GENERAL GOVERNMENT

LAO

60 YEARS OF SERVICE

2002-03 Analysis

MAJOR ISSUES

General Government

☑ **Proposed Deferral of Retirement Contributions Has High Price Tag**

- To increase the state's fiscal flexibility, the budget proposes to defer $2 billion in state retirement contributions to the Public Employees' Retirement System and the State Teachers' Retirement System, including $1.6 billion from the General Fund, over three fiscal years. In exchange, the state would provide additional retirement benefits to the members of the two systems.
- In present value terms, this fiscal flexibility would cost the state well over $4 billion. We recommend that the deferral proposals be rejected (see page F-15).

☑ **Industry Should Contribute to Medfly Control**

- Controlling the medfly population reduces agricultural damage. As such, the state's consumers benefit as do certain agricultural industries. Consequently, the cost of medfly control should be shared by the state (General Fund) and the agricultural industries. We recommend the enactment of legislation that directs the Department of Food and Agriculture to assess the agricultural industry for half the state's cost of medfly control (see page F-110).

☑ **"Peace Officer Procedural Bill of Rights" Mandate Costs More Than Anticipated**

- The state's costs to reimburse local governments for providing procedural protections for peace officers involved in disciplinary actions will be about the same as the state's costs to operate all peace officer training programs. We recommend that the Legislature delete $50 million proposed to reimburse local governments and refer the matter to the Joint Legislative Audit Committee for review. We further recommend that the Legislature place this mandate on “pause” in the budget year (see page F-54).

☑ **DOIT: Limited Success Justifies Limited Reauthorization**

- The Department of Information Technology (DOIT) is scheduled to sunset on June 30, 2002. Based on our review, DOIT’s overall performance of its legislative mandates is one of limited success. Therefore, we recommend a two-year reauthorization of DOIT and a Bureau of State Audits review of DOIT’s progress in meeting its mandated responsibilities (see page F-29).

☑ **Improving Tax Agency Operations**

- The audit and collection activities of the Board of Equalization generate substantial state revenues, and ensure that all taxpayers pay their fair share and are treated equitably under the law. Given the importance of these activities and inadequacy of certain current information about them, we recommend that the Legislature institute an annual reporting requirement that would provide the data necessary to determine their appropriate staffing and funding levels (see page F- 41).

- The budget proposes additional funding for audit and collection activities by the Franchise Tax Board. We withhold recommendation on these items pending additional information that these monies can be effectively used. We recommend increasing settlement activities in order to accelerate the receipt of revenues to the state (see page F- 47).

TABLE OF CONTENTS

General Government

OVERVIEW

General Government

Total state funding for general government is proposed to decrease by about 2 percent in the budget year. The budget proposes reductions in most general government program areas, with the exception of tax relief. The budget shows an increase of $1.3 billion in tax relief expenditures, or 44 percent above the current-year level, due to the way funds were appropriated for the vehicle license fee reduction.

The "General Government" section of the budget contains a number of programs and departments with a wide range of responsibilities and functions. These programs and departments provide financial assistance to local governments, protect consumers, promote business development, provide services to state agencies, ensure fair employment practices, and collect revenue to fund state operations. The *2002-03 Governor's Budget* proposes $13.3 billion in state funds for these functions. The proposed budget-year funding is $251 million (1.9 percent) less than estimated 2001-02 expenditures.

SPENDING BY MAJOR PROGRAM

There are six major program areas within general government:

- Local government subventions, which include shared revenues and local government financing.
- Tax relief.
- Tax collection programs.
- Regulatory programs.
- Energy-related programs.
- State administrative functions.
- State retirement and employment.

We describe these program areas below and Figure 1 shows the estimated 2001-02 and proposed 2002-03 expenditures by program area.

Figure 1

General Government Spending by Program Area

2001-02 and 2002-03
(In Millions)

Agency/Program	Estimated 2001-02	Proposed 2002-03	Difference
Local government subventions	$3,688	$2,814	-$874
Tax relief	3,079	4,424	1,345
Tax collection	637	632	-5
Regulatory	2,838	2,428	-410
Energy	415	260	-155
State administration	1,341	1,139	-202
Retirement	1,505	1,555	50
Totals	**$13,503**	**$13,252**	**-$251**

Local Government Subventions

The local government subvention program—proposed to total $2.8 billion in 2002-03—(1) distributes state-collected revenue (primarily from the VLF and gas tax) to local government agencies and (2) provides local governments additional funding for specified programs.

The Governor's budget proposes to subvene to local governments $2.4 billion in shared revenues (virtually all from special funds). This compares to the current-year total of $3.3 billion, due to the way funds were appropriated for the VLF reduction. Another $385 million in local assistance (all General Fund) is proposed for the Citizens' Option for Public Safety program ($233 million) and other local government programs.

Tax Relief

The state provides local tax relief—both as subventions to local governments and as direct payments to eligible taxpayers—through a number of different programs. The Governor's budget proposes more than $4.4 billion for tax relief appropriations in 2002-03. The two largest are the VLF reduction ($3.7 billion) and the homeowner's exemption ($410 million) programs. The Governor's budget shows an increase of

$1.3 billion from 2001-02 due to the way funds were appropriated for the VLF reduction.

Tax Collection Programs

The Franchise Tax Board (FTB) and the Board of Equalization (BOE) are the state's two major revenue collection agencies. The FTB is responsible primarily for collection and administration of the state's personal income tax (PIT) and the bank and corporation tax (BCT). In addition, it assists in the collection of various types of nontax delinquencies, including child support payments and vehicle-related assessments. The BOE is responsible primarily for administration and collection of the sales and use tax (SUT), as well as excise taxes on fuel, cigarettes, and alcoholic beverages.

Expenditures. The budget proposes total funding of $632 million for these two agencies in 2002-03, down roughly $5 million (about three-quarters of one percent) from the current year. This includes funding FTB's General Fund-related tax collection activities at $373 million, representing an increase of about 2 percent from 2001-02. Proposed funding for BOE's General Fund-related tax collection activities is $165 million, representing a decrease of about 3 percent from the current-year level.

Estimated Tax Collections. The budget estimates that 2002-03 state tax collections will be approximately $48.5 billion for FTB and $33.9 billion for BOE, or $82.4 billion in total. Roughly $73.4 billion of this represents General Fund revenues, including 55 percent from the PIT, 30 percent from the SUT, and 8 percent from the BCT.

Regulatory Activities

A total of 20 departments are responsible for providing regulatory oversight of various consumer and business issues. These agencies protect the consumer and promote business development while regulating various aspects of licensee, business, and employment practices. The groups regulated range from individuals licensed to practice different occupations to large corporations licensed to conduct business in the state. Most of these departments are funded from special funds that receive revenues from regulatory and license fees. Included in this group are the Departments of Consumer Affairs (DCA), Industrial Relations, Food and Agriculture, Financial Institutions, Insurance, Corporations, and the California Public Utilities Commission (CPUC).

The budget proposes total state-funded expenditures of $2.4 billion to support activities by the regulatory agencies. This amount includes $290 million from the General Fund and $2.1 billion from special funds.

The proposed expenditures are $410 million, or 14 percent, less than estimated current-year expenditures. The reduction includes (1) a drop of $330 million in CPUC expenditures due mainly to one-time energy-related expenditures in the current year, and (2) a total reduction of $77 million in various DCA expenditures.

Energy Activities

Several agencies play a role in implementing and managing the state's energy-related policies. These entities include:

- The California Energy Commission (CEC), which is the state's primary policy and planning agency in the energy area.
- The Electricity Oversight Board (EOB), which among other responsibilities monitors the state's electricity market.
- The California Power Authority (CPA), a relatively new entity created during the state's 2001 electricity crisis, to finance new electricity generation and assure an adequate electricity supply for the state.
- The California Energy Resources Scheduling (CERS) division within the Department of Water Resources, which currently purchases electricity for the state on behalf of the state's three largest investor-owned utilities. (Its expenditures to purchase electricity, which are off-budget, total an estimated $7.6 billion in the current year and a projected $5.1 billion in 2002-03.)

In addition to the energy agencies listed above, CPUC is involved with various energy-related regulatory activities. However, because it also is involved in regulating many other industries, CPUC is included under the regulatory category for purposes of this overview. The Division of Oil, Gas, and Geothermal Resources (DOGGR) located in the Department of Conservation is also involved in various energy-related regulatory activities, including oil drilling activities. This program is discussed in the "Resources" section of this *Analysis*.

The Governor's budget proposes to expend $260 million in 2002-03 on energy-related activities (excluding $41 million for such activities by CPUC, roughly $14 million by DOGGR, and the off-budget electricity expenditures by CERS). This is a decline of $155 million, or 37 percent, from the current year. This reduction reflects a large number of one-time current-year expenditures in CEC's budget intended to reduce electricity demand and augment electricity supply in response to the 2001 energy crisis. In addition, CERS required a significant amount of one-time expenditures in the current year to get its electricity purchasing operations started.

State Administrative Functions

There are more than 30 departments and agencies that provide a wide range of administrative services. These services range from oversight and support of other departments (Departments of General Services and Information Technology) to economic development (Technology, Trade, and Commerce Agency) to various specialized services provided to individuals and communities (Office of Emergency Services, the Military Department, and the Department of Veterans Affairs).

