the time project funds may be issued, but not spent; and*

- *Written formalized guidelines for use by the State Bond Commission and its Working Group with deadlines to ensure prompt and timely implementation of the GO bond commitments by the State (This is currently being implemented).*

Bond bills passed by the Mississippi Legislature have become considerably more standardized in recent years, particularly with respect to ensuring that interest earned on bond proceeds is used by the State to pay debt service as well as planning and oversight provisions. The Legislature may wish to require that capital projects, in particular, conform to certain uniform requirements including:

- *Requiring standardized bond language in State law to have all interest earned by agencies on State GO bond proceeds to be returned to the State Treasury for debt service for each bond issue.*

Furthermore, the State Treasurer's Office has determined that more than $800 million in state bonds have been authorized, but for various reasons have never been issued. The Treasurer has also identified more than $166 million assigned to projects which are no longer feasible under existing bond authorizations. Through House Bill 1301, his office getting close to $120,000,000 of that repealed during the 2005 legislative session. To address these challenges, the Legislature should consider:

- *Repealing old authorized, but unissued debt; and*

- *Adopting sunset provisions in all future GO bond authorizations and bond proceeds spending.*

Addressing as many of the identified areas of concern as possible will accelerate project completion, thereby reducing substantially the amount of unspent bond proceeds the State has.

Expanding the authority for short-term borrowing, using variable-rate debt and other bond management tools can provide real savings for Mississippi. One example of this has been the Nissan funding experience. Utilizing these techniques, the State has saved a minimum of $10 million a year on the financing of the Nissan project. It is clear that this project demonstrated that under favorable economic conditions use of variable rate debt can yield very impressive cost savings. As long as economic conditions will permit the State should utilize as much of its existing variable debt capacity as it can.

The key purpose of this study is to suggest approaches and management practices which, if implemented, will lead to significant reduction in costs associated with issuance and management of GO bonds. Other critical savings components include:

- *Expanded utilization of preplanning and construction management for capital construction projects to ensure that all state bond recipients fully meet Bureau of Buildings standards and requirements;*

- *Expansion of current bond monitoring activities by OSA to continuously evaluate internal controls, tracking and disbursement of all GO bond funds;*

- *Inclusion of costs for OSA bond monitoring, and DFA financial supervision, and DFA's Bureau of Building (BoB) construction administration in bond issuances and within IRS limits.*

It would appear that sheer growth in the number and size of state bond projects has much to do with the current situation. Staffing, resources, policies and law all remain more or less in the same place from more than 15 years ago when bond issuance began to steadily increase. Then, Mississippi had less than 20% of its present level of public debt, now approaching the $3 billion level.

New technologies, financial practices, legal requirements and other related factors compel us to direct and control the continuing evolution of the State's management systems which oversee debt management policies and procedures.

OSA believes it is time for the debate to shift. To date, it has been about whether public debt is inherently helpful or harmful. Now the discussion needs to focus on how to best manage these growing obligations.

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CHAPTER I: INTRODUCTION

This chapter provides a snapshot of where Mississippi is today with regard to state general obligation bond (GO bonds) use and management. By looking back over the last few years, this section describes how we are at a turning point in the financial management and planning for GO bond use.

It points to Mississippi's more than $557 million in *unspent* bond funds originally issued as much as a decade ago; arbitrage penalties; and the more than $800 million in authorized but unissued debt that was present in 2004.

This chapter also describes recent changes to GO bond issuances such as the use of variable rate bonds, short-term debt, and refundings. Additionally, changes in Bond Commission membership (all members are in their first term); new banking technologies; and other management factors have combined with the issues above to offer Mississippi the opportunity to resolve these challenges—one of the biggest is providing for better long-term planning for capital construction needs.

INTRODUCTION

Unspent bond proceeds exceeded $740 million dollars as of January 1, 2004. Interest payments on this $740-plus million dollars exceed $40 million annually.

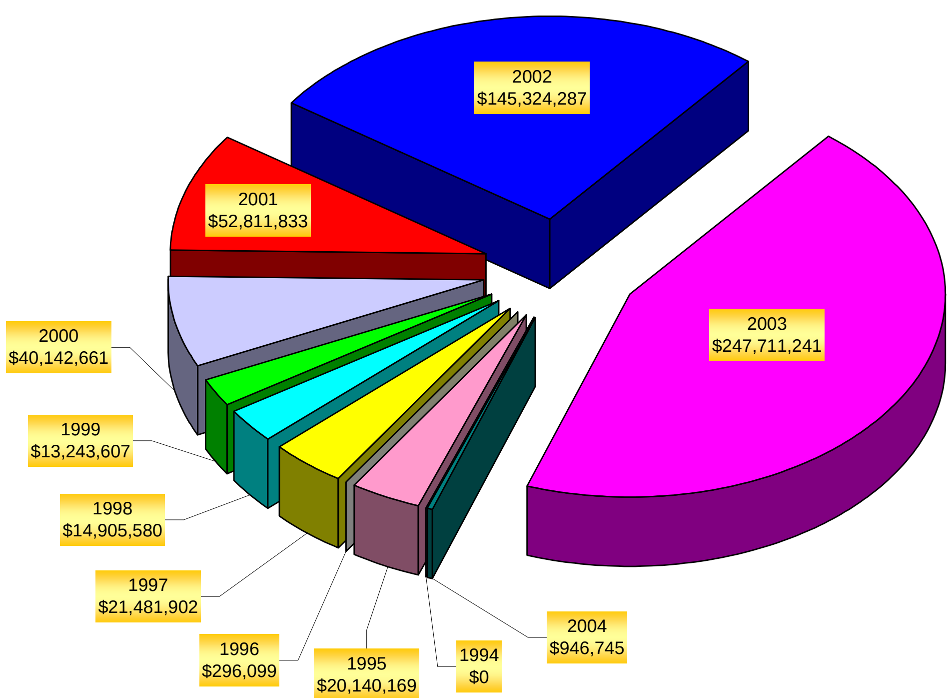
The State Auditor, after meeting with the State Treasurer and the Executive Director of the Department of Finance and Administration (DFA) early in 2004, undertook a study to determine where substantial savings could occur in the general obligation (GO) bond process. Several concerns emerged from the initial meetings. Among the most striking was that unspent bond proceeds, that is, those money borrowed by the State to pay for capital improvements, land acquisition, and economic development initiatives—but not yet spent on the projects—exceeded $740 million dollars as of January 1, 2004. Interest payments on this $740-plus million exceed $40 million annually. [1]

$163 million in bond funds have remained unspent for three or more years.

Unspent bond funds have declined over the past seven months to $557,004,124 as of August 1, 2004. While this is definitely a positive trend, they are likely to return to similar levels, at least temporarily, when additional debt is issued in the near future. The accompanying pie chart entitled: "Unspent Bond Funds: 1994-2004" depicts the breakdown of this $557 million over the past eleven years. It should be noted that while 70% of these funds were issued in 2002 or later, over $163 million in bond funds have been waiting to be spent for three or more years.

In a few cases, bond programs have received funds after the initial year of issue or may involve revolving loan funds. The balances reflected in the chart below do not include these funds.

Unspent Bond Funds: 1994-2004



[1] The interest being paid is not affected by how long proceeds remain unspent. Borrowing money and not using it in a timely manner risks arbitrage penalties, shows poor planning, and is not sound fiscal management policy.

Federal tax penalties issued by the IRS for violation of arbitrage rules cost the State over $10 million over the *last four years.*

Each year, the State faces arbitrage penalties—actually known as 'rebates,' because the money is paid to the Internal Revenue Service (IRS)—that are paid because unspent bond proceeds have earned interest and have been unused for too long. While one might think that earning interest on these funds would mean a windfall for the State, just the opposite is true. Not only is the State investing these funds at a rate substantially lower than the interest rate of the borrowing, several agencies for which the bonds were issued are keeping the interest earned on the investments. In addition, federal tax penalties issued by the IRS for violation of arbitrage rules cost the State over $10 million over the last four years. While eliminating arbitrage penalties completely may not be possible, because of the nature of activities involved, experts emphasize that money should be borrowed only when spending is imminent. **The federal 'bottom line'?** The condition for states being allowed to issue tax-exempt bonds is that they aren't allowed to turn around and invest those same monies at a profit. [2]

To add to the confusion, the State Treasurer's Office reported that there were more than $800 million in state bonds which had been authorized by the Mississippi Legislature, but for a variety of reasons, were never issued.

More than $800 million in state bonds authorized by the Legislature have never been issued.

Of that, more than $166 million in GO bonds authorized are likely never to be issued.

As of March 1, 2005 this amount has risen to $1,159,996,546. The State Treasurer is trying to remove at least $130,000,000 of this amount because his office has identified more than $166 million in projects which, they believe, have been abandoned, completed, or are no longer contemplated in which the bonds were never issued. Nevertheless, these funds were authorized and still must be regarded as state financial obligations. This contributes, to some degree, to a perception by bond rating companies that the State has a greater debt obligation than it really does. Unlike revenue bonds, GO bonds are secured by the full faith and credit of the State. They are the backbone of Mississippi's public debt. However, they are vulnerable to changes in the state's credit worthiness and economic stability.

In addition, too much unused GO bond money can affect the State's bond rating. Better interest rates and bond ratings ultimately save the State interest money. One of the reasons there is so much unspent bond money relates to an issue of authority. Until relatively recently, DFA consistently advised the State Bond Commission that it did not have the discretionary authority to issue authorized funds for projects as those funds were needed. Instead, it usually issued the entire amount at one time. This contributed significantly to the growing balance of unspent proceeds.

Reinterpretation of existing law by former Attorney General Mike Moore has led to a different position that allows the Commission to rely

[2] However, unspent taxable proceeds have no effect on arbitrage.

on the DFA Bond Division Director to determine the funds actually needed at the time that bonds are being issued. Utilizing this authority combined with the ability to determine what funds are needed when and where, could allow savings in interest costs on money not currently "working hard" for the State. Unfortunately, even if the State were to eliminate the $166 million in authorized funds for projects that are no longer current, there would still be at least $600 million categorized as 'funds authorized but not yet issued'.

"Waiting to issue debt until agencies are ready to actually begin a project is fiscally sound." -Phil Bryant

OSA sees issuing debt for projects when agencies are ready to begin actually paying for the improvements—called "just in time" issuances—as sound fiscal policy. However, the absence of time limitations on funds being authorized without being issued could mean additional increases in the total authorized and unissued amounts in the near term.

Other recent changes in GO bond issuance are also notable. *The successful issuance of variable rate bonds in 2003 for Nissan plant construction has saved an estimated $10 million dollars a year in interest payments.* Using as much variable rate debt as the law allows (20% of total GO bonds issued), while potentially complex in administration, does offer opportunity for additional savings. These bonds change interest rates each week, unlike the more conventional fixed rate kind. The variable rate debt authority—passed by the Legislature in anticipation of issuing the bonds used to fund the State's contribution to the Nissan project—has only been used once since that time. Current utilization is at 14%, still below the maximum 20%. Since the original version of this report in August, 2004, it appears as if the State intends to utilize more of its variable rate debt authority.

Changes in the future:

Advances in automated accounting systems and related technologies make it possible to enact additional financial management improvements which might not have been cost-effective in the past.

The Nissan project also provided the State with an opportunity to authorize use of short-term debt (sometimes called commercial paper). Short-term debt generally means less than one yeaand for most of these obligations—less than six months long. The financial authority given by the Legislature applied specifically to the Nissan project. It gave the State a way to issue debt for a few months until it could determine with more precision how much of its project related debt could be paid for with tax-exempt bonds and how much required more costly taxable bonds.

Another factor which has influenced direction of bond issuance has been the increased use of refundings to reduce the cost of public borrowing. The State receives proposals from companies specializing in refundings. It selects the ones where reduction in interest costs makes reissuance particularly attractive. While the present financial climate may limit the number of instances in which the State may benefit from refinancing outstanding bond issues, this approach has contributed significantly to reducing the cost of borrowing, especially during times of higher interest rates.

Furthermore, several factors are at work which may lead to additional changes to the bond process in the immediate future. For the first time in 16 years, all three members of the State Bond Commission, i.e., the Governor, State Treasurer, and Attorney General, are in their first terms of elective office. The State Fiscal Officer, who, as the executive director of the Department of Finance and Administration, is responsible for ensuring that all prospective bond matters are brought to the Commission in a timely, fiscally responsible, and cost-effective way, is new as well. Top-level management's interest and involvement in conducting a thorough review of current practices and procedures are regarded as being a very positive response to the issues and opportunities at hand.

Public facilities built in times of historically low interest rates may ultimately be replaced or upgraded in years of higher interest rates when financial conditions are very different than they are today.

In addition, changes in automated accounting systems and related technologies have further reduced transfer times for funds, verification of documents, and other bond issuance activities. This may make it possible to enact additional financial management improvements which might not have been cost-effective in the past.

The previously cited concerns and opportunities have led the Performance Audit Division of the Office of the State Auditor to explore these issues in greater depth in order to identify areas where real savings might be realized. Debt management practices are increasingly important. Public facilities and projects built with general obligation bond proceeds during times of historically low interest rates may ultimately be replaced or upgraded in future years when interest rates are much higher and financial conditions are very different than they are today.

A BIG CHALLENGE: CAPITAL PLANNING NEEDS

One of the challenges currently facing the State in reducing its unspent proceeds balance is developing an effective means of projecting and prioritizing its capital needs. According to the Bureau of Buildings, the present method of determining long-term capital needs appears to be a piecemeal approach. This may in part be the result of a chronic shortage of necessary funds—the pie is simply too small—coupled with the fact that 'big picture' plans are not always matched with financial resources.

One of the challenges facing Mississippi in reducing its unspent proceeds balance is developing an effective means of projecting and prioritizing its capital needs.

The Auditor's Office concurs in the Bureau of Buildings' belief that the general absence of a long-range strategy to address the condition and quality of facilities and other capital assets makes long term planning difficult which, in turn, causes projects to be seen independently rather than as the fulfillment of a larger vision of capital development. Creating a coherent capital program, not just a list of prioritized projects, and attaching to capital needs a concept of how they might actually be funded is necessary if the State is to create momentum which drives agencies to move as deliberately as possible from one capital phase to the next.

In an effort to explore the opportunities offered by expanding long term capital planning, DFA's Bureau of Buildings has been examining a variety of potential models. One promising approach is currently under development by the National Association of College and University Business Offices (NACUBO), the Association of Physical Plant Administrators (APPA), and others. While its intended application may currently be limited to creating a coordinated approach to identifying long-term capital needs, the same generic procedure could ultimately be applied more widely to maintaining and enhancing the State's entire infrastructure and capital facility investments.