The budget proposes $1.1 billion in state funds to support these functions in 2002-03. This is a decrease of $202 million, or 15 percent, from current-year expenditures. The decrease is primarily due to the proposed reductions in local assistance for (1) professional services and energy management under the Department of General Services ($79 million) and (2) various housing programs under the Department of Housing and Community Development ($58 million).

State Retirement Programs

The state contributes to the retirement systems for all state employees and public school teachers. Retirement-related expenditures account for a significant part of state spending on an annual basis. Contributions are made from the General Fund and various special funds. In 2002-03, state expenditures for public employee retirement-related costs (excluding University of California costs) will total $2 billion, including $1.6 billion from the General Fund.

Figure 2 (see next page) summarizes the General Fund costs for various retirement programs in the budget year. The General Fund provides for employer contributions and/or various other payments to four retirement systems. In addition, the state (1) contributes to the payment of premiums for health and dental benefit plans for retired state employees and (2) makes Social Security and Medicare contributions for most state employees.

Public Employees' Retirement System (PERS). The PERS is the retirement system for most state employees. As shown in Figure 2, the budget projects General Fund expenditures of $58 million for PERS in 2002-03. This is significantly less than the amount of contributions in the current year. This is because the administration has negotiated with PERS to reduce the payments for the current and budget years in order to lower total state General Fund expenditures in exchange for additional retiree benefits. (Please see the discussion of the agreement in the "Crosscutting Issues" section of this chapter.)

Figure 2

General Fund Costs For Retirement Programs[a]

2002-03 (In Millions)	
State Retirement Plans	
State Teachers' Retirement	$521
Judges' Retirement	117
Public Employees' Retirement	58
Defined Contribution Plans[b]	39
Subtotal	($735)
Other Retirement Benefits	
Health and Dental Benefits for Annuitants	$554
Social Security and Medicare[c]	358
Subtotal	($912)
Total	**$1,647**

a Excludes costs for University of California employees.

b State's contribution to supplemental retirement plan for correctional officers and their supervisors and managers.

c Legislative Analyst's Office estimate based on 2000-01 costs.

State Teachers' Retirement System (STRS). The STRS is the retirement system for teachers in public K-12 schools and community colleges. The STRS receives contributions from teachers and their employers. These contributions, however, have historically been insufficient to provide for the cost of basic retirement benefits (which were increased by 1998 and 2000 legislation), the protection of retirees' purchasing power, and past unfunded liabilities (the system no longer has an unfunded liability). These shortfalls have been covered by annual transfers from the General Fund.

In the budget year, the shortfalls are expected to total $933 million. The budget, however, proposes to postpone a portion of the payment for this shortfall. Specifically, the administration is in negotiations with STRS to defer paying nine quarters of contributions in order to reduce total state General Fund expenditures. In exchange, the state would provide additional benefits to STRS members. At the time this analysis was prepared, the agreement had not been finalized and the additional benefits were yet to be determined. (Please see the discussion of the agreement in the "Crosscutting Issues" section of this chapter.)

Health and Dental Premiums. The budget also includes $554 million from the General Fund to pay the state share of health and dental insurance premiums for retired state employees and their qualifying beneficiaries. This is about $68 million more than estimated current-year expenditures, reflecting an increase in the number of retirees. The PERS is currently negotiating the health premium rates for the second half of the budget year. These negotiations may result in a change in the estimated General Fund cost for the budget year.

Employee Compensation

There are about 176,000 rank-and-file state employees (not including those in higher education) covered under state collective bargaining law. The pay, benefits, and working conditions for these employees are typically spelled out in memoranda of understanding (MOUs). As of January 1, 2002, the Legislature has approved MOUs for nine of the state's 21 collective bargaining units, most of which are effective through June 2003. (The MOUs for six bargaining units are currently under consideration by the Legislature, and the administration has not reached agreement with the remaining six units.) Major provisions in these MOUs included (1) an increase in employees' take-home pay by reducing employee retirement contributions and (2) the state paying for a portion of health insurance premium increases.

The Governor's budget proposes $210 million, including $130 million from the General Fund, for the cost of employee compensation adjustments in 2002-03. This includes additional health benefit costs and travel reimbursements negotiated as part of the new MOUs.

CROSSCUTTING ISSUES

General Government

STATE RETIREMENT CONTRIBUTIONS

RETIREMENT PROPOSALS HAVE COSTLY PRICE TAG

The Governor's budget proposes deferring $2 billion in state retirement contributions, including $1.6 billion from the General Fund, over three fiscal years. Our analysis shows that the fiscal flexibility this proposal provides now would cost the state in excess of $13 billion, including more than $9.7 billion from the General Fund, over more than 30 years. In present value terms, this is equivalent to getting about $2 billion worth of fiscal flexibility at a cost of well over $4 billion.

The state contributes annually to the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS). Contributions to PERS cover state employees and nonteacher school employees. About 55 percent of the contributions towards state employees' retirement are paid from the General Fund, with the other 45 percent coming from various special funds. Contributions towards nonteacher school employees' and teachers' retirement come entirely from the General Fund.

Proposals to Defer State Retirement Contributions

The budget proposes deferring about $1 billion of the state's General Fund retirement contributions to PERS and STRS in 2002-03 in exchange for administration support of additional retirement benefits.

The Governor's budget proposes to postpone payment of the state's retirement contributions to both PERS and STRS in exchange for the administration's support of increased retirement benefits. The objective of these proposals is to achieve one-time savings, largely in the current year and budget year, to help address the state's General Fund shortfall. The administration has indicated that it will reassess these proposals at the time of the May Revision in light of the state revenue picture at that time.

Figure 1 shows the savings that would result from deferring the state's retirement contributions. Figure 2 shows the costs to pay off the deferrals and to pay for the additional retirement benefits. We discuss the proposals and their costs below.

Figure 1

Savings From Proposed Deferral of State Retirement Contributions

(In Millions)

	2001-02	2002-03	2003-04
PERS			
General Fund[a]	—	$496	$125
Special funds	—	408	—
Subtotals	—	$904	$125
STRS			
General Fund[b]	$96	$412	$441
Totals	**$96**	**$1,316**	**$566**

[a] Includes state contributions for state employees and nonteacher school employees.

[b] The General Fund pays the entire amount of the STRS contribution.

Deferral of PERS Contribution. In December 2001, the PERS board lowered the contribution rates for state and nonteacher school employees for the current and budget years by recognizing past investment returns more quickly. The rate adjustments reduced the state's contribution amount for the budget year by $1.029 billion, of which $904 million would have been payable in 2002-03 and the remaining $125 million in 2003-04, as shown in Figure 1. (This is because the state pays its General Fund contributions one quarter in arrears, making fourth quarter payments fall into the next fiscal year.) As a result, in the budget year, the state can save $496 million in General Fund outlays, including $371 million for state employees' retirement contribution and $125 million for nonteacher school employees' retirement contribution. Without these rate adjustments now, the state would have realized the savings over a longer period in future years.

In order to compensate for realizing these savings immediately, the state would pay higher contributions over 30 years. As Figure 2 shows, the state would have to pay about $86 million beginning in 2003-04, including $60 million from the General Fund. Over time, the amounts would generally increase with the growth in payroll. Based on information from PERS, we estimate that the state's contribution to make up the deferred amount would total $3.4 billion over a period of about 30 years, assuming an interest rate of 8.25 percent, which is the projected rate of return on PERS investments. The amount includes total General Fund costs of $2 billion and special fund costs of $1.4 billion.

Figure 2

Costs of Retirement Deferral

(In Millions)

	2003-04	2004-05	2005-06	2006-07	Total Through 2033-34
PERS					
Payback of deferral	$86	$83	$64	$66	$3,407
Purchasing power protection	—	—	—	185	6,345
Totals	**$86**	**$83**	**$64**	**$251**	**$9,752**
STRS					
Payback of deferral	—	$56	$58	$61	$3,275
Increased benefit	a	a	a	a	a
Totals	**$0**	**$56**	**$58**	**$61**	**$3,275**
Grand Totals	**$86**	**$139**	**$122**	**$312**	**$13,027**

a STRS agreement is not yet finalized. Additional benefits are yet to be determined.

The PERS Deferral Contingent on Additional Benefits. In exchange for lowering the state's retirement contributions, the administration has agreed to support legislation that would increase payments to retirees, effective January 1, 2005, to ensure that the value of their retirement benefits does not drop below 80 percent of the initial value of their pension amount ("purchasing power protection"). Currently, the inflation protection is set at 75 percent of a retiree's initial pension amount.

Based on information from PERS, we estimate that the 30-year cost of providing this benefit for state and school employees is about $2 billion in present-value terms—$1.4 billion for service already rendered and $0.6 billion to provide the benefit on an ongoing basis. Beginning in 2006-07, we estimate that the state would have to pay about $135 million for the cost of past service and about $50 million for the ongoing cost. These amounts would increase annually with wage growth, with the past-service component paid off after 20 years.

Figure 3 shows the cost of the PERS retirement deferral proposal to the General Fund and special funds. As Figure 3 shows, the cost of the PERS agreement would total about $9.8 billion over 30 years.

Figure 3

Cost of Retirement Deferral by Fund

(In Millions)

	General Fund	Special funds	Total Through 2033-34
PERS	$6,422	$3,330	$9,752
STRS[a]	3,275	—	3,275
Totals	**$9,697**	**$3,330**	**$13,027**

[a] Figures do not include costs to provide yet-to-be-determined additional benefits.

Deferral of STRS Contribution. The provisions of the STRS agreement had not been finalized at the time of this analysis. Under the current tentative agreement, however, the state would defer payment of nine quarters of its contributions for teachers' retirement benefits. This results in current-year and budget-year General Fund savings of $508 million, as shown in Figure 1. Additional savings in 2003-04 are estimated at $441 million. According to STRS, the state would make up these deferred payments by increasing the state's contribution to STRS in the future—about $56 million beginning in 2004-05 and increasing annually with wage growth. Total General Fund costs—including 8 percent interest, which is the assumed rate of return on STRS investments—for deferring $949 million from the current year through 2003-04 would be about $3.3 billion over 30 years, as shown in Figure 2.

In exchange for deferring these contributions, the administration has agreed to support an as-yet-undetermined increase in benefits.

Proposals Are Costly; Costs Stretch Far Into Future

We recommend that the retirement proposals be rejected because they are very costly. These costs would total over $13 billion, be paid over many years, and tie up future state revenues. In present value terms, the proposal is equivalent to getting about $2 billion worth of fiscal flexibility at a cost of well over $4 billion.

Our review shows that for the amount of General Fund flexibility the state gets with the PERS and STRS agreements, the deferral proposals are extremely costly. As Figure 3 shows, these costs as currently structured would total over $13 billion and would last for the next 30 or so years, thereby reducing the state's fiscal flexibility for a long time to come. In present value terms (that is, adjusted for cheaper dollars in the future and foregone investment returns), this is equivalent to getting about $2 billion worth of fiscal flexibility at a cost of well over $4 billion.

The PERS Proposal Has Effective Interest Rate of About 20 Percent; STRS Rate Would Also Be High. The PERS proposal would cost the state about $9.8 billion over 30 years, assuming that the state does not pay back the deferred amount early. Our analysis shows that this is equivalent to the state paying an interest rate of about 20 percent in order to achieve one-time savings of $1.029 billion (including $621 million from the General Fund).

Because the additional benefits to be provided under the STRS agreement are not yet determined, total costs to the state for that proposal cannot be estimated. Consequently, the effective interest rate for the STRS proposal is unknown. Nonetheless, it would undoubtedly be significantly higher than 8 percent.

Interest Rates Higher Than the Market Rate. The interest rates charged to pay off the deferrals—8.25 percent for PERS and 8 percent for STRS—equal the rates of return the retirement systems assume they can achieve from investments. These rates are significantly higher than what the state would have to pay to borrow the funds in the private market, and are higher than the Pooled Money Investment Account (PMIA) rate. Thus, even if the state did not have to provide any additional benefits under either the PERS or the STRS proposal, the state would still be paying a premium to achieve the budget-year savings in state retirement contributions.

Special Funds Would Incur Cost for Unnecessary Deferral. The state's revenue problem principally affects the General Fund. However, the retirement proposals would result in budget-year savings to special funds as well, even though the state does not need to defer costs for these funds. As shown in Figure 3, special fund costs of the PERS proposal would total $3.3 billion over 30 years. While the deferred special fund contributions would not benefit the state's fiscal condition in the budget year, the additional cost that results could necessitate increases in various fees and taxes in the future.

Proposals Tie Up Future Funds. The PERS and STRS proposals would commit General Fund revenues for decades to solve a relatively short-term fiscal problem. As Figure 2 shows, beginning in 2006-07, the state would have to pay a total of $312 million for the proposals. This amount includes about $228 million in General Fund costs. These ongoing costs would reduce the state's fiscal flexibility by hundreds of millions of dollars for many years to come.

Analyst's Recommendation. Given these concerns, we recommend that the Legislature reject the proposed deferral of state retirement contributions to PERS and STRS and the additional retirement benefits as proposed. Instead, the Legislature should investigate other means of freeing up General Fund resources or reducing expenditures in 2002-03 that are less costly or have less impact on future revenues. Our office has made recommendations in this *Analysis* for the Legislature's consideration and also identified additional expenditure and revenue options in a companion publication.

SOFTWARE ENTERPRISE LICENSE AGREEMENTS

Current state practice allows each department to purchase and maintain its own software contracts for the same software product. Because of this practice, the administration generally does not combine its purchasing power and purchase software on a statewide basis. Through the use of Enterprise License Agreements (ELAs), which are software contracts encompassing the entire state, the administration could reduce state costs, improve automation cost estimates, and provide more consistent software support levels. We provide a number of suggestions and recommendations that can help the Legislature ensure ELAs are cost effective and beneficial to the state.

Background

When a department makes a determination that it needs a particular software product, the department contacts the software firm and negotiates the "best price" and contract terms and conditions that it can receive. Upon completion of contract negotiations, the department is responsible for making annual payments and ensuring that the software vendor meets the contractual agreements.

Problems With Current Software Acquisition Process. Since each department negotiates its own software contracts, the state does not combine its purchasing power to obtain software on a statewide basis. It also means that the price each department pays for the same software product line varies depending upon the department's software needs and its contract negotiation skills. Finally, the state's total cost for particular software products are unknown since the Departments of Finance and Information Technology do not require departments to report software needs and costs.

Enterprise License Agreements

An Enterprise License Agreement (ELA) is a software license contract that applies to an entire organization or "enterprise." In the case of the state, an ELA could encompass all or a combination of departments. An ELA will include annual contract payments and software specifications, and it can include sub-agreements such as volume purchase and maintenance agreements.

New Trend in Software Licensing. The ELAs are a relatively new trend in software agreements and provide government agencies with opportunities unavailable in the past. State ELAs allow large numbers of government agencies to use the same software product with one annual payment. Some states have already established forms of these agreements; however, ELAs vary depending upon the needs and size of the states' information technology operations. In May 2001, California entered into an ELA with the Oracle Corporation. At that time, the administration indicated its intention to enter into additional ELA contracts.

The ELA Benefits. State ELAs have the potential to reduce costs, improve automation cost estimates, and provide consistent software support for all state entities. State ELAs eliminate software price variations and reduce departmental resources being used for monitoring software contracts. In addition, software cost estimates of proposed projects would improve because the state would know before a software purchase the state's actual agreed upon cost of the software. A properly negotiated ELA would establish minimum and maximum levels of software support, thereby guaranteeing that the state would receive consistent software support across all departments. If the state combined its purchasing power, it could potentially acquire the software at a lower price than each department buying it separately.

Potential Risks With ELAs. State ELAs also pose a new level of risk for a state. For example, ELAs are generally multi-million dollar contracts covering several fiscal years, whereas departmental contracts are generally under a million dollars and are renewed on an annual basis. An ELA requires the state to enter into a contract that will obligate large amounts of funds over multiple years for one specific product. If the state fails to properly assess its current and future software needs, the state could be in a contractual agreement that does not meet its needs and yet still requires large annual payments.

Options for Developing a Successful ELA

In order to maximize benefits and reduce risks from ELAs, there are several steps the state should take in developing these types of contracts. In this section, we discuss some of those steps as summarized in Figure 1.

Conduct Statewide Assessment. Before beginning procurement activities, the state should first conduct a statewide assessment covering (1) the *reasons* an ELA makes sense at this time; (2) what it is that the state specifically needs from a statewide ELA, including the capacity, maintenance and support requirements; and (3) the costs and benefits of entering into such an agreement. In addition, the assessment must determine the strategy the state will use to transfer its existing contracts into the new contract.

Figure 1

Steps Necessary for Developing a Successful ELA

- ✓ Conduct statewide assessment
- ✓ Assign clear responsibility and assemble procurement team
- ✓ Use a modified competitive process
- ✓ Conduct independent "Best Price Analysis"

The state currently requires departments to complete Feasibility Study Reports (FSR) for large IT projects. The FSR, with some modifications, should be used as the mechanism to document the ELA assessment process, and can be used during ELA procurement activities and contract negotiations.

Assign Clear Responsibility and Assemble Procurement Team. Upon completion of the assessment phase, the state must assign a department to be responsible for conducting the procurement, negotiating the contract, and administering the contract. We would recommend that the Department of General Services (DGS) be assigned this lead role because DGS is responsible for other statewide procurements.

As it does on all large procurements, DGS will need to assemble a team of experts for the ELA procurement. However, this team should be composed of staff with strong negotiation skills, software acquisition expertise, and knowledge of the competing companies and their product lines.

Use a Modified Competitive Process. Current laws require that procurements over $25,000 be conducted through a competitive process. The traditional procurement approach includes issuing a request for a bid and then allowing multiple vendors to compete for the contract. However, since specific software is owned and manufactured by only one company, competitive procurements can be difficult. However, there are procurement methods that the state can use to ensure competition. For example, if the software is sold through resellers then the state can issue an invitation to bid to the potential resellers. If there is only one software vendor providing the product, then the state can use a "best value" contracting process that evaluates the proposal not just on cost but on other considerations such as increased support levels and price reductions on future products.

Conduct Independent "Best Price Analysis." Before signing the contract, the state should acquire services to conduct an independent analysis of the tentative agreement. It is important that the analysis be conducted by an entity uninvolved in the procurement and contracting processes to insure an objective evaluation of the tentative agreement. This analysis should compare the state's tentative agreement with government and private industry contracts of similar size and scope. The analysis should compare the agreement's costs, and the terms and conditions to determine if the state's agreement is competitive with other such contracts.