The general absence of a long-range strategy … makes long term planning difficult which, in turn, causes projects to be seen independently rather than as the fulfillment of a larger vision of capital development.

Their university model focuses on a systematic process to integrate each institution's mission statement, strategic plan, facilities and land use master plans, long-term capital forecasts and capital budgets into a reliable mechanism to accurately anticipate future needs. Perhaps the most successful application of this approach to date has occurred in North Carolina where North Carolina voters approved a $3.1 billion bond referendum in 2000 which passed with 74 percent of the vote. It involved improvements over a ten-year period totaling $2.5 billion for the 16 UNC institutions and $600 million for North Carolina community colleges.

It is necessary for Mississippi to develop a new and more extensive form of long-term capital budgeting which allocates and prioritizes needs.

It has become necessary to develop a new and more extensive form of long-term capital budgeting which allocates and prioritizes needs. There are two major reasons why the Bureau of Buildings' efforts in this regard have focused to date on the State's colleges and universities. First, issued, but unspent bond proceeds from the IHL & State Agencies Capital Improvement fund, CJC Capital Improvements, and other funds for fiscal years 2002 and 2003 alone exceed $150 million. At least another $5 million in unspent proceeds are carried over from previous years. Second, Ayers Settlement issues and other circumstances have led to over $65 million in authorized, but unissued GO bonds at state institutions. It is understood that a certain amount of unspent proceeds is inevitable between the time of issue and the time that capital costs and incurred and payment is required.

CHAPTER II:
HISTORICAL TRENDS

This chapter looks back at Mississippi's debt growth and payments over the last several decades and describes how the decisions made then are affecting us now. It discusses the changing spending philosophy that has caused our per capita debt to grow to four times what it was just ten years ago. Management of the debt growth is another area on which the Department of Finance and Administration and the State Treasurer's office has begun to focus.

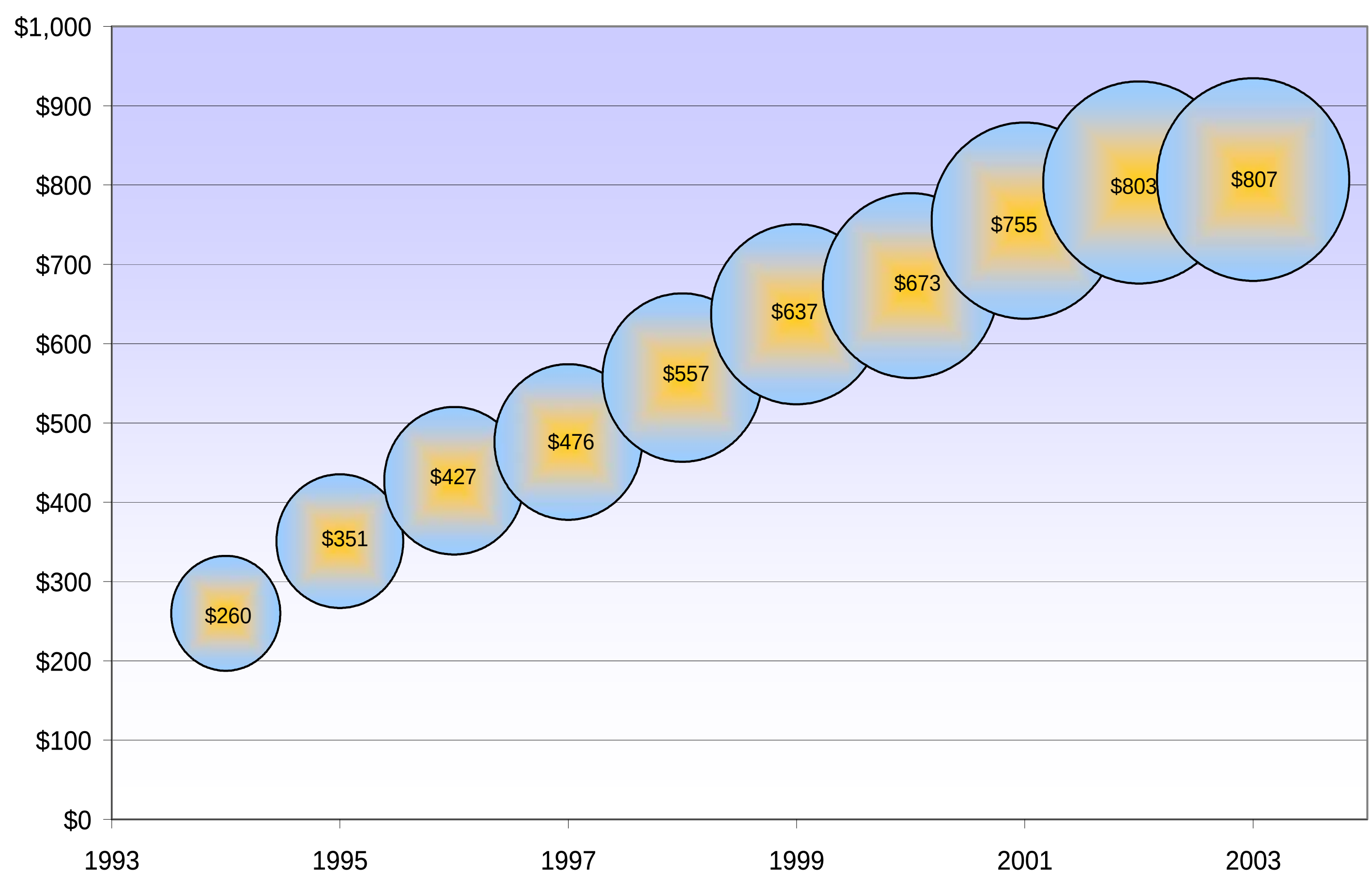
HISTORICAL TRENDS

Whatever the reasons, the increased use of general obligation bonds triggered a capital construction boom that quickly spread beyond the state colleges and universities.

Prior to about 1988 State issuance of GO bond debt was much more limited than it is today. Exceptions were occasionally made for a few capital construction projects involving highways and economic development projects like the ones involving the State Port and shipbuilding related activities.

The table below represents debt incurred, per capita, over the last decade. It represents an increase almost four times greater today than 1994.

Per Capita GO Bond Debt by Year



Studies of long term capital needs and development of long range capital plans have reinforced the belief that public debt is an essential tool in creating conditions favorable to future economic growth.

While there does not seem to be any definitive explanation as to how this came about, several elements almost certainly came into play. First, fiscal conservatism at the State's community colleges and universities which involved a 'pay as you go' approach began to change in the early 1980's in response to a concerted gubernatorial effort to get Institutions of Higher Learning (IHL) improvements to be funded with bonds instead of the usual annual appropriations. Second, lower interest rates and a strong state economy followed a national trend towards increased public works and related capital construction projects. The addition of gaming revenues in the early 1990's further reinforced this trend. Whatever the reasons, the increased use of general obligation bonds triggered a capital construction boom that quickly spread beyond the state colleges and universities.

"It simply became more cost effective for governments to borrow the entire amount needed and service the debt with inflationary dollars."
- Phil Bryant

The ensuing period of general prosperity created financial conditions which undermined the traditional view that capital construction should be paid for with accumulated funds. It simply became more cost-effective to borrow the entire amount needed and service the debt with inflationary dollars.

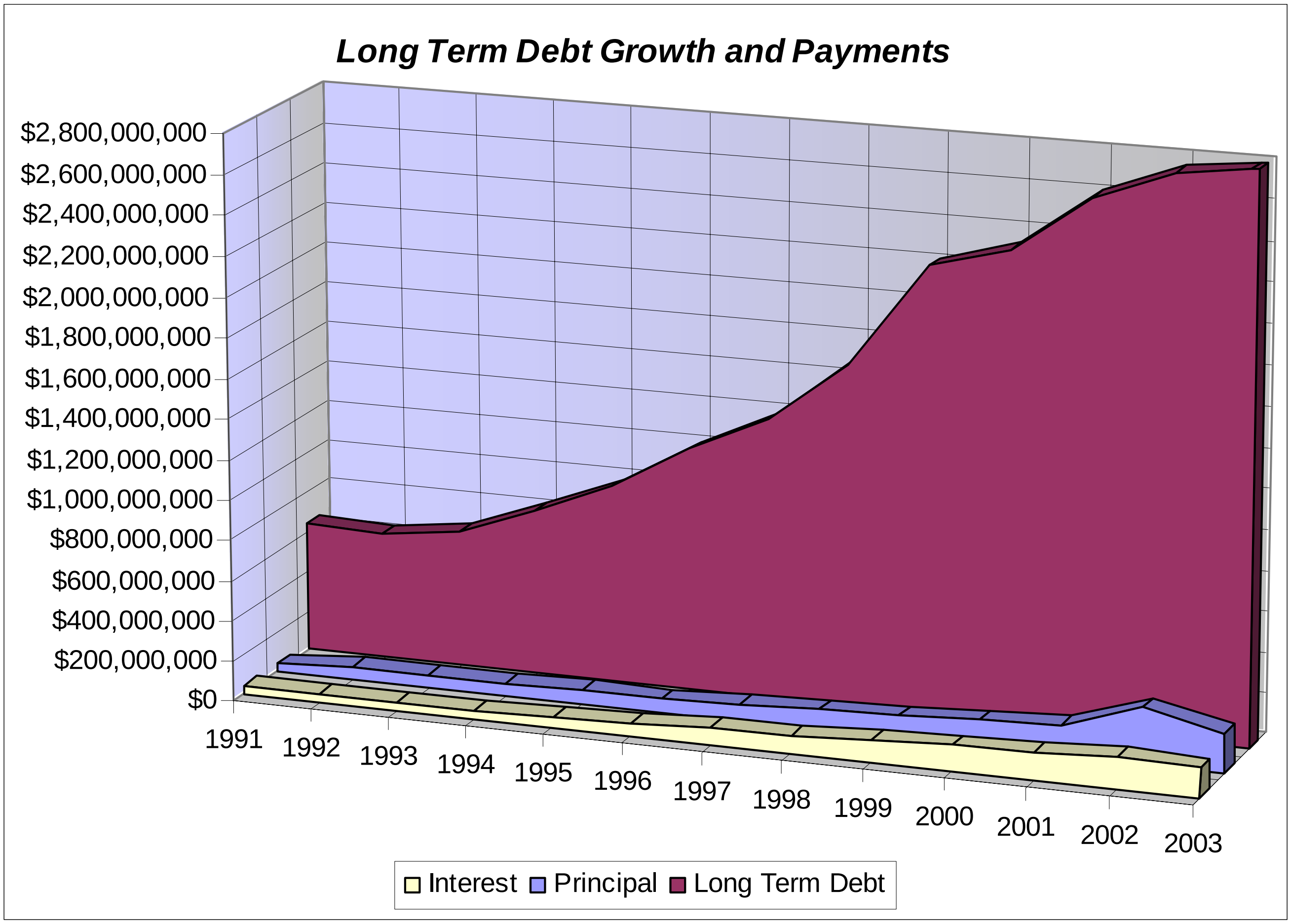
This change in public fiscal policy may have led to a corresponding change in the way legislators—and ultimately the State's taxpayers—view public debt. Rather than simply regarding public debt as inherently wrong or at best, 'a necessary evil', studies of the State's long-term capital needs and the development of long-range capital plans have led to the belief that public debt is an essential tool in creating conditions favorable to future economic growth. OSA believes it is time for the debate to shift. To date, discussion has been about whether public debt is inherently helpful or harmful. Now it needs to focus on how to best manage these growing obligations.

Mississippi's long-term public debt grew from a little over $600 million in 1991 to almost $2.8 billion by 2003.

At the same time that the State began to see sizeable increases in the amount of long-term debt issued for capital construction purposes, legislators began to use general obligations bonds as an economic development incentive to stimulate job creation and for related purposes. This emphasis led to the passage of a number of new programs including: the Advantage Mississippi Act, the Mississippi Business Investment Act, the Mississippi Major Economic Impact Act, the Small Business Enterprise Development Act, and numerous others.

It is time for the debate to shift from whether such debt is inherently helpful or harmful to a dialogue regarding how best to sensibly manage our growing obligations.

The table on the following page shows that Mississippi's long-term public debt grew from a little over $600 million in 1991 to almost $2.8 billion by 2003.



Even though the amount of GO bonds issued has grown dramatically, the resources and staffing provided have remained more or less constant.

For whatever reason, even though the amount of GO bonds issued has grown dramatically in recent years, the resources and staffing provided for the purpose have remained more or less constant. The old saying "if it ain't broke, don't fix it," may have persisted long after market conditions, regulatory complexities, the Best Practices of other states, and scale of debt-related activities have shifted elsewhere. In addition to providing the resources needed by DFA and the State Treasurer to manage the issuance process and proceeds, real, meaningful oversight by the Audit Department can effect cost savings through better management.

Discussion about enhancing the State's GO debt management system should promote adoption of even better ways to responsibly manage the State's public debt.

A fear exists among some that reform proposals for the State's GO debt management system might be misinterpreted by national agencies and they would not be seen for what they are—simply promoting adoption of even better ways to responsibly manage the State's public debt. However, because of the strong and open relationship with these national entities, these fears are not valid. OSA finds the present environment within the State is characterized by very positive, extensive and collaborative relationships between the agencies involved and those who are responsible for overseeing the bond management process.

The basic soundness of Mississippi's approach to management of bond monies and issuance of debt is widely appreciated. The key purpose

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At the end of the following section *Defining Challenges & Opportunities for Significant Cost Savings*, are examples designed to illustrate the types of challenges faced by the State. Applying the recommendations in this report can prevent many of the problems inherent in these case studies. Further, these recommendations, as they are acted upon, can create savings; chief among them is immediate savings of arbitrage penalties and other unnecessary "lost" monies.

CHAPTER III:
CHALLENGES AND OPPORTUNITIES FOR SIGNIFICANT COST SAVINGS

This chapter identifies five challenge areas along with recommended solutions that can help the State achieve greater financial efficiency in its bond process. These challenges include:

1. Arbitrage penalties
2. Unspent bond proceeds
3. Unreturned interest payments
4. Unissued bonds
5. Other Financial and Management Issues

In addition, this chapter illustrates what happens when project delays cause increased interest earnings, arbitrage penalties and unnecessary interest payments.

Finally, this chapter provides three examples of real savings from changing our current processes. They are:

1. Preplanning savings
2. Reduced project development time savings
3. Debt management practice changes that yield savings

DEFINING CHALLENGES & OPPORTUNITIES FOR SIGNIFICANT COST SAVINGS

In order to achieve savings, the State must refine its approach to managing major cost components.

Initial discussions among the support agencies engaged in bond management activities identified five challenge areas, which deserve thorough consideration by policymakers. Furthermore, there are several key areas where the State can find savings related to the GO bond management process. In order to achieve these savings, the State *must* refine its approach to managing major cost components. Discussions of these challenges and opportunities lead to potential solutions in the following subsections. Undertaking a number of performance related measures may help achieve cost reduction goals and result in potential savings for the State.

#1 Arbitrage Penalties

Challenge:

Arbitrage Penalties

The goal?

Limit the time bond funds are available in order to eliminate federal arbitrage penalties.

Challenge. Mississippi has paid out $10 million in federal arbitrage rebates (penalties) in the last 5 years because it did not spend the proceeds fast enough, but instead earned interest, which was forfeited to the Internal Revenue Service (IRS).[3] The goal? Limit the time bond funds are available in order to eliminate federal arbitrage penalties.

Opportunity. Shorten the time allowed for bond fund use from issuance to project completion;

Current Status: No fixed time for which bond funds are available for project completion is currently required by State law, rule, or procedure.

Justification: The bond proceeds management system must be modified to ensure that bond funds are fully disbursed inside the four-year IRS window to avoid arbitrage penalties. Acceleration of project completion times is a performance goal which can be measured financially and factored into legislative consideration regarding future bond issuance. These penalties can be avoided by spending the money in a shorter period of time, or issuing the money only when needed. Limiting the time available for project completion reduces potential arbitrage penalties as well as the inflationary effect which affects capital construction costs. Prior to awarding bids, regulatory delays, site problems, or other factors can result in lengthy delays which can significantly exceed original cost estimates when upward inflationary pressures are applied to labor and material costs. All of this, as well as the overly flexible time allowances for project completion, inherently increase wasteful and costly arbitrage penalties. The cost of these penalties can raise the effective interest rates.

Recommended Solutions. (1) Implement written formalized guidelines for the State Bond Commission for their bond issuance process with deadlines to ensure prompt and timely implementation of all general

[3] The Treasurer has noted (Letter March 25, 2005) "that while $2 million/year is not ideal, it is also not excessive." He further notes that his office is exhausting every effort to reduce future arbitrage penalties.

obligation bond commitments by the State. These guidelines could either be enacted in State law or promulgated under the Administrative Procedures Act. (2) Create sunset provisions to limit the time that new project funds can be authorized but not issued by the State Bond Commission as well as limiting the time project funds can be issued but not spent.

#2 Unspent Bond Proceeds

Challenge. In 2004, Mississippi had $746 million in unspent GO bond proceeds—This $746 million costs the State in the neighborhood of $40 million in interest payments each year.[4] The goals? Reduce unspent GO bond proceeds ensuring that the effective interest rate is not raised by arbitrage penalties and other related costs. Reduce the "opportunity cost" and put the State in the best management position possible by not having large amounts of public funds sitting around not being put to good use. Borrow money as the projects are ready.

Challenge:

Unspent Bond Proceeds

The goal?

Reduce unspent GO bond proceeds to ensure the effective interest rate is not raised by arbitrage penalties and other related costs.

Opportunities. The State must take necessary steps to spend outstanding bond proceeds as rapidly as possible by establishing written guidelines and procedures to strengthen its bond proceeds management system to prevent these large accumulations of unspent funds. (1) Strengthen & improve existing agencies' management systems to better predict bond fund needs. (2) Establish project performance requirements to reduce premature bond issuance.

Current Status: There is no formal system to forecast bond fund needs on a project-by-project basis and no fixed written criteria are applied to bond proceeds requests by recipients of authorized projects.

Justification: (A) If monies can be managed better by issuing bonds 'just in time' to permit their actual use, then developing a tracking system to allow support agencies to anticipate capital requirements on a monthly or quarterly basis may lead to additional cost savings. (B) Premature issuance leads to unspent bonds. It is not good business practice to borrow money and not use it. In the absence of structured guidelines, bond funds were issued in the past before recipients were actually ready even though an agency made a request for issuance. While steps are being taken by the DFA Bond Division director to determine individual project readiness, the process remains without any standardized written criteria which may also be needed to further enhance public accountability.

Recommended Solutions. (1) Determine whether additional statutory authority is needed to allow the State to distribute bond proceeds, as project timing issues dictate, among those bond recipients cited in the Official Statement for the specific project purposes authorized by the Legislature as long as the amount provided does not exceed the total project amount authorized. Virginia does this.

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[4] The Treasurer has noted that as of March 1, 2005 (after issuing an additional $120 million in November), the State's total unspent proceeds were reduced to $509 million. Approximately $200 million of that was issued as taxable debt thus eliminating arbitrage concerns. Also, since this project was begun the Treasurer has been able to reduce unspent bond funds more than 4 years old down to $6 million. To offset the $40 million in interest payments, the Treasurer invests proceeds while they are unspent.

Challenge:

Unreturned Interest Payments from Agencies

The goal?

Capture interest earned by agencies on State GO bond proceeds to be returned to the State Treasury for debt service.

(2) Prohibit the issuance of GO bonds for capital outlay until all required preplanning, including regulatory approval processes, are completed and the project is ready for final design work or construction. Not doing this leads to project delays of sometimes years, which can lead to arbitrage penalties, besides showing a lack of management and planning.

#3 Unreturned Interest Payments from Agencies

Challenge. Significant amounts of interest on bond issues are being kept by agencies instead of being returned to the State Treasurer. There are two parts to this challenge. (1) Funds that the agency should have returned to the State—as required by the bond resolution—have failed to be returned. (2) Some bond resolutions fail to require that interest earned on unspent bond proceeds be returned to pay debt service. The goal? To capture interest earned by agencies on State GO bond proceeds to be returned to the State Treasury for debt service.

Opportunity. Standardize requirements in all GO bond issues that interest earned on specific projects be returned to the State Treasury to pay debt service. Require resolutions for future capital construction projects to return interest earned for debt service by the Treasury rather than, as is currently the case in select instances, permitting these monies to be retained in the agency's project account. This eliminates an entity's desire to "let the project linger" in order for project funds to draw interest.

Allowing agencies to keep interest earned prevents the State from using that money to reduce debt on its GO bonds.

Current Status: Over the years, there has been a lack of consistency from one bond resolution to the next regarding the return of interest proceeds back to the Treasury to pay down bond debt. Although legislative draftsmen strive to keep bond bill wording similar now, *without requiring standardization, there can be no guarantee of consistency in bond authorization language from bill to bill.* This money is not ever eligible to be used for operations. The State Treasurer has identified agencies with unreturned interest earnings. However, they have faced some difficulty in getting agencies to return interest earnings.

Justification: The State Treasurer—not agencies, universities of community colleges—pay the principal and interest on debt.

As part of its bond monitoring activities, the Office of the State Auditor should be responsible for working with the State Treasurer's Office to ensure the return of unused bond funds and earned interest to the State for debt repayment.

Recommended Solutions. (1) The Legislature should exercise its authority to standardize language in State law to require all interest earned by agencies on State GO bond proceeds to be returned to the State Treasury for debt service within each bond issuance.

(2) As part of the Auditor's bond monitoring authority, task OSA to work with the State Treasurer to obtain documentation relating to any agencies that have failed to return interest funds or other monies, which may be required by their bond resolutions or by State law, and work together to recover those funds to reduce debt.

#4 Unissued Bonds

Challenge:

Unissued Bonds

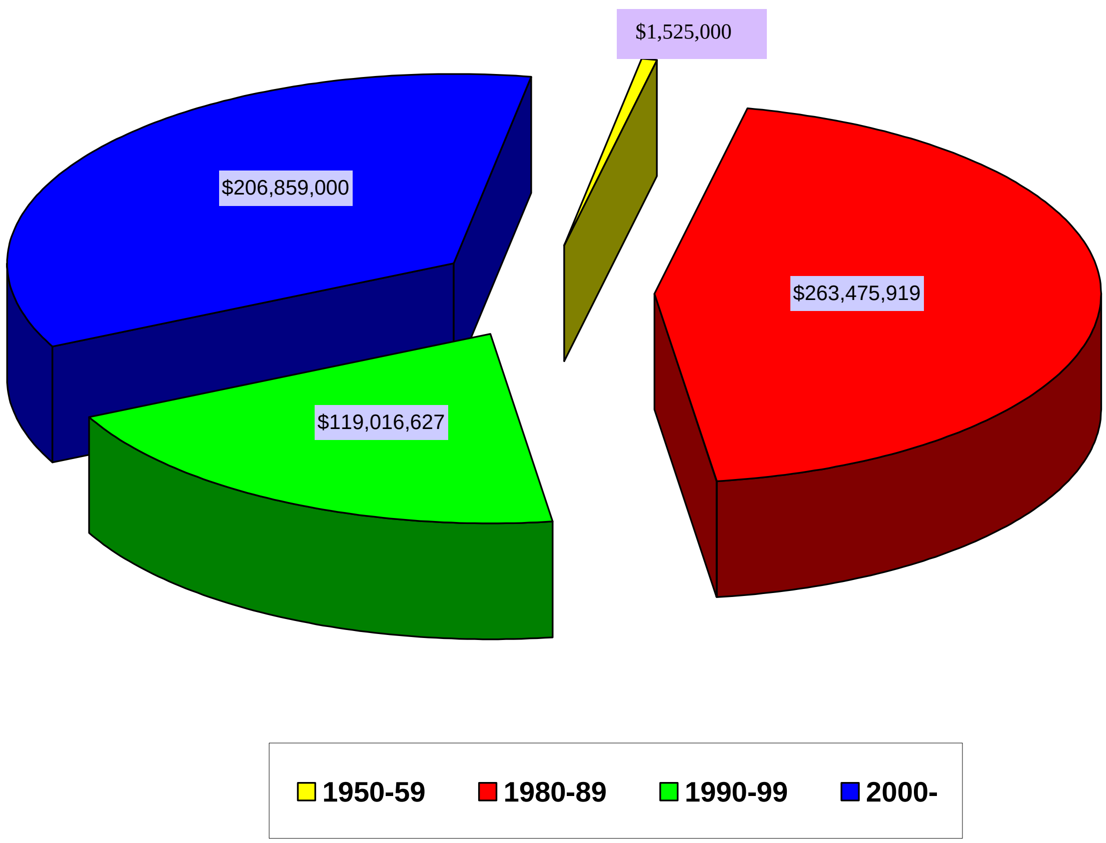
The goals?

Repeal projects authorized by statute, but never issued, to substantially reduce the State's potential financial obligations.

Mandate time limits and sunset provisions on the issuance of bonds.

Challenge. The Treasurer's Office recently reported an additional $800+ million in GO bonds that had been authorized, but for various reasons remains unissued.[5] Currently, with no time limit to issue bonds after they have been authorized, the State is in danger of allowing this accumulation to increase even more. The goals? Repeal projects authorized by statute, but never issued, to substantially reduce the State's overall potential financial obligations and mandate time limits and sunset provisions on the issuance of bonds. Below is a chart showing unissued bonds by decade based on numbers provided by the State Treasurer's office. It should be noted that there still exists unissued debt from the 1950's—more than 50 years old.

UNISSUED DEBT BY DECADE



Opportunities. Repeal the authority for bonds which have not been issued, if it is determined that projects are no longer feasible and limit the amount of time between authorization and issuance. (1) Remove old, unissued bond authorizations from State law. (2) Shorten time allowed for issuance of GO bonds by the State Bond Commission.

Current Status: In 2004, more than $166 million in projects were identified as having been abandoned, completed, or are no longer contemplated in which the bonds were never issued. Furthermore,

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[5] HB 1301 2005 Regular Session which passed both House and Senate (3/29/05) takes care of close to $120 million of the remaining authorized but unissued debt.

the State does not require a deadline in State law, rule, or procedure for the issuance of authorized bonds.

Justification: There is currently no time limitation for the issuance of bonds, thus allowing them to lay dormant and unissued, yet still on the books. Additionally, limiting the time for bond issuance could cause bond recipients to accelerate planning and preparatory activities so that they can capitalize on funds in a timely manner, thus reducing the opportunity for delays which lead to unspent funds and possibly arbitrage penalties.

Recommended Solutions. (1) The Legislature should continue to consider repealing old authorized, but unissued debt identified in a recent study by the State Treasurer. (2) The Legislature should adopt issuance sunset provisions in all of its future GO bond authorizations.

Challenge:

Financial & Management issues

The goals?

Increase use and availability of short-term debt for capital projects.

Use the full 20% of variable rate debt authority to maximize interest savings.

Increase preplanning and construction administration to reduce cost overruns and assist in more rapid completion of capital projects.

#5 Other Financial & Management Issues

Challenges. 1) Because bonds are often issued once or twice a year, projects may be 'ready to go' before bond proceeds are available. If the project is ready, but the money isn't or, if the money is ready and the project is not, delays can occur that can result in increased costs. The State has not capitalized on its ability to issue short-term, fixed rate debt as it did in the Nissan effort. 2) Money can be borrowed at lower interest rates for very short periods, where the interest is only fixed for a week at a time. The State has not capitalized on its use of variable rate debt as much as it can. Currently the State has only a portion of what it could use for variable rate debt. 3) Projects face cost overruns where preplanning is not adequate, which may require deficit appropriations.

The goals? (1) Increase use and availability of short-term debt for capital projects. 2) Use the full 20% of variable rate debt authority to maximize interest savings. 3) Do more cost effective preplanning and construction administration to reduce cost overruns and assist in more rapid completion of capital projects.

Opportunity 1. Create short-term borrowing options when bond issuance is not feasible.

Current Status: The State Bond Commission and State Treasury were given the general authority to issue short-term debt when needed prior to the issuance of bonds in the 2004 Extraordinary session.

Justification: In an inflationary economy such as the one we anticipate in the next several years, 'time is money'. In the recent past, there have been times where bond monies have been prematurely issued and are, consequently, waiting on bond recipients to expend them. There have also been times when projects have been waiting on bond funds. Having ways to borrow for the interim period prior to bond issuance could capitalize on other opportunities to save.

Recommended Solution 1. Use short-term debt authority to allow for the issuance of commercial paper or similar notes as a temporary means of funding capital projects before general obligation bonds can be issued. This may be particularly useful in the preplanning stage of capital projects as well as with certain economic development bond projects where a separation between taxable and non-taxable activities may not be immediately available.