Contract Provisions in a Successful ELA

Since ELAs pose potential financial and programmatic risks to the state (as well as benefits), a successful ELA should also include a number of unique contractual terms and conditions or "provisions" aimed at specific factors within the software industry. We discuss the specific ELA provisions that we believe will minimize potential ELA risks and offer the most advantages to the state in more detail below.

Provisions That Address Uncertainties. Software products continually change, and software companies acquire and eliminate product lines on a routine basis. In addition, the software industry is continuously evolving with technologies that are more sophisticated and have more capabilities. For these reasons, the ELA should have provisions that protect the state from the uncertainties in the software industry. These provisions could either limit the duration of the contract or allow the state or the vendor to renegotiate the contract should specific circumstances occur. For example, in the event the software company announces that it will no longer support the software, the state or the vendor should be able to renegotiate the contract to eliminate the software support provisions.

Allows Flexibility in Software Rights. The ELA should include a number of provisions aimed specifically at software rights such as ownership, maintenance, support, transfer, upgrades, testing, and back-up systems. These provisions should provide enough flexibility to allow the state to move software from one location to another, from one computer to another, and allow its use during testing and on back-up systems without additional costs.

Legislative Oversight Needed

We believe ELAs with the provisions described above can provide many benefits to the state and help minimize potential risks. However, we believe the Legislature has an important oversight role in ensuring that these agreements are ultimately cost effective and beneficial to the state. While ELAs should be provided to the Legislature during the annual budget process, there may be circumstances in which this may not be possible. For this reason, we recommend that the Legislature add a new Budget Control Section to the budget to ensure that tentative ELAs are reviewed by the Legislature prior to obligating state funds. This will provide an opportunity to review the ELA proposal to ensure that a thorough statewide assessment and cost benefit analysis has been conducted and adequate protections have been implemented that minimize risks and meet the state's software needs. We recommend the Legislature adopt the following language:

> Sec. 11.10. (a) Departments are required to notify the Legislature prior to entering into an Enterprise License Agreement, not previously approved by the legislature, that obligates state funds in the current year or future years, whether or not the obligation will result in a net expenditure or savings. Departments are required to prepare a Feasibility Study Report documenting a statewide software assessment and cost benefit analysis. No less than 30 days prior to the effective date of the agreement, the Director of the Department of Finance shall notify in writing the Chairperson of the Joint Legislative Budget Committee, and the chairperson of the committee of each house of the Legislature that considers appropriations and that consider the state budget, of the state's intention to enter into Enterprise License Agreement. Each notification required by this section shall (1) explain the necessity and rationale for the proposed agreement; (2) identify the cost savings, revenue increase, or other fiscal benefit of the proposed agreement; and (3) identify the funding source for the proposed agreement.
>
> (b) The following definitions apply for the purposes of this section:
>
> (1) "Enterprise License Agreement" is a software license contract that can be used by multiple state agencies subject to both Chapter 7 (commencing with Section 11700) of Part 1 of, and Article 2 (commencing with Section 13320) of Chapter 3 of Part 3 of, Division 3 of Title 2 of the Government Code.

CLEAN ENERGY GREEN TEAM

Background

Chapter 329, Statutes of 2000 (AB 970, Ducheny), created the Clean Energy Green Team to facilitate the development and permitting of new electricity generation capacity in the state. This Green Team is to provide potential power plant developers with information regarding siting a power plant in California, including information on how to mitigate the environmental effects of a power plant. It was also charged with providing assistance to developers in obtaining essential "inputs" (natural gas, water, and air emission offsets), as well as assistance in working with local governments in obtaining local permits and ensuring their approvals. The Green Team is also to develop recommendations for establishing incentive financing programs for renewable and distributed energy resources. The Green Team is to remain in effect until January 1, 2004.

Green Team Members. In order to coordinate the expertise of many different departments in facilitating the development of new electricity generation in the state in a timely manner, the Green Team was comprised of members from several different state agencies. The Green Team consists of the following government entities:

- ***State Departments***. Heads of the Electricity Oversight Board, California Public Utilities Commission (CPUC), California Energy Commission (CEC), and the Governor's Office of Planning and Research.
- ***State Agencies***. Secretaries of Environmental Protection; Resources; and Technology, Trade, and Commerce.
- ***Local/Regional Entities***. Representatives from air quality management districts.
- ***Federal Entities***. Representatives from the Environmental Protection Agency, and Fish and Wildlife Services.

Accomplishments. The Green Team has produced several documents, including a developer's guide for building power plants in California and documents on air and water quality issues. Work was also done to facilitate communication between developers and state and local agencies, including several workshops that sought to coordinate the permitting process. Some of the 51 new power plant applications filed in the prior year and current year may have been facilitated by activities of the Green Team.

Eliminate Green Team Funding One Year Early

We recommend deleting funding for the Clean Energy Green Team, including $100,000 and 1 personnel year (PY) from Item 8660-001-0461 in support of the California Public Utilities Commission, and $132,000 and 1 PY from Item 3940-001-0001 in support of the State Water Resources Control Board.

Proposed Spending. While several agencies have been involved in the Green Team, only two have funds and positions in the budget that exclusively support Green Team activities. The CPUC has one limited-term staff attorney dedicated to Green Team activities through the end of 2003-04. This position is budgeted at roughly $100,000 a year from the CPUC's Utilities Reimbursement Account. Additionally, the State Water Resources Control Board also has a limited-term position dedicated to Green Team activities through the end of 2003-04. This position is budgeted at $132,000 and is supported by the General Fund.

Current Activities. We understand that the Green Team has not been actively engaged in any new activities since the accomplishment of those activities listed above. In addition, the recession and conservation efforts have contributed to lower consumer demand for electricity and lower electricity prices. In addition, over 2,000 megawatts (MW) of new electricity generation have come on-line in California over the past year. There is another 3,600 MW in construction to be on-line for next summer and 9,800 MW, comprised mostly of larger power plants, in construction and scheduled to be on-line by 2003. These combined factors have resulted in the CEC receiving fewer siting applications for new power plants over the past few months. Thus, the demand for additional resources to assist potential developers in developing proposals to build new power plants—beyond those already provided by the CEC and other agencies—is not needed. Therefore, we recommend deletion of the funding and positions dedicated solely to the activities of the Clean Energy Green Team.

DEPARTMENTAL ISSUES

General Government

DEPARTMENT OF INFORMATION TECHNOLOGY (0505)

The Department of Information Technology (DOIT) is responsible for ensuring that appropriate plans, policies, and procedures are in place to guarantee successful implementation of state information technology (IT) projects. The budget proposes $9.5 million ($8.8 million from the General Fund and $750,000 from reimbursements) for support of the department's operations in 2002-03, a decrease of $1.5 million, or 15 percent, above estimated current-year expenditures. The budget proposes 64 personnel-years for the department in the budget year.

REAUTHORIZATION OF DOIT

Authority for the Department of Information (DOIT) sunsets on June 30, 2002. Reauthorization provides the Legislature the opportunity to evaluate DOIT's performance, and make adjustments, as necessary, to ensure DOIT meets legislative directions. To this end, we assess DOIT's overall performance, discuss the difficulties it has had in meeting some of its mandates, and provide recommendations to the Legislature on how to adjust DOIT's responsibilities in the future.

Background

In 1995, the Legislature enacted Chapter 508, Statutes of 1995 (SB 1, Alquist) for the planning, implementation, and oversight of the state's IT activities. The Legislature determined that legislation was necessary in order to address multiple problems affecting the state's IT activities. Chapter 508 established DOIT with specific responsibilities intended to improve the state's ability to apply IT in a cost-effective manner and improve the Legislature's confidence in major IT initiatives. This legislation included a sunset date of July 1, 2000. Chapter 873, Statutes of 1999 (AB 1686, Dutra) subsequently extended the sunset date to July 1, 2002.

Reauthorization Provides Opportunity to Evaluate DOIT's Performance. Sunset dates are established in order to provide the Legislature an opportunity to evaluate performance when considering whether to reauthorize a department. In this review, we examine (1) each major area of DOIT's responsibilities, (2) the accomplishments and activities left undone by the department, and (3) the difficulties that DOIT has faced in meeting certain responsibilities.

Assessment of DOIT's Performance

We have identified four major categories of DOIT's responsibilities. For each of these categories, we review the specific mandated activities, DOIT's accomplishments, activities not yet addressed, and assess the extent to which DOIT has met legislative direction.

Based on our review, DOIT's overall performance of its legislative mandate has been one of limited success. In all of its major areas of responsibilities, DOIT has experienced some accomplishments and some misses. In its planning and policy role, DOIT has had the most success with most of its accomplishments occurring in this area. In its procurement role, DOIT has issued some policies but it has not issued all the policies directed by the Legislature. The DOIT has been unsuccessful in meeting a number of its mandates in the project review and oversight area. In the area of various miscellaneous IT activities, DOIT has had the least success with most of its mandated activities not being met. We have summarized our findings in Figure 1 and discuss them in more detail below.

Planning and Policy Development

The DOIT's primary role is to provide planning and policy guidance on the state's IT through the issuance of state plans and policies. The DOIT's major accomplishment in this category was planning the state's Year 2000 (Y2K) remediation efforts by setting the state's overall Y2K remediation policy, and establishing standardized Y2K reporting and oversight processes.

Figure 1

DOIT's Major Responsibilities, Accomplishments, and Activities Not Addressed

Accomplishments	Activities Not Addressed
Planning and Policy Development	
• Completed state's Y2K remediation activities. • Issued Statewide IT Plan. • Began review of department IT plans. • Completed a data center consolidation study. • Assisted DGS in transitioning the state to the new telecommunications network. • Drafted a policy on Operational Recovery Planning (ORP) and began reviewing department ORPs.	• Has not updated the statewide IT plan in five years. • Did not implement any initiatives identified in statewide IT plan. • Did not provide 2001 annual report to the Legislature. • Has not issued policies on system and information security, data confidentiality, and access to public records as directed by Legislature.
Project Review and Oversight	
• Reviews and oversees most state IT projects. • Issued five project-related policies. • Began reviews of Post Implementation Evaluation Reports. • Developed project and risk assessment tools.	• Does not document its basis for approving IT projects, ensure departments assess project risk, consistently use departments project reports as oversight tools, receive project updates from departments, and ensure that departments evaluate completed projects. • Has not issued policies on risk mitigation plans, project summary, project sizing, independent project oversight, project delegations, maintenance and operations, and project transmittal letters as directed by Legislature. • Provides limited information on its oversight activities.
Procurement	
• Has issued three policies.	• Has not issued policies on Letter of Credit and procurement alternatives.
Other IT Responsibilities	
• Has been involved in the state's IT staff recruitment and retention issues. • Began development of an on-line project inventory system.	• A wide range of miscellaneous activities have not been addressed. • Has not issued policies on project management training and intellectual property as directed by Legislature.

However, DOIT has also experienced some shortcomings in this category. For example, DOIT has not updated the statewide IT plan since 1997 and has not implemented any initiatives from that plan. In addition, DOIT has not issued a number of policies that the Legislature directed it to issue.

Timeframes Not Specified. One of the reasons that DOIT has experienced shortcomings in its planning and policy development role is that DOIT's enabling legislation did not specify timeframes for implementing many of its responsibilities thereby allowing each administration to establish its own priorities for DOIT. Without specific timeframes in which to implement its mandates, DOIT has been able to defer or not address many of its mandates.

Overlapping Policy Development Responsibilities. Another reason DOIT has had limited success is that its policy development and other areas of responsibilities often overlap with the responsibilities of several other departments. For example, DOIT's policy development responsibilities overlap with the Department of General Services (DGS), Department of Personnel Administration, Department of Consumer Affairs' Office of Privacy Protection, and Office of Emergency Services (OES). This overlap causes confusion as to which department is responsible for what activities. For example, the Government Code specifies OES is responsible for the state's disaster response and recovery, and DGS is responsible for business resumption planning, including the loss of electronic information. However, DOIT's enabling legislation states it is responsible for developing policies ensuring department business operations will continue to function in a disaster. The Government Code is unclear how OES, DGS, and DOIT's roles differ or may even be the same.

Project Reviews and Oversight

The second major area of responsibility is reviewing IT project proposals to ensure compliance with state policies and plans. The DOIT has the authority to approve or deny project proposals based on compliance with state policies and plans. In addition, DOIT is responsible for (1) monitoring on-going projects, (2) making recommendations for corrective actions, and (3) suspending or terminating those projects that are out of compliance with state policies. It reviews and oversees most state IT projects.

Since its establishment, DOIT has issued five policies related to project reviews and oversight. However, DOIT has not issued a number of policies that the Legislature directed it to issue. In addition, its project reviews and oversight activities are deficient according to the Bureau of State Audits (BSA) in its June 2001 audit of DOIT's mandated activities.

The DOIT Does Not Report Oversight Activities. The DOIT is ultimately responsible for approving, denying, or suspending all state IT projects. However, DOIT has never suspended or terminated a state IT project even though it has the authority to do so. According to DOIT, 14 percent of state IT projects require corrective action and 7 percent are at risk of failure. The DOIT states that it works with departments to correct project problems. However, the Legislature receives limited information on these corrective actions and their outcomes.

Procurement

The DOIT is responsible for issuing policies that improve the acquisition of state IT projects and services. Specifically, the policies should share risks with vendors, improve the acquisition process, and ensure projects are funded and scheduled in phases. Since 1995, DOIT has issued three policies related to procurement. However, DOIT has not issued all the policies that the Legislature directed it to issue. For example, the Legislature has directed DOIT to issue policies on Letter of Credit and procurement alternatives, and yet these policies have not been issued.

Procurement Role Conflicts with DGS. We believe DOIT has had limited success in its procurement role because DOIT's role conflicts with DGS's role as the state's procurement officer. The DGS has the responsibility of developing procurement policies and enforcing state procurement laws. The DGS and DOIT have had difficulties separating their policy development roles because IT procurement policy is a subset of overall state procurement policy and practices. Evidence of this overlap occurred during recent legislative testimony in which the Director of DGS indicated that the Government Code was unclear as to whether DGS or DOIT was responsible for software procurement policies, practices, and contracting.

Miscellaneous IT Activities

In addition to its three major areas of responsibilities, DOIT is also responsible for an assortment of miscellaneous tasks ranging from maintaining a project inventory system to promoting civil service reforms for the state's IT professionals. In this area, DOIT has been involved in the state's IT staff recruitment and retention efforts and is in the process of developing a project inventory system. However, DOIT has not implemented most of its responsibilities in this area. For example, DOIT was directed by the Legislature to issue policies on project manager training and qualifications and yet has not issued these policies.

Some Mandates Are Obsolete or Have Multiple Interpretations. We believe that one of the reasons for this lack of success is that many of these activities are either no longer relevant or the exact requirement is unclear. An example of an activity that is no longer relevant is establishing and maintaining criteria for advanced technology projects that were used in the 1980s to evaluate how well new technologies meet state program needs. Advanced technology projects are no longer used because state procurement methods changed allowing vendors to propose IT solutions for solving the state's program problems.

An example of an activity in which the mandate has multiple interpretations is identifying available IT resources from the public and private sectors. The mandate may mean that DOIT is responsible for recruiting IT staff from the private sector or it could mean that DOIT is responsible for creating a master service agreement of IT firms that the state has authorized as IT business partners. Either interpretation appears to be consistent with DOIT's current statutory authority.

Reauthorize DOIT and Correct Problems

It is important to both the administration and the Legislature to have oversight of state information technology activities. Because of its importance, we recommend that the Legislature reauthorize the Department of Information Technology (DOIT) for two years. However, we recommend that the Legislature, through the reauthorization process, (1) clarify DOIT's responsibilities and (2) direct the Bureau of State Audits (BSA), prior to 2004, to assess the extent to which DOIT has addressed its mandated activities.

Clarify DOIT's Responsibilities. As noted earlier, many of DOIT's activities overlap other department's responsibilities or are unclear as to legislative intent. The Legislature can strengthen DOIT's role by clarifying specifically what DOIT is expected to perform in its role, thereby reducing overlap and confusion between departments. The Legislature should also direct other departments to work with DOIT in meeting its mandates and set specific timeframes in which these tasks must be accomplished. The Legislature should clarify DOIT's mandates so there is no ambiguity about legislative intent. Finally, the Legislature should establish clear priorities, requirements, and timeframes in which DOIT must meet its mandated activities.

Extend DOIT for Two Years. We recommend that DOIT be reauthorized for two years. We further recommend that the Legislature direct BSA to conduct an audit evaluating DOIT's performance and the extent to which DOIT has met its mandated responsibilities by December 2003 to provide the Legislature with the information it will need when considering DOIT's 2004 reauthorization.

OFFICE OF THE INSPECTOR GENERAL FOR VETERANS AFFAIRS (0553)

The Office of the Inspector General for Veterans Affairs (OIGVA) was established in January 2000. The office was created to provide independent review of the operations and financial conditions of the state's veterans programs, such as the veterans' homes and the Cal-Vet Farm and Home Loan Program administered by the state Department of Veterans Affairs (DVA). The office also operates a toll-free complaint hotline for veterans.

The budget proposes total expenditures of $531,000 for the office in 2002-03, about $24,000 less than estimated current-year expenditures. General Fund expenditures would be $441,000, about $29,000 less than the estimated current-year level.

Office Workload and Staffing Issues

We find that the report submitted to the Legislature by the Office of the Inspector General for Veterans Affairs does not provide sufficient information to determine whether its staffing is adequate to meet its statutory responsibilities.

Supplemental Report. The *Supplemental Report of the 2001 Budget Act* directed the OIGVA to report to the Legislature by December 1, 2001 regarding: (1) the office's statutory requirements, (2) the funding necessary to comply with its statutory responsibilities, (3) workload measures and performance standards the office would use to evaluate its compliance with its statutory responsibilities, and (4) a staffing schedule for meeting its workload measures and performance standards. The language also directed the Legislative Analyst to comment on the findings and recommendations in OIGVA's report. We received this report on January 17, 2002. Accordingly, we provide our comments below.