Opportunity 2. Reduce cost of borrowing required capital.

Creating short-term debt authority as a temporary means of funding capital projects before general obligation bonds can be issued is useful in the preplanning stage of capital projects and certain economic development bond projects.

Current Status: The State Treasurer's Office has done an outstanding job in taking the necessary steps to borrow funds for fixed rate bond issues at the lowest possible rate. However, slightly more than one-quarter of the State's variable rate debt capacity is unused at the present time.

Justification: As noted elsewhere, variable rate debt was used successfully with the Nissan project. The State's current ceiling on issuance on this type of debt instrument is twenty percent (20%) of the total general obligation bonds issued. Currently, the State's use represents almost three-quarters of the 20% limit. *Use of this mechanism in the recent past has saved the State millions over the interest that would have been paid on the same amount of fixed rate debt.* It should be noted that while the State saves money during the period of variable rate use, this is only a temporary measure. When bonds are converted to a fixed rate basis there are substantial additional legal and administrative costs. Nevertheless, these additional costs are usually small when compared to the interest monies saved.

Recommended Solution 2. As long as the economic conditions will allow, the State should fully utilize the 20% allowed for variable rate bonds. Further, because of the potential complexity of overseeing variable rate bonds, Treasury should be provided with enough resources to continuously manage market timing issues, including contracting with financial advisors to assist with all competitive GO bond issues. Currently financial advisors are used only for non-competitive refundings.

Opportunity 3. Expand preplanning requirements for capital construction projects;

Use of variable rate debt in the recent past has saved the State millions over the interest that would have been paid on the same amount of fixed rate debt.

Current Status: Preplanning requirements are only in place for some capital construction projects, but even those are limited by existing DFA Buildings, Grounds, and Real Property management capabilities and resources. Increasing their resources would allow DFA to manage more projects effectively. DFA construction administration has been severely constrained by staffing limitations.

Justification: Preplanning is the key to reducing construction cost overruns as well as shortening the total length of time of major projects. While much of the savings would come primarily from reduction in cost overruns, using funds in a timely manner helps lead to fewer arbitrage penalties from unspent funds. Construction management is a critical function that plays a key role in limiting

Preplanning is key:

While savings would come primarily from reduction in cost overruns, using funds in a timely manner helps lead to fewer arbitrage penalties from lingering unspent funds.

OSA supports DFA recommendations to utilize private firms to supplement the staffing resources of the Bureau of Buildings, Grounds, and Real Property Management for preplanning related functions.

Unspent bond funds can lead to arbitrage penalties. Interest earned on these delayed projects may be forfeited to the federal government when delays occur.

cost overruns which can result in more, and possibly unnecessary bond issuances. Additional savings would also come from reductions of capital project cost overruns.

Recommended Solution 3. Clarify existing authority, to ensure all preplanning requirements are met by state recipients of bond funds, regardless of whether they utilize the State's preplanning revolving fund or are exempted from preplanning requirements altogether. OSA supports DFA recommendations to utilize private firms to supplement the staffing resources of the Bureau of Buildings, Grounds, and Real Property Management for preplanning related functions to free-up personnel for more critical project review activities aimed at reducing costly project delays, overruns, and facility failures to meet basic functional requirements.

Additional Recommendations for Savings

The Mississippi Legislature should also consider the following means of ensuring effective and efficient oversight in the area of GO bonds:

- Rather than increasing costs to other state agencies, continue to include costs associated with OSA's bond monitoring activities in the bond authorizations since these projects are time-limited. In addition, standardize the inclusion of costs for financial supervision and construction administration for Bureau of Buildings.

- Authorize and fund a feasibility study to determine how best to develop an efficient financial tracking system which would enable all support agencies to have 'real-time' access to the information needed to forecast bond funding needs and to properly sequence the distribution of proceeds to take advantage of timing considerations.

- Increase the authority already in place for the Office of the State Auditor to evaluate internal controls and expand its role in monitoring and tracking the expenditure and disbursement of GO bond proceeds.

Project Delays: Earned Interest and Arbitrage Penalties

Arbitrage penalties and other unplanned cost increases raise the effective interest rate of bonds and should be avoided.

Over the past few years, a small number of state projects have experienced delays which have contributed significantly to the unprecedented accumulation of unspent bond proceeds. Seemingly, no major category of capital project is exempt from these occurrences. Road projects, capital facilities, and even land improvements have experienced delays which led to unusually high balances of unspent funds. Unspent funds can lead to arbitrage penalties. Interest earned on these delayed projects may be forfeited to the federal government when these delays occur.

To illustrate this, one such open project has tax-exempt GO bonds issued nine years ago in 1995. The total amount authorized was $19.7 million issued in two parts (1995 & 2000). Of the $5.7 million in bonds originally issued in 1995, $1.2 million were still on hand as of September 1, 2004. So far this year the unspent balance has only been reduced by $337,198. In addition, of the remaining $14 million issued in 2000, $5.1 million remains unspent as of September 1, 2004. This unspent balance has declined by $1,108, 733 since the beginning of the year down from $6,240,021. Today, this nine-year old project, as yet incomplete, still has $6.3 million in unspent project funds.

Managing debt better and avoiding premature issuance of bonds can keep the effective interest rate close to the original interest rate.

The Inflationary Effect. According to Inflationrate.com, the wholesale price index grew by an annual rate of 2.21% in the 1990's and 1.57% per year since that time. This would mean that a delay of nearly ten years could mean a loss in buying power of what the same amount would have bought when the project was first envisioned and begun. Furthermore, the interest earned on the present unspent amount has totaled approximately $300,000 a year. The Bureau of Buildings reported that over $1.5 million in interest has been earned on these funds. Because of the wording in the bond resolution it is unclear whether the interest will be returned to the State for debt service.

Project Delays: Unnecessary Interest Costs

Once the bonds are sold, interest payments must be made whether or not the money is being spent. A twenty-year bond will have a scheduled maturity date in twenty years. However, issuing debt prematurely, even if the State gets a "great" interest rate, opens the door to arbitrage penalties. These arbitrage penalties can effectively "erase" any low interest rates achieved by issuing the bonds early. Managing debt better and thereby avoiding premature issuance of bonds, can reduce the effective interest rate which increases when arbitrage penalties and other related costs are involved.

Another more recent project, initiated in the mid-1990's, also had two separate taxable GO bond issues: one for $2 million in 2001 and the other for the remaining $15.5 million in 2002. At the beginning of 2004, $1.14 million remained from the first issuance and $14.86

million remained from the latter issue. As of September 1, 2004, about $824,883 remained from the 2001 issue, while about $12.38 million remained from the 2002 issue. Therefore, around $13.2 million is unspent at the present time even though it was issued two or more years ago.

It would appear that all of the expenditures between 2002 and January, 2004 totaled less than the outstanding balance for the 2001 issue, suggesting that the $15.5 million was issued at least two years before it was needed. With fixed rate taxable bond interest at around 5%, interest of around $1.5 million was paid as a result of premature issuance. If arbitrage penalties become a reality, the effective interest rate may go well above current the interest rate achieved at the time of the bond issuance.

Both projects have some similarities. First, in accordance with their legislative authorizations, the Bureau of Buildings had only nominal involvement during the formative stages of planning and development. As a result, some of the internal controls which would have otherwise existed were not applied. In the case of the latter project, a public entity was created to function in the role of Bureau of Buildings. This entity was unsuccessful at getting the project off the ground. After at least five years with no bonds being issued, the Bureau of Buildings stepped in to fill the void and the project finally began to move forward with the first bond issuance. Unfortunately, funds have been issued and are generating interest payments with no measurable results. Second, both projects experienced problems obtaining property and dealing with other external issues (such as permitting) which resulted in re-bidding, legal issues, and other delays.

Before land acquisition, permits, and other important preplanning issues were resolved, bonds were sold and then lack of preplanning caused costly delays—delays which are still costing Mississippi money. These projects illustrate how lack of preplanning and project oversight can lead to substantial delays, premature issuance of bonds, and larger than normal unspent balances. Addressing these issues can materially reduce the inflationary costs, arbitrage penalties, and other related expenses.

Estimate of Preplanning Savings

As stated elsewhere in the report, substantial savings may result from additional preplanning requirements and resources administered by DFA's Bureau of Buildings (BoB). It is hoped that a conservative savings estimate can provide a more realistic glimpse of the opportunities for controlling cost overruns for Mississippi's capital construction projects.

Project cost overruns, largely because they are unanticipated, can pose serious problems for project and debt managers alike. While there is an abundance of anecdotal evidence regarding the alleged use of change orders by contractors to compensate for low bidding on State capital construction projects, there is relatively little data to substantiate that this is a widespread occurrence. This would suggest that the bulk of change orders are the result of: owner or tenant decisions or design issues caused by architect or engineer errors and omissions; work related or construction condition issues; or factors which impact on implementing the project under 'real world' conditions.

The Woolfolk Building renovation is a case in point. Change order figures are contained in a summary report prepared in November, 2002 for the architectural and engineering consortium involved with the project. It states that change orders totaled $5,378,483.83 or 8.84% of the original $55,434,532.91 and ultimately increased total project costs to $60,813,016.74. Of this increase, 83% of the change order costs were initiated by the owners or tenants, while the remaining 17% related to errors (.03%), omissions (6.70%), and work related or construction conditions (10.18%). Changes in administration and other factors are cited as relating to most of the change orders coming from the state agency tenants. Therefore, in this particular case, only about $900,000 of the $5.4 million in changes would have been directly influenced by preplanning activities.

Extending this same proportionality to the total change orders for all state capital construction projects, for FY 04, the Bureau reported change orders totaling $16,078.477.45, an increase of 3.69% in the cost of capital projects originally costing $436,138,039.52. According to BoB increased preplanning requirements and resources could reduce change orders by an estimated 10 to 15 percent.

Using the conservative figure of 10%, these proposed measures could have saved the State a minimum, additional $1.6 million.

Achievable Savings from Reducing Project Development Time

Fully funded capital projects often are faced with downsizing or cost overrun issues before construction ever begins.

According to industry sources, state contractors, and the DFA Bureau of Buildings, substantial inflationary increases occur in the costs of building materials for capital projects from the time that project costs are determined until construction actually takes place. In Mississippi, the average length of time from the Legislative Budget Office budget request stage to awarding bids is approximately three (3) years. However, according to the Bureau, cost estimates seldom reflect the price of materials more than two years in advance. This means that fully funded capital projects often are faced with downsizing or cost overrun issues before construction ever begins.

According to information published recently in a Portland Cement Association (PCA) trade publication, concrete is up 4.4% from a year ago, while lumber, milled steel products and gypsum board are up 26.5%, 43.3%, and 23.4% respectively. The price of raw steel has increases during the same period from $400 a ton to around the $800 dollar level. For example, using the R.S. Means Estimating Guide (an industry standard reference), for load bearing walls—such as those used in two to three story college classroom construction—costs have increased from $78.40 per square foot in 1994 for a 45,000 square foot structure to $119.65 in 2004 for a similar sized structure. This represents a 53% increase in the past decade.

National contractors with extensive experience carrying out capital projects for Mississippi … estimate that these (construction) costs generally increase at a rate of five (5) to ten (10) percent annually.

National contractors with extensive experience carrying out capital projects for Mississippi track changes over in time in construction material costs, estimate that these costs generally increase at a rate of five (5) to ten (10) percent annually. They have indicated that from July, 2003 to July, 2004, the cost of building concrete structures, similar in design to many of the larger projects currently being built by the State, escalated between eight (8) and ten (10) percent. As a consequence, for example, the Bureau of Buildings has indicated that Ayers Case capital projects, previously estimated at $75 million a few years ago, would now cost around $95 million.

The Bureau of Buildings also reported that new capital projects have been added at the rate of approximately $100 million dollars a year over the past decade. They have also stated that the lag time between legislative approval and construction could be reduced by a full year from around 3 years to 2 years—if manpower were available to expedite preplanning, design work, and other related activities.

In addition, previously bonds were frequently issued prematurely before site selection or other critical decisions were made. The breakdown in communication between the Bond Commission and those responsible for issuing the bonds may have been, in part, the result of inadequate project oversight resources. The Bureau now estimates that the management and oversight activities necessary to accelerate project development by one year, whether expended through contracts or increased 'in-house' staffing, would cost about $400,000 annually.

Conservatively stated, if this is so, inflationary effects have actually eaten into capital construction projects at a rate of not less than five (5) percent annually, reducing project development times by one year could annually save the State, a minimum of $5 million in new capital projects. The actual savings could be considerably larger depending on the types of structures and materials involved.

Cost Reduction Example for State Debt Management Practices

The Auditor's Office generated a 'real world' bond acquisition and debt management example using interest rates that are approximately what Mississippi would pay in today's market. It compares borrowing $100 million dollars in fixed rate, tax-exempt GO bonds for 20 years with borrowing the same amount during a three-year period. *The example uses the typical annual State agency amount for capital budgeting—it does not include economic development construction projects, college and university capital construction or transportation construction projects, which together can more than triple this $100 million figure.* In this three-year period, all construction payments would be made using a form of short-term debt and then converting the remaining debt to tax-exempt fixed rate bonds for the remaining 17 years.

The cost of a GO bond's typical debt service schedule the way the State does it now for a $100 million bond issue over 20 years would have a true interest cost of 3.9957%. It would require total interest payments of around $48.03 million. The State would earn approximately $3,554,815.00 from the construction fund as it draws down the bond proceeds to pay the construction expenses over the first three years. This means that the net interest cost over 20 years would be $44,479,014.00.

In the proposed, modified short-term debt approach, a level draw of $100 million in construction payments over the three-year period from a short-term commercial paper or similar account is assumed. In such an account money is borrowed only as it is needed. The State pays a short-term variable interest rate as this occurs. Assuming a variable interest rate of 1.5% (which is typical at this time), the State pays $2,034,638.00 in interest expenses over the three-year period. In this scenario, the State will also pay off a total of $16,175,872.00 in principal.

The principal and interest during the 17 years after construction is completed amounts to approximately $116 million. In this case, fixed rate bonds are issued for the remaining principal of $83.8 million for 17 years at a true interest cost of 3.7890% and a total interest expense of $32,174,623.00. This true interest cost for the fixed rate bond would be slightly lower than the 20-year cost of money. Combining this with the much lower rate using the commercial paper during the three-year construction period produces a substantial savings. The total interest paid over the entire 20 years would be $34,209,261.