Statutory Requirements. The report fully documents the office's statutory requirements. Those requirements include review of the veterans' homes, the Cal-Vet loan program, other programs such as the County Veterans Service Offices, and any investigations involving DVA employee misconduct. The requirements also include an obligation to respond to requests for information from the Governor, the California Veterans Board, the secretary of the department, the Veterans Home Allied Council, the Legislature, and veterans receiving services.

Funding Needed to Comply with Statutory Requirements. The OIGVA's office consists of the OIGVA, one investigator, one auditor, and an executive assistant. The OIGVA's budget also contains some funding that the OIGVA has used to hire retired annuitants on a temporary basis to assist with its workload. Although the office had requested additional positions in past years, the office has not requested or provided justification for augmenting their staff for the budget year. The OIGVA reports that its current funding and staffing levels are adequate to meet its statutory responsibilities. Although current funding and staffing may be adequate, as we discuss further below, the report does not substantiate this finding.

Workload Measures and Performance Standards. The OIGVA's report indicates that professional auditing standards are used in determining workload. Those standards are used in developing the office's annual audit plan, which includes a summary of the number of hours budgeted for scheduled audits. The report contains the audit plan for 2001-02.

Further, the report refers to the office's strategic plan as containing the office's performance measures used to evaluate the effectiveness of the audit and investigative work. We have reviewed a draft of the plan. The performance measures listed appear to be reasonable and complete for evaluating the office's compliance with most of its statutory responsibilities.

Staffing Schedule. The staffing schedule submitted by OIGVA accounts for the office's allocation of staff time for direct auditing work that is 35 percent of the budgeted time for full-time staff. However, the staffing schedule does not account for other anticipated workload. For example, the plan does not account for the staff time that would be devoted to handling complaints and conducting investigations, or for indirect activities such as administration, budget, or planning.

Although the workload associated with many of the office's responsibilities (such as conducting investigations) may be difficult to predict, the absence of this information from the report means the staffing schedule that was submitted is incomplete. Therefore, it is difficult to assess from the information contained in the report whether the staffing provided to the office is adequate to meet its responsibilities.

Internal Control Reviews Not A Clear Priority

We recommend that the office report at budget hearings on the relative priority the office is placing on completing internal control reviews, and that the office provide the Legislature with its schedule for completing internal control reviews in the current and budget years.

Responsibility for Internal Control Reviews. The state's Financial Integrity and State Manager's Accountability Act (FISMA) requires that certain internal control reviews be completed for every state agency every two years. These reviews are important because they reveal critical information about the financial and administrative management of the department and provide the basis for any corrective action that the department needs to take. These reviews previously were the responsibility of DVA's internal auditors. They effectively became OIGVA's responsibility upon the creation of that office.

The FISMA also requires state agencies to report to the Department of Finance on the adequacy of their internal control reviews every odd-numbered calendar year. According to a recent report by the Bureau of State Audits (BSA), DVA had not filed such reports since 1995. We are advised that DVA did, however, file a report for 2001.

The OIGVA's report indicates that one permanent position, with help from retired annuitants that have been devoted to such review work, is sufficient to conduct the priority internal control reviews within the time limits established under state law. Further, the OIGVA's audit plan described above allocates time to perform four internal control reviews. However, as of January 2002, the OIGVA had conducted only one of the four internal control reviews. Given that each review is budgeted for 564 hours (equivalent to 14 weeks for one person's time), it is unclear whether the office can complete the scheduled reviews before the end of the fiscal year. Notably, the internal control reviews are not identified as one of the major goals in the office's draft strategic plan. As a result, it is unclear whether the completion of these reviews is a priority for the office.

Analyst's Recommendation. In our view, it is important that DVA's internal control reviews be completed within the timelines established in state law. However, it appears that the OIGVA may be having difficulty fulfilling its responsibility to carry out these reviews, even though it says it has the staffing it needs to do so. Accordingly, we recommend that the OIGVA report at budget hearings on the relative priority the office is placing on completing internal control reviews, and that the office provide the Legislature with its schedule for completing internal control reviews in the current and budget years.

DEPARTMENT OF INSURANCE
(0845)

In California, the Department of Insurance (DOI) is responsible for regulating insurance companies, brokers, and agents in order to protect businesses and consumers who purchase insurance. Currently, there are about 1,400 insurers and 230,000 brokers and agents operating in the state.

The budget proposes total expenditures of $166 million for DOI in 2002-03. This is $2.4 million, or 1.5 percent, more than estimated current-year expenditures. About 98 percent of the proposed expenditures will come from the Insurance Fund, which derives its revenues from regulatory assessments and fees.

Shift Funding for Tax Collection and Audit Program

We recommend that the baseline of $1.1 million for the Tax Collection and Audit program be funded from the Insurance Fund instead of the General Fund. We further recommend the enactment of legislation to provide funding for the tax collection and audit function from the Insurance Fund on an ongoing basis. (Delete $1,131,000 from Item 0845-001-0001 and add $1,131,000 to Item 0845-001-0217.)

Insurance companies are required to pay a tax based on gross premiums. The tax generates $1.3 billion annually. The Tax Collection and Audit program within DOI is responsible for auditing all tax returns filed by insurance companies and brokers, as required by law. The department has four years to assess filers for unpaid taxes. The DOI completed nearly 1,400 audits of more than 2,300 returns filed in 2000. This included 1,329 desk reviews of filed returns and 53 on-site audits. This resulted in additional premiums tax assessments of $9.5 million, or 0.7 percent of premiums tax revenue, and $12 million in penalties and interest.

Up until 1996-97, the tax collection and audit program was funded from the Insurance Fund. The department eliminated the program that year because of Insurance Fund revenue shortfalls requiring staffing cuts. Chapter 894, Statutes of 1997 (SB 512, Committee on Insurance), reestablished the program for 1997-98 with $908,000 from the General Fund, which has supported the program since that time. The current-year program level is $1.1 million.

Ensuring that insurance companies and brokers pay all premiums taxes due is part of the department's regulatory function. Therefore, it is appropriate that the program be supported from the Insurance Fund, which generates revenue from regulatory assessments and fees, as noted above. Accordingly, we recommend that baseline program funding of $1.1 million be paid from the Insurance Fund instead of the General Fund. We further recommend the enactment of legislation to provide funding for the tax collection and audit function from the Insurance Fund on an ongoing basis.

Augmentation for Tax Collection and Audit Program Not Necessary

We recommend that the General Fund request for $636,000 and seven positions to increase the number of gross premiums tax audits be rejected because it is not cost-effective to audit all insurers each year. We further recommend the enactment of legislation to (1) eliminate the requirement that DOI audit all tax returns filed by insurance companies and brokers and (2) direct the department to prioritize tax audits. (Delete $636,000 from Item 0845-001-0001.)

The budget proposes an additional $636,000 and seven positions (from the General Fund) to audit all returns within a year of filing and to perform more on-site audits. In our view, it is unnecessary and not cost-effective to audit *all* tax returns. Rather, DOI should prioritize audits within existing resources, as the Board of Equalization (BOE) and Franchise Tax Board (FTB) do. For example, BOE audits about 3 percent of sales tax accounts each year, focusing on sales activities and records that are most likely to be reported incorrectly. Similarly, FTB audits less than 1 percent of all personal income and bank and corporation tax returns each year. Furthermore, DOI has four years to issue additional tax assessments so it is unnecessarily costly to complete all audits within one year of the filing date. Consequently, we recommend deletion of this request. We further recommend the enactment of legislation to (1) eliminate the requirement that DOI audit all tax returns filed by insurance companies and brokers and (2) direct the department to prioritize tax audits.

Additional Funding Authority Should Await Progress on Staffing

We withhold recommendation on budget bill language that authorizes additional expenditures related to filling vacant positions until the Department of Finance provides the following at budget hearings: (1) information on DOI's progress in filling vacancies, (2) an estimate of the funding level needed to support the filled positions as well as DOI's need for positions that are still vacant, and (3) whether the proposed language is needed in 2002-03.

The DOI has historically used excess salary savings from vacant positions to fund operating expenses. For the current year, as part if its efforts to reduce this practice and eliminate vacant positions, the Legislature adopted language that authorizes the Department of Finance (DOF) to augment DOI's appropriation by up to $4.9 million, with 30-day notification to the Legislature, to fund vacant positions. The language prevents DOI from siphoning funds from staff support to pay for operating expenses and creates an incentive for the department to fill a significant number of vacant positions it claimed to need.

The same language is proposed for 2002-03. We withhold recommendation on the language to provide DOI the same flexibility as in the current year. At the time this analysis was prepared, we understood that DOF was awaiting the department's report on its progress in filling vacant positions in the current year and the need for additional funds. Depending on the number of vacant positions filled, the 2002-03 budget may have to be adjusted to provide ongoing support for these positions and the necessity of the language reconsidered. Given the forthcoming report to DOF, we withhold recommendation on the proposed budget language. We further recommend that DOF provide information at budget hearings on DOI's progress in filling vacancies, including an estimate of how much the department would need in additional funds to support these positions through 2002-03, and whether the proposed language is still needed for the budget year.