The possible risks are these—the State is exposed to variable interest rates during construction; second, because the maximum term is 270 days, it will have to be rolled over at least every 9 months or so; and third, long term rates could be higher or lower after the 360-month construction period thereby reducing or increasing projected savings. This risk can be mitigated by using a Financial Advisor to closely monitor and roll the remaining debt into permanent financing at any time.

The 20-year savings for a $100 million issue over the present method would be in excess of $10.2 million by substituting this form of short-term debt during the three-year construction period.

CHAPTER IV: RECOMMENDATIONS

This chapter re-caps the ten recommendations that are found throughout the report.

RECOMMENDATIONS

Mississippi is poised on the edge of an opportunity to effect positive change and achieve substantial savings with regard to debt management.

The bond issuance and bond proceeds management processes must be assessed with four primary performance goals in mind—to reduce the amount of bond proceeds issued, but not spent; obtain the lowest possible interest rate on borrowings; return any unused proceeds or associated earned interest to Treasury to be used for debt service; and reduce the amount of funds authorized but not issued. To do this, the State needs to develop a series of initiatives in four main areas:

- Increase public accountability and standardize bond practices.
- Shorten project completion time by better money management.
- Increase emphasis on planning and administration of capital projects.
- Expand the State Auditor's role in monitoring and oversight of bond issues.

Mississippi is poised on the edge of an opportunity to effect positive change and achieve substantial savings with regard to debt management. There are significant opportunities for cost reductions if we address the challenges posed by these unspent funds. Among these are the following:

1. Create sunset provisions to limit the time permitted for issuance of authorized bond projects and expenditure of bond proceeds to eliminate federal arbitrage penalties.

2. Develop formal written guidelines for bond issuance and proceeds supervision to ensure prompt and timely implementation of all GO bond commitments.

3. Require bond resolutions for future capital construction projects to return interest earned on proceeds to Treasury.

4. Create short-term debt authority to allow for commercial paper or similar notes to allow Treasury to fund projects, instead of having to wait on bond issuance.

5. Authorize DFA to develop procedures to allocate funds within a bond issue among those projects that are part of the issue to ensure timely and cost-effective use of the available proceeds.

6. Prohibit issuance of bonds for capital projects until preplanning requirements and regulatory concerns are met. Take necessary steps to ensure preplanning resources are adequate.

7. Expand current policy of the contractual use of financial advisors for *all* GO bonds, making greater use (as markets allow) of the current 20% variable rate limit.

8. Remove any unissued bond authorizations which are no longer needed and shorten the time allowed for the issuance of GO bonds by the State Bond Commission.

9. Study the feasibility of creating a financial tracking system for bond projects capable of forecasting funding needs and monitoring the status of unspent bond funds.

10. Expand the State Auditor's bond monitoring role of oversight of the expenditure and disbursement of all bond proceeds.

Finally, the Legislature should include funds for expanded project and debt management activities conforming to IRS limitations on allowable uses of bond proceeds, where possible, in the bond legislation itself rather than elsewhere in the budgetary process.

Chapter V: Background & Legal Framework

This chapter outlines the various stages of the bond issuance process from the Legislature's authorization through an agency's request, the Bond Commission's approval, the bond sale, and finally debt repayment. This process is summarized in a flow chart which identifies the main activities required to successfully issue new general obligation bonds.

The chapter describes the interaction between the Department of Finance's Bureau of Buildings, Grounds, & Real Property Management (BoB) and state agencies to ensure that timely requests and utilization of bond proceeds actually take place. Furthermore, this section discusses two inherent challenges that may prevent more efficient use of bond proceeds:

- State law governing bond issuance does not appear to make reference to time sensitivity or the need to expend funds in a timely manner; and

- Mississippi law at present lacks consistent and/or standardized deadlines for spending bond funds; they tend to be based on the wishes of those who are initiating or requesting bills.

Bond Issuance Process Overview

The Mississippi State Bond Commission is comprised of the Governor, the Attorney General, and the State Treasurer.

Typically the State of Mississippi issues fixed rate general obligation bonds several times a year. New issues are handled using a competitive bid process. Refundings of existing bond issues at a lower interest rate do occur and are approached somewhat differently because they are based on proposals from individual financial firms. They are awarded based on negotiated bids. The process for issuance of variable rate bonds is slightly different and still evolving because it has only applied on two occasions to date. *A flowchart describing the bond issuance process appears at the end of this section.*

The issuance of all new debt requires authorization by the Mississippi Legislature. In the case of capital construction projects, public entities request funds and furnish information to the Department of Finance and Administration (DFA), which is used by the Bond Counsel to draft an issuing resolution that is sent to the State Bond Commission.

At a minimum, the Bond Commission *Working Group* members include :

- **State Treasurer's Office Bond Division Director;**
- **the Department of Finance & Administration Bond Division Director;**
- **the Attorney General's representative to DFA; and**
- **Bond Counsel.**

The State Bond Commission is comprised of the Governor, the Attorney General, and the State Treasurer. They must approve the issuance of all general obligation state bond debt issued on behalf of the State.

The issuing resolution, accompanied by the request from an agency, which must be approved by the State Bond Commission, is first reviewed by a team of advisors generally referred to as the 'Working Group." It is composed of at least four members, but often includes several of their staff as well. At a minimum, members include the State Treasurer's Office Bond Division Director; the Department of Finance and Administration's Bond Advisory Director, a representative of the Governor's Office, Attorney General's Office to DFA and the Mississippi Development Authority's office.

The Working Group is not statutorily created, nor does it operate under any separately established rules or procedures. It is responsible only to the State Bond Commission which has full authority to do what it deems necessary and proper to act on the bond authorizations provided annually by the Legislature.

The Bond Counsel, once selected by the Commission, handles any bond sale legal advertisements. Bond Counsel's role depends to some extent on the complexity of the proposed issuance and the terms and conditions of the contract. The services may vary somewhat from one bond issuance to the next.

The Working Group and the Bond Counsel next prepares a Preliminary Official Statement (POS) and an Official Bid Form. In the past they were then mailed to prospective buyers who have either called in or are on a master bid list. On the sale date, the State Bond Commission and Bond Counsel would accept 'Good Faith' checks or Surety Bonds and bids to select an underwriter for the bond issue. Today, with the capabilities of the internet, it is rare for the process to work this way. Now, bids are received via the internet using "Sure-Bid." Checks are only provided with hand-delivered bids. Bids are verified by the Treasury Bond Division Director and the Bond Advisory Division of DFA. The bidder with the lowest True Interest Cost is selected as the underwriter.

Individual interest rates submitted by the winning bidder determine the interest rate the State pays. The front page of the Official Statement of each issue shows interest rates applicable each year. The 'Good Faith' check of the low bidder is deposited by the Treasury, and the checks of the other bidders are returned. Actual bids are located in the files in the Treasurer's vault. If there is a surety bond, good funds are delivered within 24 hours.

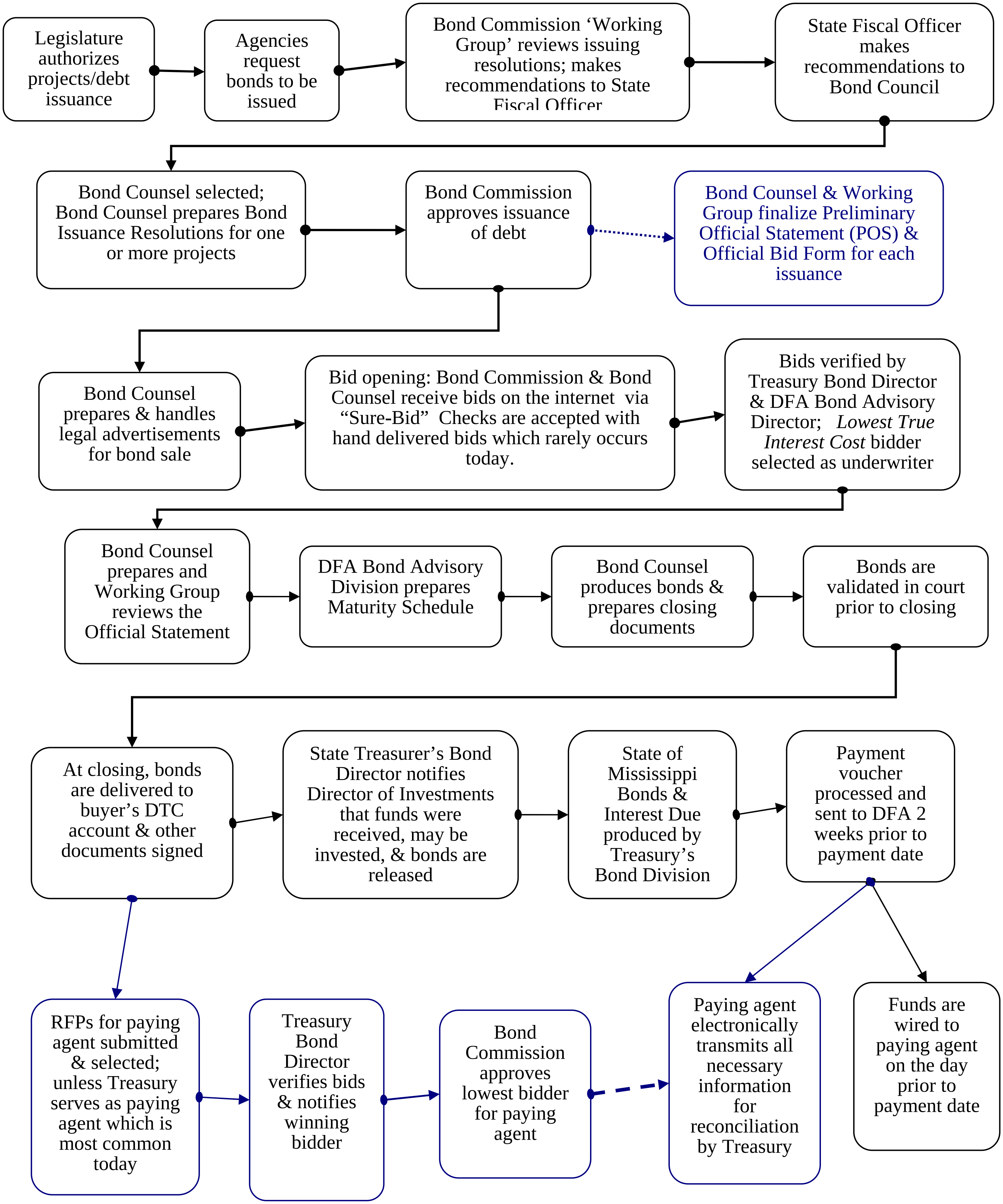
Next the bond counsel prepares and the working group reviews the 'Official Statement'. The Bond Maturity Schedule is prepared by the Bond Advisory Division of DFA. While traditionally, the paying agent was also selected using a Request for Proposals (RFP) process, today the Treasurer serves as their own paying agent in list cases. Bids are verified by the Bond Director. The lowest bidder selected by the State Bond Commission as paying agent.

The bonds are validated by the State Bond Attorney. This individual, appointed by the Governor, receives $500 per bond issuance to determine that the bonds are being properly issued for the purposes authorized by the Legislature. Bonds are validated in court prior to closing.

Bonds are produced by Bond Counsel and sent to the Depository Trust Company (DTC) for delivery at closing. Then, upon verification that the monies have been received by one of the local banks and placed in demand accounts, the bonds are delivered to the buyer's DTC account. Also at the closing, when the funds are received and all the documents are signed, the Bond Director notifies the Director of Investments in the State Treasurer's Office that good funds are received and that the funds may be invested. The bonds are then released.

After preparation of monthly repayment schedules, a printout entitled: "State of Mississippi Bonds and Interest Due" is sent to Treasury's Bond Division Director. The Bond Division then prepares the payment voucher for bond principal and interest payments. The Director of Accounting reviews the payment vouchers (PV's) and supporting documentation. The PV is signed and sent to DFA for processing with a copy filed at Treasury. The paying agent electronically sends all necessary information for reconciliation by Treasury.

Bond Issuance: Fixed Rate GO Bonds, New Issues Only



After Bonds Are Issued

With the bonds issued and the repayment schedule fully developed, the DFA Bond Division director, in consultation with the Bond Division director at Treasury and, in the case of capital construction projects, the director of the Bureau of Buildings, Grounds, and Real Property (BoB) begin the process of monitoring the use of the bond proceeds. In the case of economic development funds, this is done in collaboration with the Mississippi Development Authority (MDA).

In the event that only a portion of the total project funds are included in a bond issue, a determination must be made when an additional issue is needed. Because use of bond proceeds from a given issue is tied exclusively to those authorized projects approved by the Legislature, any use of bond proceeds for a purpose not specifically authorized in that particular bond resolution is prohibited under federal tax laws and is regarded as a serious offense. Such a misuse could result, among other things, in the loss of the State's ability to issue tax-exempt bonds which would cripple its ability to raise large amounts of capital.

Legal and Administrative Framework

Section 29-17-1 et. seq. of the Mississippi Code of 1972, annotated, assigns the responsibility for issuance of bonds authorized by the Legislature to the State Bond Commission. Section 29-17-19 states:

> *Such general obligation bonds may be issued without any other proceeding or the happening of any other conditions, and things which are specified or required by this chapter. Any resolution […]shall become effective immediately upon its adoption by the State Bond Commission, and any such resolution may be adopted at any regular or special meeting of the State Bond Commission by a majority of its members.*

Nowhere in the authorizing legislation does there appear to be any reference to time sensitivity or the need to issue or expend authorized funds in a timely manner, nor is there any stated concern about the need to mitigate potentially adverse effects of unspent bond proceeds.

While State law does not prescribe an exact procedure related to bond issuance, the Bond Commission was given a very broad 'necessary and proper' clause giving it authority to act as needed. Section 29-17-13, Mississippi Code of 1972, annotated, says that the Commission is empowered to: "*…to do any and all things necessary and advisable in connection with the issuance and sale of such bonds*."

The language of recent bond bills adopted by the Mississippi Legislature usually read as follows:

> *[…]upon adoption of a resolution by the Department of Finance and Administration declaring the necessity for issuance of any part or all of the general obligation bonds, DFA shall deliver a certified copy of its resolution or resolutions to the State Bond Commission. Upon receipt of such resolution the Commission, in its discretion may act on it.*

There are no specific deadlines in state law at present for issuance or spending of bond funds.

The language would appear to leave the issue of whether or not, when, and how much of monies authorized should be issued by the State Bond Commission, which acts on resolutions brought before it by the Department of Finance and Administration. Furthermore, after naming the Governor, Attorney General, and the State Treasurer as the members of the Bond Commission, State law, in §31-17-101, Mississippi Code of 1972, annotated, gives them powers and duties which include authority to: "[…]*delegate one or more of its officers, agents, employees, such powers and duties as it may deem proper, and may adopt rules for the conduct of its business*."

As a practical matter, a working group is assembled for each proposed bond issuance. The functions carried out by the Working Group on behalf of the Bond Commission are not formalized according to any written guidelines or procedures. Nevertheless, the process is generally regarded by those with oversight responsibilities as being highly effective and efficient.

According to DFA, rules set down in writing regarding the official actions taken by the State Bond Commission do not include specific guidelines regarding the presentation of resolutions and other related matters to the Commission by the Working Group. Section 7-1-403, Mississippi Code of 1972, annotated, in defining the powers and duties of the DFA's State Bond Advisory Division, charges them in subpart *(a) to: […] maintain a close working relationship with agencies authorized to incur bonded indebtedness in order to know the probable schedule for the issuance of bonds so that coordination may be accomplished for orderly issuance;* Subpart (c) requires *[…]all state agencies and political subdivisions to submit annual reports, and other interim reports as necessary, on projects financed by state revenue bonds or by state bonds which have the general obligation pledge of the state, but which are primarily backed by specific revenues.*

Nowhere in the Bond Commission authorizing legislation does there appear to be any reference to time sensitivity or the need to issue or expend funds authorized by the Legislature in a timely manner, nor is there any stated concern about the need to mitigate potentially adverse effects of unspent bond proceeds. There are no specific deadlines in state law at present for issuance or spending of bond funds. However, since 2001 most, but not all bond legislation has contained a provision requiring a written explanation be provided if bond funds remain unspent after four years.

CHAPTER VI: CONCLUSIONS

This chapter summarizes the challenges faced by the state as it manages a rapidly increasing public debt which has increased five-fold in the past fifteen years. It also revisits many of the measures detailed in the report such as unspent bond proceeds, unissued funds, project readiness and timeliness, debt repayment, and management resources, which all play key roles in potential savings and efficient use of taxpayer dollars.

This final section reiterates that the bond management process can be further refined and improved to save additional taxpayer dollars and notes that both the State Treasurer and the Department of Finance and Administration have begun to implement some changes.

The chapter concludes by calling for adoption of written formalized guidelines, wherever possible, to be applied during each stage of the GO bond process to ensure even greater public accountability, especially the timeliness of bond projects and their repayment.

CONCLUSIONS

Responsible management of increasing amounts of public debt, proponents say is 'do-able'.

While Mississippi's bond proceeds management process works, it can still be refined and improved to save taxpayer dollars.

These recommendations must be addressed if we are to substantially reduce the amount of unspent bond proceeds in Mississippi.

Mississippi needs to adopt written formalized guidelines with deadlines to ensure prompt and timely implementation of all GO bond commitments by the State.

As Mississippi's bonded indebtedness has rapidly increased, so has the amount of unspent bond proceeds which the State has on hand. Topping $746 million at the beginning of 2004, these borrowed monies have resulted in millions in IRS arbitrage penalties. It would appear that sheer growth in the number and size of state bond projects has much to do with the current situation. Staffing resources to support capital project preplanning, long term capital planning, financial management and forecasting, and the exacting and time-sensitive servicing of State debt remains more or less at the level of funding which existed 15 years ago. At that time, Mississippi had less than 20% of its present level of public debt, now approaching the $3 billion level.

Proponents say responsible management of increasing amounts of public debt is 'do-able'. Most other states agree. Nevertheless, the State should not ignore any opportunities to reduce the costs brought on by our commitment to borrow billions to invest in our state's future.

While Mississippi's bond proceeds management process works, it can still be refined and improved to save taxpayer dollars. To do this, legislators must recognize the importance of accelerating the time it takes to implement bond projects while shortening the amount of time which bond proceeds are lying idle, drawing interest which may end up being paid to the federal government in the form of arbitrage penalties.

Many of the needed measures detailed in this report have the support of the agencies involved and are already being implemented since the August 2004 draft of this report was released. These measures must continue to be addressed if we are to substantially reduce the amount of unspent bond proceeds within our State.

At the present time, the Legislature still has authorized over $1 billion in bond project funds which they authorized, but which the Bond Commission has never issued. In 2004, the Treasurer's Office determined that more than $166 million are assigned to projects which have been completed, abandoned, or simply no longer conform to the project descriptions in the authorizing statutes. While there is no interest involved and no unspent funds, it seems to be the perception among bond-rating companies that these are still obligations which inflate the numbers as to how much debt the State has already assumed. Where possible, these obligations, if they are no longer realistic, should be repealed.

Like other states with similar challenges, Mississippi needs to adopt written formalized guidelines with deadlines to ensure prompt and timely implementation of all GO bond commitments by the State. In addition, a sunset provision is needed to limit the length of time that new bond projects can be authorized, but not issued. The Legislature also needs to strictly limit the time agencies have to expend bond proceeds issued to them.

Furthermore, the Legislature should consider requiring bond resolutions for nearly all bond projects to have language that mandates interest earned for debt service be returned to the Treasury, thus removing any incentive which might exist to retain rather than spend bond proceeds. Finally, because bonds, especially for capital construction, have apparently been issued in the past before they were needed, the State should prohibit the issuance of general obligation bonds for capital outlay until preplanning is completed, regulatory approval processes are done, and the project is really ready for expenditure of funds to take place.

Not only is it in the public interest to provide greater public accountability for bond funds management and related support activities, but reducing the amount of unspent bond funds can save millions in cost reductions ranging from elimination of arbitrage penalties to significant reductions in capital project cost overruns. The sooner we address these issues, the more taxpayer money can be saved.

Appendix A:
Letters From The MS Department of Finance and Administration And The State Treasurer Concerning This Report

STATE OF MISSISSIPPI
HALEY BARBOUR, GOVERNOR

DEPARTMENT OF FINANCE AND ADMINISTRATION
J.K. STRINGER, JR.
EXECUTIVE DIRECTOR

October 11, 2004

Honorable Phil Bryant
State Auditor
Suite 800
Woolfolk State Office Building
Jackson, Mississippi 39201

Dear Mr. Bryant;

It was my pleasure to have an opportunity to review the draft report on Bond management. You and your staff are to be commended on the work of such an undertaking. I am listing my responses to the report as follows:

> Written formalized guidelines for use by the State Bond Commission and its Working Group with deadlines to ensure prompt and timely implementation of the GO bond commitments by the State.
>
> **The Bond Commission has moved and asked for a set of procedures to be brought before the Commission as soon as they can be developed. A working group has been established and is made up of representivies from the Department of Finance and Administration, Attorney General's office, the Office of the State Treasury and Development Authority.**
>
> Sunset provisions to limit both the time new projects can be authorized, but not issued by the Bond Commission, as well as the time project funds may be issued, but not spent.
>
> **It is felt that this can be accomplished through the actions of the Bond Commission as policy. Section 31-17-101, gives the Commission authority to "adopt rules for conduct of its business".**
>
> Legislation prohibiting the issuance of GO bonds for capital outlay until all required preplanning, including regulatory approval process, is complete and the project is ready for final design work or construction.
>
> **Although I concur with this idea, I must ask how this will be funded. Additionally, where would the resources come from to manage the preplanning? The Treasurer stated his position that bond proceeds should not be used. I would like to see more discussion on this matter.**

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Requiring standardized bond language in state law to have all interest earned by agencies on State GO bond proceeds to be returned to the State Treasury for debt service for each bond issued.

I concur with this concept.

Increasing OSA's current bond monitoring role the responsibility to work with the State Treasury to obtain documentation related to agencies failing to return interest funds, so that these monies may be recovered.

How would the OSA fund this activity and what resources would be required?

Repealing old authorized, but unissued debt.

It might be risky to open old bond authority statutes without the risk of authorization being moved to other projects without proper justification of those new projects. The suggestion that a letter from the Bond Commission stating that an agency has completed or abandoned the project would help to insure that the authority is not moved or expanded.

Adopt sunset provisions in all future GO bond authorizations and bond proceed spending.

Language giving the Bond Commission the authority to establish time-limits would give the Commission the latitude to review project delays. The Commission could review the projects and grant extensions were it warranted.

I would like to thank you and your staff for allowing me to be a part of this study. If I can be of any additional help, please call me at 359-3160.

Sincerely,

Mike Lucius

Mike Lucius
Director, Bond Advisory Division

cc: Hoopy Stringer
Rita Wray

STATE OF MISSISSIPPI
HALEY BARBOUR, GOVERNOR

DEPARTMENT OF FINANCE AND ADMINISTRATION
J.K. STRINGER, JR.
EXECUTIVE DIRECTOR

TO: Honorable Phil Bryant
State Auditor

FROM: J. K. Stringer, Jr.
Executive Director

DATE: March 21, 2005

RE: Addendum to Review of Draft Report Entitled "A Report of Unspent Bond Funds and Bond Proceeds Management: Opportunities for Savings" as designated by the * below.

As the individual charged with the responsibility of ensuing that all prospective bond matters are brought to the Commission in a timely, fiscally responsive, and cost effective manner, I thank you for the opportunity for me and my staff to review your draft report entitled "A Report of Unspent Bond Funds and Bond Proceeds Management: Opportunities for Savings". Your staff is to be commended on a report that was thorough and well written. To assure accuracy and completeness of the report, I am requesting your office's review of some key points that changed as time and new administration has taken responsibility for the Bond process. The following are suggestions for changes:

> On page 30 the fourth paragraph, the last sentence to read **"At a minimum, members include the State Treasurer's Office Bond Division Director, the Department of Finance and Administration's Bond Advisory Director, a representative of the Governor's Office, Attorney General's Office and the Mississippi Development Authority's office."**
>
> On page 31 the third paragraph, the second sentence to read **"The Bond Maturity Schedule is prepared by the Bond Advisory Division of DFA."**
>
> On page 32 update graphic to illustrate current practice – **see attached**
>
> *Addendum – On page 48 number 2, the first sentence to read **"Expand Construction Administration by Professionals whereby the responsibility of the professional is increased to have someone on-site daily for larger projects and groupings allowed for smaller projects."**

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> On page 50 the third paragraph, the third sentence to read "**The Division Director routinely consults with a working group comprised of staff from DFA, the Treasury, the Governor's Office, Attorney General's Office and the Mississippi Development Authority's office as well as bond counsel hired for that particular issue.**"

We, in the Department of Finance and Administration, concur with the recommendations found on pages 27 and 28 of the report and stand ready to offer assistance in accomplishing the goal of providing greater public accountability for bond funds management and related support activities as well as reducing the amount of unspent bond funds, thereby saving millions in cost reduction.

JKS/RTW

cc: Rita Wray
Mike Lucius
Ray Gilda

STATE OF MISSISSIPPI
TREASURY DEPARTMENT

TATE REEVES
STATE TREASURER

POST OFFICE BOX 138
JACKSON, MISSISSIPPI 39205
TELEPHONE (601) 359-3600

March 25, 2005

Honorable Phil Bryant
State Auditor
Suite 800
Woolfolk State Office Building
Jackson, Mississippi 39201

Dear Auditor Bryant:

Thank you for the opportunity to respond to Report #88 of the Performance Audit Division of the Office of the State Auditor. The vast majority of the highlighted opportunities have been addressed over the past year. Much of the improvement has been derived from greater focus placed on debt management by the State Treasurer and the Governor – both of whom took office in January, 2004.

Debt management in the Office of the State Treasurer has improved dramatically in the last 15 months. It is my belief that the understanding of the importance of timely spending of bond proceeds has improved dramatically over that same time in the Bureau of Buildings due to the hiring of Mr. David Anderson.

Having said that, it is my goal to respond to each of the identified challenges and opportunities in Chapter III of the Report:

> #1 Arbitrage Penalties - "Mississippi has paid out $10 million in federal arbitrage rebates (penalties) recently because it did not spend the proceeds fast enough, but instead earned interest, which was forfeited to the Internal Revenue Service (IRS)."
>
> **The term "recently" is truly misleading in this context as $10 million in arbitrage penalties has been paid in the last five years. In a bond program with nearly $3.2 billion in outstanding debt, I believe that while $2 million a year is not ideal, it also is not excessive.**
>
> **Further, if the arbitrage was in fact due to earning interest outside the allowed time limits, there was no real "loss of funds" from arbitrage –**

interest was earned (it could not have been earned had the bond proceeds been spent) and was forfeited to the Federal Government.

The vast majority of these arbitrage penalties were incurred before I took office. As you will see in my response to unspent bond proceeds, the Office of the State Treasurer is exhausting every effort to reduce future arbitrage penalties.

#2 Unspent Bond Proceeds – "In 2004, Mississippi had $746 million in unspent GO bond proceeds – This $746 million costs the State in the neighborhood of $40 million in interest payments each year."

As of March 1, 2005, there was $509 million remaining in unspent bond proceeds (which was after an additional $120 million was issued in November). Of this amount, approximately $200 million was issued on a taxable basis, thereby eliminating any concerns over arbitrage penalties. Further, nearly $36 million is held in revolving loan funds that will never be completely spent. Of the $300 million in tax-exempt debt, $260 million has an issuance date within the last 4 years and therefore causes little concern. Of the nearly $40 million in tax-exempt debt issued more than 4 years ago, the Bureau of Buildings reported to the State Bond Commission (a requirement in the Laws of 2000) that all of the $24 million remaining in the Series 2000 issue should be expended by the end of calendar year 2005.

Of the $16 million in unspent bond proceeds that is tax-exempt and was issued over 4 years ago, nearly $10 million dates back to the February, 1995, Mississippi Major Economic Impact Act, Series F. While this issuance has a long and complicated history, I am happy to report that the Mississippi Development Authority, with the support of the Office of the State Treasurer, got legislation passed in the 2004 3rd Extraordinary Session that allows these proceeds to be spent on various tax-exempt uses in and around our military installations in an attempt to deter the possible ramifications from BRAC. To date, nearly $700,000 has been spent, and I would anticipate continued use of all of these proceeds in the near future.

The Office of the State Treasurer will continue to monitor the remaining $6 million in unspent proceeds more than 4 years old that remain on the books.