BOARD OF EQUALIZATION
(0860)

The Board of Equalization (BOE) is one of California's two major tax collection agencies. In terms of its responsibilities, BOE: (1) collects state and local sales and use taxes, and a variety of business and excise taxes and fees, including those levied on gasoline, diesel fuel, cigarettes, and hazardous waste; (2) is responsible for allocating tax proceeds to the appropriate local jurisdiction; (3) oversees the administration of the property tax by county assessors; and (4) assesses railroad and specified utility property. The BOE is also the final administrative appellate body for personal income and corporation taxes that the Franchise Tax Board (FTB) administers, as well as for the taxes that BOE administers. The BOE is governed by a constitutionally established five-member board—four elected members and the State Controller.

The *2002-03 Governor's Budget* proposes approximately $311 million in support of BOE operations, of which roughly $193 million is from the General Fund. This proposal represents a decrease of about 2.5 percent in total support, and about 3 percent in General Fund support, from estimated expenditures in the current year.

Audit Activities Deserve Annual Assessment

We recommend adoption of supplemental report language directing the Board of Equalization to report annually to the Legislature regarding its audit and related compliance activities.

BOE's Audit Activities. The BOE maintains an audit program whose mission is to ensure that businesses accurately report sales and use taxes (SUT) that are due to the state. The BOE audits approximately 3 percent of active registered sellers' accounts each year, concentrating on those considered most likely to be inaccurate in their tax reporting. The BOE's audit and compliance activities result in approximately 2 percent of the state's (General Fund only) SUT revenues—in excess of $450 million.

Audit Report Found Problems. In the early-to-mid 1990s, the Legislature approved an additional 250 auditing staff (200 in 1992-93 and 50 in 1995-96) to supplement BOE's existing auditing activities. According to a March 1999 Bureau of State Audits (BSA) report, the revenues raised from these additional auditing positions fell well short of BOE's estimates, for several reasons:

- Failure to account for staff vacancies.
- Decline in audit hours by experienced staff due to training responsibilities.
- Deployment of authorized audit positions to audit support activities.
- Lower-than-expected productivity for newly hired auditors.

It is noteworthy that the BSA report did not point to a lack of "quality" accounts to audit as a significant reason for the shortfall in audit collections.

Recent Actions Affecting the Audit Program. The 1999-00 budget requested an additional 116 personnel years (PYs) to conduct BOE audit activities. These positions, however, were not approved by the Legislature. Then, in 2001-02, 50 PYs were shifted from the audit program to collections activity on a temporary basis. This was undertaken based on the expectation that the return from collection-related activities was higher than for audit-related activities. To date, the shift appears to have been successful in increasing overall revenues. It is currently anticipated that these positions will revert to audit activities beginning in 2003-04.

The result of these actions is that BOE has not received an increase in budgeted audit positions in recent years, and, in fact, has seen a diversion of resources to other activities. In addition, a systematic appraisal of the benefit-cost ratio of the BOE's audit and compliance activities has not been conducted since the BSA study released in March 1999, which in turn, was based on data from 1997-98.

Concerns Exist Regarding Audit Vacancies. The BOE has noted in its response to the BSA report that two of the major difficulties that it faces in its audit program are: (1) keeping its professional audit positions filled, and (2) the rapid turnover that exists in the program. According to the board, the inability to fill positions in the past has resulted in the hiring of support staff and less highly trained professionals to carry out the audit activities. In addition, the relatively high turnover has resulted in higher training costs than would occur with a more stable workforce.

LAO Recommendations. In the past, we have raised concerns with respect to the Legislature's lack of sufficient information to review the board's methodology for estimating the increased revenues from additional auditing. Although BOE's response to supplemental report language in November 1997 and the BSA audit provided valuable information to the Legislature, these were conducted several years ago, and no information is provided on a regular basis to the Legislature regarding these audit-related revenue issues. In addition, no recent formal reports have addressed the board's compliance activities.

Given the importance of audit and compliance activity, both for the integrity of the tax system as well as for revenue purposes, we recommend that the Legislature institute an annual reporting requirement regarding BOE's audit and compliance activities. The Legislature requires a similar report from the FTB. The purpose of the report would be to give the Legislature information necessary to evaluate the appropriate level of resources to devote to the audit and compliance activity by the BOE, and address the issue of vacancies in the audit and compliance programs. In addition, this report, coupled with the existing annual report from FTB, would help the Legislature determine the appropriate allocation of audit and compliance activity between the state's two main tax agencies.

We recommend that the Legislature adopt the following supplemental report language:

> The Board of Equalization (BOE) shall provide to the Chair of the Joint Legislative Budget Committee and chairs of the fiscal committees of the Legislature by December 1 of each year, beginning December 1, 2002, a report containing the following information: (1) description of the methodological approach used to conduct its audit and compliance activities, including the work plan relating to these activities; (2) the number of hours and costs associated with direct audit and compliance activities, as well as supporting (overhead) activities; (3) the revenues associated with its audit and compliance activities; and (4) data regarding the revenue and cost impacts associated with any increase or decrease in resources devoted to audit and compliance activities. Items 2, 3, and 4 should include prior-year actual data, current-year estimated data, and budget-year projected data. This information shall also be provided to the Department of Finance, in a format it specifies, with submission of documents used to prepare the Governor's budget as well as when BOE makes a request to alter funding or personnel services for audit or compliance activities. Such information shall also be provided as a part of any budget change proposal submitted to the Legislature regarding resources for auditing or compliance activities.

Keep an Eye on Investigations

We recommend that the Board of Equalization monitor closely any adverse effect on General Fund revenues of shifting the focus of its investigations activity, so as to protect the sales and use taxes revenue stream, and report to the Legislature by December 1, 2002 on its findings.

The BOE's investigation activities involve responding to reports of tax fraud and evasion. For the budget year, the direct cost of staffing for the investigations division is approximately $3.3 million. The budget proposes a shift of funding for investigations from the General Fund to special funds in response to a shift in investigations from SUT to Cigarette and Tobacco Tax evasion. This funding shift is to occur for both the current year as well as the budget year. While this results in a reduction in General Fund costs of roughly $600,000 annually, we are concerned that General Fund revenues could suffer from this shift in resources. This could occur, for example, if the investigations division were unable to respond appropriately to compliance issues related to the SUT. We therefore recommend that the Legislature require that the board monitor shifts in investigations activity closely to protect the SUT revenue stream. Adoption of the following supplemental report language would be consistent with this recommendation:

> The Board of Equalization shall provide to the Chair of the Joint Legislative Budget Committee and chairs of the fiscal committees of the Legislature by December 1, 2002, a report that contains the following information: (1) a description of the methodology and approach used in allocating investigations resources among the various tax programs; (2) actual or estimated data regarding the number of investigation cases, associated workload, and revenue impacts for each tax program for the prior, current, and budget years; and (3) data regarding additional investigations workload that is currently not funded.

STATE TREASURER
(0950)

The State Treasurer has a number of responsibilities related to the management of the state's financial assets. These responsibilities include:

- Providing custody for all money and securities belonging to or held by the state.
- Investing temporarily idle funds.
- Paying warrants and checks drawn by the State Controller.
- Preparing, selling, and redeeming the state's general obligation and revenue bonds, as well as the short-term notes used for cash-flow borrowing.

The Governor's budget proposes expenditures totaling $26 million for the Treasurer's office in 2002-03, which represents a decrease of 17 percent from current-year expenditures. The request includes $12 million from the General Fund, a 28 percent decrease from 2001-02. This decrease is primarily related to reduced expenditures for the second phase of the office's debt management system.

Added Positions For Tobacco Securitization Not Justified

We recommend the Legislature delete $220,000 because additional positions are not needed to implement and manage the administration's proposed Tobacco Securitization Bond Program. (Reduce Item 0950-001-0001 by $220,000.)

Background. The Governor's budget includes $140,000 in the current year and $220,000 in the budget year for two new permanent positions to implement and manage the Tobacco Securitization Bond Program. This program is being proposed by the Governor to raise $2.4 billion in cash to help balance the General Fund budget (for a detailed discussion of this proposal, see *Securitization of Tobacco Settlement Revenues* in the Health and Social Services chapter of this *Analysis*). We understand that the administration will be seeking statutory authorization for this program and the $140,000 in current-year funding in a separate bill. The Treasurer's office asserts that these permanent positions are needed because of the complex nature of the tobacco securitization bond sales and the ongoing need to manage variable rate debt that may be sold under the program.

Additional Positions Not Merited. We agree that the sale of bonds backed by revenues from the tobacco settlement will be a complex undertaking, involving a variety of legal and financial issues not normally associated with bond sales. However, we would expect that the great majority of these tasks will be handled through contracts with firms from the Treasurer's existing pool of financial advisors, bond counsel, and underwriters—many of which have experience with issuing tobacco securitization bonds. These expenses are normally paid for from the bond proceeds.

Furthermore, as a practical matter, it is highly unlikely that internal staff could be hired and "brought up to speed" in time to assist in the issuance of the tobacco securitization bonds, given the accelerated schedule anticipated for their sale. As an example, we would note that prior to the implementation of the hiring freeze, the Treasurer had filled only one of the seven positions authorized in 2001-02 for implementation of the electricity bond sale and the office's variable rate bond program.

Regarding the need for ongoing positions associated with the tobacco bond program, the main justification offered by the office is increased workload associated with management of variable rate debt. Based on our discussions with local issuers of tobacco settlement bonds, it is unclear whether variable rate bonds could be used for this type of issue, given the uncertainties that variable interest rates would add to calculations involving annual payments and reserve requirements needed to secure tobacco-related bonds. Even if variable rate debt were issued, however, we believe that the added ongoing workload could be easily accommodated within the office's existing budget, given that four new permanent positions were authorized this year for management of variable rate debt.