With respect to the $40 million figure, it is misleading to quote this number without also mentioning the interest earned by the State Treasury on these proceeds. For instance, in the most recent bond issue, we sold $60.77 million in tax-exempt bonds at a cost of capital of 3.802%. We then invested the proceeds at rate of 3.66%, thereby reducing our actual interest cost to less than 15/100 of 1 percent on those proceeds while they are available for investment.

If we were able to apply that scenario across the entire $746 million in the example, our actual interest cost to the taxpayers, after earnings, would be less than $1.1 million.

#3 Unreturned Interest Payments from Agencies – "Significant amounts of interest on bond issues are being kept by agencies instead of being returned to pay down resulting debt."

Let me address interest payments in two parts:

1) The Office of the State Treasurer would strongly support the recommended solution that the "legislature should exercise its authority to standardize language in State law to require all interest earned by agencies on State GO bond proceeds to be returned to the State Treasury for debt service within each bond issuance."

2) Currently, there is no outstanding interest owed for debt service that is significantly past due. While this was a problem under previous administrations, it is no longer an issue. Therefore, the recommended solution of "task(ing) OSA to work with the State Treasurer to obtain documentation" is simply not necessary.

It should also be noted that the following statement under *Justification* on page 15 is not a true statement:

"If the interest earned were returned to the Treasurer to pay down debt, the principal would decline faster."

It is true that if all interest were returned to the State Treasury, fewer general fund dollars would be required to service our State's annual debt burden.

#4 Un-issued Bonds – "The Treasurer's Office recently reported an additional $800+ million in GO bonds that had been authorized, but for various reasons remain unissued."

As you are aware, my staff has done an extensive study on so-called "authorized but un-issued debt" which led to the introduction of HB 1301 (and a companion Senate Bill sponsored by Chairman Robertson) by Chairman Percy Watson. I appreciate the work of both chairman on this important piece of legislation, and I anticipate final passage of this bill by the end of this legislative session.

The Office of the State Treasurer strongly supports "sunset provisions in all of its future GO Bond authorizations."

#5 Other Financial & Management Issues – The stated goals are…

"1) Increase use and availability of short-term debt for capital projects."

The Office of the State Treasurer agrees with the need to have flexibility and the option of short-term borrowing. In fact, we worked with the Governor's office and the leadership in the House and Senate in 2004 to make this a reality. Consequently, Senate Bill 2010, 2004 3rd Extraordinary Session, lines 171-185, gives us this authority.

2) "Use the full 20% of variable rate debt authority to maximize interest savings. The Legislature should consider raising the variable rate cap to 25%."

The Office of the State Treasurer believes the 20% cap is sufficient to meet the needed diversification variable rate exposure provides. We do not believe that an increase in that cap would be looked upon favorably by the rating agencies. Furthermore, the short term savings in variable rate debt can be more than offset by rising interest rates over the term of an issue. For instance, the VRDO's issued in the Nissan transaction were accruing interest at approximately 1% immediately after issuance. Today, that rate has risen to nearly 3 percent, increasing expected debt service by nearly $9 million in FY 2006.

With respect to "market timing" and the use of financial advisors, the Office of the State Treasurer does not believe market timing can be effectively utilized, and therefore we have requested no additional resources for this task. We do not believe that financial advisors are necessary for competitive issues.

Additional Recommendations for Savings:

"Rather than increasing costs to other state agencies, continue to include costs associated with OSA's bond monitoring activities in the bond authorizations since these project are time-limited. In addition, standardize the inclusion of costs for financial supervision and construction administration for Bureau of Buildings."

The Office of the State Treasurer strongly disagrees with financing recurring expenditures with long-term debt. To pay for such expenses as the Audit department and the Bureau of Buildings from bond proceeds is just bad business. Recurring expenses such as these should be funded through the appropriations process.

"Increase the authority already in place for the Office of the State Auditor to evaluate internal controls and expand its role in the monitoring and tracking the expenditure and disbursement of GO bond proceeds."

The Office of the State Treasurer supports the bond monitoring program to ensure expenditures and disbursement of bond proceeds are in compliance with federal and state laws. However, we do not support using funds that are "derived from proceeds from bonds issued" to pay for these recurring expenses such as is allowed in Section 69-46-7 of the Mississippi Code.

This section provides for funding from bond proceeds for the Department of Audit "to defray costs incurred by the department in assisting the board in carrying out the provisions of the Mississippi Land, Water, and Timber Resources Act."

I consider a proactive debt management strategy as one of the most important aspects of the Office of the State Treasurer. We have made significant progress in this regard over the past year. For instance, unspent bond proceeds have been reduced from nearly $800 million to $509 million (with an additional $120 million in new issuance during this time). We anticipate less than $10 million in tax-exempt debt outstanding issued before November 2001 at the end of this year. Also, we have decreased substantially the negative arbitrage resulting from interest earned vs. the interest paid on our outstanding debt through innovative investment management. Furthermore, we have reduced our overall outstanding debt by over $100 million in that time frame, resulting in the first decline in a fiscal year since the late '80's.

Again, thank you for the opportunity to respond to Report #88 of the Performance Audit Division. If I can further assist you or your staff, please do not hesitate to call me.

Sincerely,

Tate Reeves

J. Tate Reeves, CFA
State Treasurer

Appendix B:

Examples of Potential Savings Based on Report Recommendations

AND

Letter of Response to Examples of Potential Savings from the Mississippi Department of Finance and Administration

Estimated Savings from OSA Bond Report Recommendations

- Reducing the cost of construction change orders by even a conservative 15%, Mississippi could save **a minimum of $2.4 million per year** *(see page 2 of this memo, "Preplanning Savings Estimate").*

- For each $100 million in capital construction where project development time is reduced by one year (from 3 to 2 years), the State can save significant amounts—**a minimum of $5 million each year.** *(see page 3 of this memo, "Savings from Reduced Project Development Time")*

- Every time Mississippi issues capital construction bonds, it can save millions:

  - By modifying each $100 million set of issues, the State can take advantage of lower interest rates on short-term variable rate debt during the initial 3 project years (typical construction phase) and then,

  - Finance the remaining amounts using fixed-rate debt for these issues over a 17-year period. Mississippi could realize savings of more than $105 million over those years; **an average of $5.25 million per year**, per $100 million issued. *(see page 4 of this memo, "Using Short-Term, Variable Rate Debt During the Construction Phase")*

- By continuing to do these three things with each new issue, Mississippi could realize approximate annual savings of close to **$13 million minimum.**

- *If college & universities' capital construction projects, economic development construction projects, and transportation construction projects were also handled in this manner, these savings figures could easily be doubled or even tripled.*

- The above opportunities do not include additional savings from management and oversight changes such as:

  - Reductions of interest payments on unspent bond proceeds (currently costing Mississippi $40 million/year); and
  - Reductions in arbitrage penalties which have amounted to more than $10 million over the last 5 years.

***Eventually, fewer savings will be available as Mississippi improves its management—
We'll be doing things better!***

Preplanning Savings Estimate

- Project cost overruns involving capital construction projects can pose serious problems for project and debt managers alike;
  - Project cost overruns can be triggered by:
    - Agency (owner or tenant) decisions to change their priorities or reverse prior decisions;
    - Design problems caused by errors and omissions by architects or engineers;
    - Work related or construction condition issues.
- Example—The Woolfolk Building renovation work illustrates cost overruns problems:
  - Change orders totaling $5,378,483.83 were added;
  - They increased the costs from $55,434,532.91 to $60,813,016.74;
- In FY 2004, DFA's Bureau of Buildings (BoB) reported $16,078,477.45 in changes orders representing 3.69% of the costs of projects totaling $436,138,039.52;
- BoB believes change orders could be reduced by as much as 20% with enhanced procedures and resources;
- Using a conservative estimate of 15%, the measures could have saved the State an additional $2.4 million per year.

Report Recommendation: *The Legislature should clarify existing authority for DFA's, BoB to ensure all preplanning requirements are met by state recipients of bond funds, regardless of whether they utilize the State's preplanning revolving fund or are exempted from preplanning requirements altogether. OSA supports DFA recommendations to utilize private firms for preplanning related functions to free-up personnel for more critical project review activities aimed at reducing costly project delays, overruns, and facility failures to meet basic functional requirements.*

Savings from Reduced Project Development Time

- Substantial inflationary increases occur in building materials from the time original costs are determined until construction begins. DFA Bureau of Buildings:
  - Average length of time from LBO request to bid award = approximately 3 years.
  - Cost estimates seldom reflect the price of materials more than two years in advance.

- Building material costs have increased from just one year ago.
  - Concrete is 4.4%.
  - Lumber (26.5%), milled steel (43.3%), and gypsum board (23.4%) are all up.
  - Raw steel has doubled in price since 2002 from $400/ton to $800/ton.
  - Construction costs have increased an average of 53% for major building components, like load bearing classroom walls, from $78/square foot (1994) to $119/square foot (2004).

- National contractors estimate construction costs are increasing about 8% to 10% per year.
  - Example- Ayers related construction projects previously estimated to cost $75 million may now cost $95 million.

- The time between legislative approval and construction start-up can be reduced from 3 years to 2 years with increased preplanning and project management.

- Based on the previous discussion of construction inflation rates, a one-year reduction saves the State substantial inflationary costs—at least 5% of the $100 million or more likely to be allocated annually to capital building projects (a savings of at least $5 million).

  - For each additional $100 million in capital construction where project development time is reduced by one year (from 3 years to 2 years), the State can save significant amounts—a minimum of $5 million each year.

Report Recommendations: *(1) Implement written formalized guidelines for the State Bond Commission for their bond issuance process with deadlines to ensure prompt and timely implementation of all general obligation bond commitments by the State. These guidelines could either be enacted in state law or promulgated under the Administrative Procedures Act. (2) Create sunset provisions to limit the time that new project funds can be authorized but not issued by the State Bond Commission as well as limiting the time project funds can be issued but not spent.*

Using Short-Term, Variable Rate Debt During the Construction Phase

- Using short-term financing during the construction phase of a capital project can save the state millions in taxpayer dollars;

- Currently, a $100 million capital project, bonded over a 20-year period of time at 3.997% would have a debt service of $148 million. The state would earn approximately $3.5 million in interest, leaving a net debt service of $144.5 million;

- Using short-term debt during the construction phase (approximately 3 years), the state would pay $2 million in interest over this "short" period and pay down $16.1 million in principal as well. This leaves leaving a balance of $83.9 million to be financed over 17 years at 3.789%. Remaining debt service would be about $32.1 million, yielding a savings of approximately $10.2 million over the life of the issue.

- *Explained another way, if Mississippi issues at least $100 million per year for capital construction, it could realize savings of more than $105 million over one 20-year period, which averages <u>$5.25 million per year</u>, per $100 million issued. In addition, because each year the state obligates more funds to capital construction, by the 20th year, the State would have more than $90 million of deferred savings still to come.*

- The primary risk of using short-term variable rate debt, which could be mitigated using a Financial Advisor, is the volatility of changing interest rates.

<u>Report Recommendations.</u> *(1) Create short-term debt authority to allow for the issuance of commercial paper or similar notes as a temporary means of funding capital projects before general obligation bonds can be issued. This may be particularly useful in the preplanning stage of capital projects as well as with certain economic development bond projects where a separation between taxable and non-taxable activities may not be immediately available. (2) As long as the economic conditions will allow, the State should fully utilize the 20% allowed for variable rate bonds. Further, because of the potential complexity of overseeing variable rate bonds, Treasury should be provided with enough resources to handle the process.*

STATE OF MISSISSIPPI
HALEY BARBOUR, GOVERNOR

DEPARTMENT OF FINANCE AND ADMINISTRATION
J.K. STRINGER, JR.
EXECUTIVE DIRECTOR

MEMORANDUM

TO: Phil Bryant
State Auditor

FROM: J.K. Stringer, Jr.
Executive Director

DATE: November 30, 2004

Re: Response to Estimated Cost Savings related to specific areas of Bond Management

The summary provided related to estimated cost savings in specific areas of bond management has been reviewed and the following comments are offered.

(1) PREPLANNING SAVINGS ESTIMATE: We concur with the findings and recommendations.

In addition, the Bureau of Buildings under the directorship of David Anderson will:

1. Continue the preplanning process for projects over $5M;
2. Initiate commissioning process for entire project duration from preplanning through construction;
3. Expand the Construction Administration responsibilities for the project professionals.

These procedural requirements should play a key role in pulling down the costs brought about from change orders.

(2) SAVINGS FROM REDUCED PROJECT DEVELOPMENT TIME: We concur

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that a reduction in project development time would save money.

In addition DFA pursued and successfully obtained legislation to

1. Expand project delivery methods to include Design-Build-Bridging method which has the potential of saving time and therefore costs; and
2. Utilize Construction Management (with risk) whereby the responsibility of the professional is increased to have someone on-site daily for larger projects and groupings allowed for smaller projects. . Projects of $20,000,000 or more should have full time professional support to help reduce change orders and improve project completion. This method requires an "at-risk" policy be implemented to ensure the project is constructed within the required time-line and at or below the project cost agreed upon through the bid process.

(3) USING VARIABLE RATE DEBT DURING THE CONSTRUCTION PHASE: We concur with the findings and recommendations of the audit.

In addition DFA pursued and successfully obtained legislation to

1. Allow for temporary borrowing to start projects prior to all bond monies for the project being sold;

We are also exploring other avenues of short term debt i.e., Bond Anticipation Notes (BANs) which is secured by anticipated proceeds from a forthcoming bond sale.

Thank you again for the summary and recommendations provided relating to relevant elements of bond management.

Appendix C:

Frequently Asked Questions About Bonds

What does it mean that bonds are general obligations of the state? With general obligation bonds, “the full faith and credit of the State of Mississippi is irrevocably pledged. If, for any reason the State Treasurer doesn’t have the funds to pay both the principal and interest when it is due, then the difference is to be paid by the State Treasurer from any funds which are not otherwise appropriated.

Capital projects funded with general obligation bond proceeds typically involve public facilities. How is a ‘public facility’ defined? According to §29-17-1, Mississippi Code of 1972, Annotated, any building or other facility owned by the State of Mississippi or occupied, used or under the control of the State, any of the State agencies, departments, community college districts, the Board of Trustees of the State Institutions of Higher Learning or institutions under their jurisdictions would be considered a ‘public facility’ for purposes of State law regarding the construction and improvement of public buildings.

Because the State Bond Commission has no staff, on whom does it generally rely for administrative support? The Commission relies chiefly on the Bond Advisory Division of the Department of Finance and Administration. The Division director routinely consults with a working group comprised of staff from DFA, the Treasury, the Governor’s Office, Attorney General’s Office and the Mississippi Development Authority’s office as well as bond counsel hired for that particular issue. Others are sometimes included in developing bond resolutions, preliminary official statements, and documents required as a part of the formal bond issuance process. There are no written procedures which place constraints on how or when these requirements are to be carried out.

Who provides legal counsel for the bond issuance process? There are several sources of legal expertise available to the State Bond Commission. First, the Attorney General is a member of the three-member commission. He also serves as the secretary and is responsible for the recording of the minutes all proceedings. Second, the Working Group includes the attorney assigned by the Attorney General’s Office to the Department of Finance and Administration. Also included in the Working Group is the bond counsel retained for that particular bond issue. The expertise provided by bond counsel is critical to the determining the technical details of the proposed issue. Finally, validation of the bonds to determine that they are being properly issued is done by the State Bond Attorney. Appointed by the Governor, this individual reviews certain bond documents and issued a written opinion is a required step in the bond issuance process.

Are there capital construction projects which, when completed, result in unspent bond proceeds (leftover money)? Generally not, although it can occur. In fact, cost overruns sometimes require deficit appropriations after the fact. However, there are projects which remain unfinished beyond a three-year period. This may occur because of a variety of factors including: political factors; unanticipated cost factors resulting from insufficient planning; unanticipated cost factors which could not have been anticipated; agency priority changes; regulatory issues; and other related circumstances.

How are the duties and responsibilities divided between the State Treasurer’s Office and the Department of Finance and Administration? The Bond Advisory Division of DFA is responsible coordinating activities with the three Bond Commission members. DFA oversees the development of bond resolutions and preliminary official statements as requested by the Commission. DFA also oversees the system whereby bond proceeds issued to state agencies are processed for payment. Treasury is responsible with all financial requirements related to the actual borrowing of the monies, including all note and bond payments, interest due from state agencies, requests for additional funds to pay cost overruns and all matters pertaining to the honoring of the State’s financial commitments.

Are all bond issues subject to the use of competitive bids to determine the bond underwriter? As discussed in the Bond Issuance Process narrative, all new issues are handled in this way. However, refundings, which are initiated by individual bond underwriting companies, are done through negotiated bids if it is determined that the savings to the State is sufficient to justify it.

Is a financial advisor routinely retained as part of the bond issuance process? Some states apparently do this while others don't. In Mississippi a financial advisor is not retained as a part of the issuance process for new issues. However, financial advisors play a key role in the refunding process. They are routinely retained when refundings occurred.

Appendix D:
Glossary of Bond Terms

GLOSSARY

Terms in boldface type appear in this report

AMORTIZATION—The process of paying the principal amount of an issue of bonds by periodic payments either directly to bondholders or to a sinking fund for the benefit of the bondholders. Payments are typically calculated to include interest in addition to a partial payment of the original principal amount.

ARBITRAGE— In general, transactions by which securities are bought and sold in different markets at the same time for the sake of the profit arising from a difference in prices in the two markets. The Internal Revenue Service regulates the arbitrage of state and local bond proceeds.

BOND—Written evidence of the issuer's obligation to repay a specified principal amount on a pre-determined date, known as the maturity date, along with interest at a stated rate or by a formula used for determining that rate. Bonds are distinguishable from notes, which mature in a much shorter period of time. Bonds may be classified according to: maturity (serial or term); source of payment (general obligation or revenue); method of transfer (bearer or registered); issuer (state, municipality, special district, etc.); or price (discount or premium).

BOND COUNSEL—An attorney or firm of attorneys retained by an issuer to give legal opinions including: the legality of authority to issue proposed bonds; that the issuer has met all legal requirements necessary for issuance; and that interest on the proposed bonds will be exempt from federal income taxation, and where applicable, from state and local taxation as well. Usually, bond counsel may prepare, or review and advise the issuer regarding authorizing resolutions, official statements, validation proceedings and litigation.

BONDED DEBT—The portion of an issuer's total indebtedness represented by outstanding bonds.

BONDHOLDER—The owner of a bond, to whom payments of principal and interest are made. The owner of a bearer bond is the person having possession of it, while the owner of a registered bond is the person whose name is shown on the bond register.

BOND PROCEEDS—The money paid to the issuer by the purchaser or underwriter for a new issue of state bonds used to finance a project or projects for which the bonds were issued. These monies may be used to pay certain costs of issuance as may be provided in the bond contract.

BOND REGISTER—A record, kept by a registrar on behalf of the issuer, which lists the owners of registered bonds.

BOND RESOLUTION—The document(s) representing the action of the issuer authorizing the issuance and sale of state bonds. Issuance of the bonds is usually approved in the authorizing resolution and sale is authorized in a separate document known as the 'sale' or 'award resolution'.

CALLABLE BOND—A bond which permits or requires the issuer to redeem the obligation before the stated maturity date at a specified price, usually at or above par by notice of redemption in a manner specified in the bond contract.

CALL PRICE—The price, established in the bond contract, at which bonds will be redeemed, if called. Call price is generally at a premium and stated as a percentage of the principal amount called.

CLOSING—The meeting of involved parties on the date of delivery to sign bonds and related legal documents and to physically deliver the bonds in exchange for payment of the purchase price. The parties at closing generally include representatives of the issuer, bond counsel, and the purchasers (underwriters).

COMMERCIAL PAPER (TAX-EXEMPT)—Short-term promissory notes issued in either registered or bearer form, and usually backed by a line of credit with a bank. Maturities do not exceed one year and generally average 30-45 days.

COSTS OF ISSUANCE—The expenses associated with the sale of a new issue of securities, including such items as underwriter's spread, printing, legal fees, and rating costs.

COUPON—The detachable part of a bond document which specifies the date, place, and dollar amount of interest payable. Bondholders detach coupons from bonds, often semi-annually, and present them to the issuer's paying agent for payment or to the bondholder's bank for collection.

DEBT SERVICE—The amount of monies needed to pay interest on an outstanding debt, the serial maturities of principal for serial bonds, and the required contributions to an amortization or sinking fund for term bonds. Debt service on bonds is calculated on a calendar year, fiscal year, or bond fiscal year basis.

DEFEASANCE—Terminating the rights and interest of the bondholders and ending their lien on the pledged revenues in accordance with the terms of the bond contract for the previous issue of the bonds. Defeasance typically occurs in connection with the refunding of an outstanding issue by the final payment, or arrangement for future payment, of principal and interest on a prior issue.

DISCOUNT—The amount by which par value exceeds the price paid for a security and which usually represents the difference between the nominal interest rate and the actual or effective rate of return to the investor.

EFFECTIVE INTEREST RATE—The actual rate of interest earned by the investor on bonds purchased, having allowed for premiums, discounts, or accrued interest over the period of the investment.

GENERAL OBLIGATION or GO BONDS—Bonds secured by the full faith and credit of the issuer (the State). These bonds are debts of the issuer.

NOMINAL INTEREST RATE—The interest rate shown on the face of the bond, representing the amount of interest to be paid to the bondholder.

NON-CALLABLE BOND—A bond that cannot be redeemed by the issuer before its maturity date.

NOTE—A written, short-term promise of the issuer to repay a specified principal amount on a certain date, along with a stated rate of interest, or according to a formula for determining that rate, payable from a certain source of anticipated revenue. Notes usually mature in less than five years.

OFFICIAL STATEMENT or FINAL OFFICIAL STATEMENT or O.S.—A document published by the issuer which discloses material information about a bond issue including: the purposes of the bond issue; how the bonds will be repaid; and the financial, economic and demographic characteristics of the issuing government. This information is used to evaluate the credit quality of the bonds.

PAYING AGENT—The entity responsible for the payment of interest and principal on bonds on behalf of the issuer. The paying agent is generally a bank or financial institution, but it could be the treasurer or some other officer of the issuer. The paying agent sometimes performs other services for the issuer including: reconciliation of the bonds and coupons paid with the monies paid to the paying agent by the issuer; destruction of paid bonds and coupons; indemnification of the issuer for wrongful payment; and registration of the bonds.

PRELIMINARY OFFICIAL STATEMENT or P.O.S.—A preliminary version of the official statement used by the issuer or underwriters to describe the proposed bond issues before determining an interest rate and offering price. It is a marketing tool used to gauge buyers' interest in the issue and is relied on by prospective purchasers to make their investment decisions.

PREMIUM—The amount by which the price paid for a security exceeds par value, generally representing the difference between the nominal rate of interest and the actual or effective rate of return to the investor.

REFUNDING—A procedure whereby an issuer refinances an outstanding bond issue with new bonds. Refunding is usually undertaken for two reasons: either to reduce the issuer's interest costs or to remove a burdensome restrictive covenant imposed by the terms of the financed bonds. The proceeds of the new bonds either are deposited in escrow to pay, when due, the debt service on the outstanding obligations, or are used immediately to retire the outstanding obligations.

REGISTRAR—The person or entity responsible for maintaining records on behalf of the issuer for the purpose of recording the owners of the registered bonds. The paying agent frequently functions in this capacity.

SERIAL BONDS—Bonds of an issue in which some bonds mature in each year over a period of years.

SPREAD or GROSS UNDERWRITING SPREAD—The income which is earned by the underwriting syndicate as a result of differences in the price paid to the issuer for a new issue of bonds, and the prices for sale of those bonds to the investing public, expressed in points or fractions of points.

TERM BONDS—Bonds coming due in a single maturity. The issuer generally agrees to make periodic payments to a sinking fund for mandatory redemption of term bonds before maturity or for payment at maturity.

TREASURY SECURITIES—Debt obligations of the U.S. government sold by the Treasury department in the forms of bills, notes, and bonds:

Bills- Short-term obligations which mature in 1 year or less, and are sold at a discount in lieu of paying periodic interest.

Notes- Interest bearing obligations which mature between 1 year and 10 years.

Bonds- Interest bearing long-term obligations which generally mature in 10 years Or more.

Appendix E:

Scope of the Study & Procedural Analysis
and
Methodology & Description of the Study Process

Scope of the Study and Procedural Analysis

The State Auditor wanted to examine the opportunities for cost savings in the general obligation bond management process from several different perspectives including: historical trends; task analysis and the respective roles of each party involved in the bond issuance and management process; and identification of savings opportunities. It was hoped that this approach would be helpful in creating a better working understanding of the challenges facing the State in managing bond costs both at present as well as in the future.

Initially, OSA's study approach involved the examination of the expanding role of public debt in Mississippi. Particular emphasis was placed on determining the role of general obligation bonds in the funding of state capital construction, economic development, land acquisition, and other related activities from the perspective of historical trends.

Second, over 40 hours of interview time was devoted to understanding the State's current bond issuance and bond management processes with emphasis on the duties and responsibilities of the principal parties. This aspect of the study focused on the support roles played by both the bond divisions of the Department of Finance and Administration and State Treasurer's Office in assisting the State Fiscal Officer and the State Bond Commission in issuing the bonds authorized by the Mississippi Legislature.

Therefore, study project objectives included:

- Creating a framework from which to understand the recent growth of general obligation borrowing and resulting bonded indebtedness;

- Comparing Mississippi's problems and approaches with those of other states;

- Developing materials to promote a lay understanding of how the bond issuance and proceeds management processes are structured and how they actually work;

- Identifying challenges and opportunities for achieving additional cost savings for the State of Mississippi; and

- Examining the feasibility of expanding flexibility in the use of bond proceeds among those projects within a given bond issue.

Throughout this process, OSA solicited information and approaches from interested parties to identify areas where significant cost savings could be achieved.

METHODOLOGY AND STUDY PROCESS DESCRIPTION

The plan for carrying out an informational review and analysis involved the utilization of both primary and secondary source materials. Materials reviewed include: Official Statements from bond issuances; the CAFR (Comprehensive Annual Financial Report); the Mississippi Code (1972, annotated) and Mississippi General Laws; Treasury reports and data; DFA reports and data; Performance Evaluation and Expenditure Review (PEER) Committee reports on the cost of bond issuance; OSA work papers from the Financial & Compliance Audit Division; internet website materials from financial management agencies in other states; Congressional Research Service materials; the Library of Congress; and other similar sources. Primary source materials focused on an extensive series of interviews with key agency staff and others including legal and financial advisors from the private sector involved in the bond issuance process.

The study applied path analysis and flow chart related methodologies, including decision trees, as the basis for conceptualizing the bond issuance process and the respective roles of the entities involved. A variety of arithmetic and statistical techniques were applied to analyze bond related activities. Bond issuance costs, interest rates and other related expenses were identified and compared, where applicable.

A survey of relevant bond related practices utilized in other states was also conducted. The survey was not intended to be scientific in nature or be generalized to apply to the nation as a whole. The purpose was to identify states with similar problems who are engaged in addressing the same concerns.

Appendix F:
Capital Construction Financing State Survey Results

The Performance Audit Division with assistance from DFA's Division of Buildings, Grounds, & Real Property Management received e-mail responses from at least eleven (11) states regarding use of GO bonds for capital outlay. The survey focused particularly on placement of multiple projects in a single bond issue and whether or not there was any flexibility in terms of use of bond proceeds among projects within a given bond issue. Such flexibility, to the extent that it could be carried out within requirements of federal tax law, would enable monies to allocate proceeds among projects in a given issue as needed, as long as the amount granted did not exceed legislative authorization.

Two responding states reported that they do not use GO bonds for capital outlay projects. These states included Idaho, which has a constitutional prohibition against use of GO bonds for capital construction, and Michigan.

In addition, virtually all the states responding indicated that project funds are issued in non-taxable GO bonds as needed, rather than necessarily in the full amount authorized by the Legislature. States typically issuing project funds in multiple bond issues over time as needed included: Montana, Vermont, Connecticut, Virginia, South Carolina, New Mexico, Missouri, and Maryland.

All of these states apparently have the needed internal controls to ensure that funds are utilized exclusively for the projects authorized in each bond issue and the amounts expended for these purposes do not exceed the total legislative project authorization. Each state expressed sensitivity regarding the ability to show clearly that bond proceeds were used only for the projects stated in the official statement. The perception that a state engaged in what might be construed as 'generic bonding' would, of course, raise serious questions regarding compliance with federal tax law.

Nevertheless, several states including Virginia and Vermont do not list the amounts for each project in their official statements and would, therefore, appear to have the flexibility to move proceeds within an issue among eligible projects, under certain circumstances. However, these states only include projects in their bond issues based on when they are ready to spend the monies. Therefore, moving monies among projects within a given issue does not seem to occur very often. Both states believe that this could be legally accomplished, however, if this were needed.