Analyst's Recommendation. Given the above, we recommend that the Legislature deny the proposal for additional staff relating to tobacco securitization bonds for a savings of $220,000 in the budget year.

FRANCHISE TAX BOARD
(1730)

The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies. The FTB's primary responsibility is to administer California's Personal Income Tax and Bank and Corporation Tax laws. The FTB also administers the Homeowners' and Renters' Assistance Program (HRA), the Political Reform Act audit program, and the Household and Dependent Care Expense Credit (HDCEC) program. In addition, FTB administers several nontax programs, including collection of child-support and other court-ordered payments. The FTB is governed by a three-member board, consisting of the Director of Finance, the Chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the board, administers the daily operations and functions of FTB.

The Governor's budget proposes $437 million ($398 million General Fund) and 5,888 positions in support of FTB's operations. The total amount of support is approximately the same as the department received in the current year, with a slight increase ($1.5 million) in General Fund support. The largest areas of reductions in the budget are associated with (1) savings from the electronic filing of tax returns, (2) savings in the Integrated Nonfiler Compliance project, and (3) staffing reductions, especially affecting customer service. On the other hand, the budget proposes substantial increases in staffing in its audit and compliance programs.

Audit Proposal Needs Careful Review

We withhold recommendation on the administration's request for an augmentation of $4.6 million to increase its Bank and Corporation Tax auditing activities, pending receipt of additional information regarding the feasibility of hiring and training the proposed staff on a timely basis. In addition, we recommend that a proposed shift of existing staff from audits with longer-range benefits to audits with more immediate revenue impacts be limited to a two-year period, so as to preserve the overall effectiveness of the audit program.

FTB's Audit Activities. The audit division of FTB is designed to encourage compliance with the state's tax laws by administering the audit function in an equitable and responsible manner. For purposes of administering the audit program, the benefits (revenues) are compared to the costs involved for a particular type of case, in order to calculate a benefit-cost ratio. Audit cases are then ranked according to this ratio, with the FTB typically seeking funding for all cases with a benefit-cost ratio of 5:1 or greater (based on the net proposed tax assessment).

FTB Proposal. The FTB's budget-year proposal includes an additional $4.6 million for more audit activities with respect to BCT taxpayers. The department expects this additional cost to result in a revenue gain of $52 million in the budget year as a result of the increased auditing activities.

The board's proposal involves hiring new staff in the eastern regional office of FTB, as well as shifting resources within the audit program. The proposal would shift resources from audits with longer-term revenue benefits to audits with more immediate revenue impacts. The first category of audits—which FTB calls discovery and claims audits—is designed to identify issues associated with tax reporting, new tax law implementation, emerging audit trends, and tax overpayments. These audits result in longer-term benefits by assuring continued effectiveness of the audit program and protecting existing revenues. The board indicates that the budget proposal would allow staff currently working on these discovery and claims audits with benefit-cost ratios of below 5:1 to shift to audits that are expected to have immediate revenue impacts of above 5:1.

Issues Exist Regarding Hiring, Training, and Retention. The FTB has discounted its estimate of revenues to be generated by the proposed new staff to account for training and "learning curve" issues associated with the first year of employment. We are concerned, however, that additional training may also be required for those audit staff being shifted from discovery and claims audits to audits with near-term revenue effects and, as a result, the revenues from this aspect of the proposal may be overstated.

In addition, with respect to the shift in auditors, the discovery and claims audits of the FTB provide important information regarding emerging trends that can have implications for how audit activities should most appropriately be managed. Consequently, a permanent shift of resources away from this program component could affect the future overall effectiveness of the audit program and, ultimately, tax compliance.

Finally, reports issued in 1999 by the Bureau of State Audits regarding the audit activities of the FTB and the Board of Equalization suggested difficulties associated with the hiring and retention of auditors. This was cited as one reason for the failure of previous augmentations to generate the expected revenues. Given that FTB currently has some unfilled audit positions, the availability of a qualified labor force is of some concern.

LAO Recommendations. We concur in FTB's efforts to devote the appropriate resources to audit activities that are expected to result in revenue generation in the budget year. Nevertheless, we recommend the following regarding the FTB proposal:

- The shift of staff from discovery and claims audits to audits generating near-term revenues should be conducted on a two-year basis to protect the long-term effectiveness of the audit system.
- The FTB should provide additional information at budget hearings regarding the effect on projected revenues of any additional training required by staff that are reallocated from one type of audit to a different audit program.
- We withhold recommendation regarding the increase in the FTB's budget to hire new staff pending receipt by the Legislature of additional information from the department at budget hearings regarding the feasibility of filling these audit positions in a timely manner and retaining staff.

Settlement Activities Could Benefit From Temporary Boost

We recommend that the Legislature augment the budget in order to expand settlement activities that could generate increased General Fund revenues of $14.1 million. (Augment Item 1730-001-0001 by $520,000 and recognize additional General Fund revenues of $14.1 million.)

Settlement Activities. The FTB is authorized to conduct a voluntary settlement program with taxpayers in order to accelerate the resolution of specific tax disputes. The acceleration of tax disputes meets the department's efficiency objective by reducing otherwise lengthy and costly administrative and court litigation procedures in order to finalize assessments and claims. The FTB's settlement authority functions in a manner similar to that of an equivalent federal program.

Supplemental Report Is Late. Last year, the Legislature raised questions regarding tax assessment regulations and the implementation of deadlines with regard to the settlement program. The Legislature approved supplemental report language requiring the FTB to evaluate the current tax assessment protest process, including time frames for each phase of the process. This report was due to the Legislature by December 10, 2001, but has not yet been issued. Consequently, we have been unable to evaluate the FTB's progress in resolving settlement cases. In our discussions with FTB staff, however, they have indicated that they are completing the resolution of settlement cases in a timely manner and that cases totaling approximately $1.9 billion in value are expected to be settled by the end of the fiscal year.

Backlog Warrants Additional Staff. Based on our review, there is an existing inventory of approximately 180 cases that could be "worked down" in the next three to four years, assuming that staffing is sufficient to conduct this work. In our discussions with FTB, it indicated that four additional staff attorneys for the settlement program (at a cost of $520,000) would generate an additional $14.1 million in revenues in the budget year. This revenue estimate takes into account training costs for additional staff, lower productivity in the initial year, and the probable final resolution regarding any subsequent appeals.

LAO Recommendation. Given the state's current fiscal situation, we recommend that the Legislature provide funding for additional settlement activity by augmenting FTB's settlement program by $520,000. We recommend that the additional support for settlement activity occur for a period of two years, with renewal subject to legislative review.

Concerns With Proposed Collection Augmentation

We withhold recommendation on the administration's request for an augmentation of $6.2 million to increase personal income tax collection activities. We recommend that the Legislature require the board to report at budget hearings regarding the timing and feasibility of hiring additional staff.

FTB Collection Activities. Tax collection activities involve collections of accounts receivable that are established by the board's self-assessment, audit, settlement, and filing enforcement activities. An automated billing system, combined with central and field office collections staff, administers the collections activity. The automated billing system initiates the billing process and accounts for tax revenues collected from voluntary compliance. The board's collections staff conducts manual collection efforts to ensure that nonvoluntary taxpayers pay the appropriate amount of taxes. As with its audit activities, FTB typically seeks funding for collection activity that result in a benefit-cost ratio of 5:1 or higher.

FTB Proposal. The board seeks an additional $6.2 million and 78.8 personnel-years (PYs) for additional collection activity above the 5:1 benefit-cost ratio. The board indicates that this additional activity will result in $27.5 million in revenue in the budget year and $55 million on an ongoing basis. The additional workload identified by FTB is in the areas of: (1) system enhancements, which have allowed a more efficient means of determining the best possible account to be collected; (2) bankruptcy cases, which have been growing at a faster rate than projected; and (3) discretionary workload, consisting of a variety of miscellaneous cases.

Although the board's request appears reasonable, we are concerned about the likelihood of hiring qualified staff by the July 1, 2002 date indicated in the proposal. We therefore withhold recommendation regarding the increase in the FTB's budget to hire new staff pending additional information from the department.

Customer Service Program Should Be Adjusted

We recommend that the administration's proposed reductions in customer service programs be adjusted to minimize the inconvenience to taxpayers. This adjustment would result in additional reductions in district office staff to fund an increase in call center activities. In addition, we recommend that the board investigate changes that would result in covering the costs of the tax practitioners' telephone hotline by establishing a fee for this service. (Redirect $800,000 within Item 1730-001-0001.)

Customer Service Program. The FTB maintains a program that provides information and assistance to taxpayers and professional tax practitioners. Taxpayers may receive assistance from FTB through four channels: (1) a centralized call center with automated and staffed responses, (2) written correspondence through the FTB central office, (3) walk-in accessibility through one of the 16 FTB field offices located throughout the state, and (4) Internet access through the department's web site.

The department's call center reaches the greatest number of taxpayers, serving approximately 2.7 million calls per year. Written correspondence is limited to approximately 200,000 inquiries, and use of the Internet is currently relatively limited. While district offices experience limited taxpayer contact, they provide an important resource to taxpayers with collections issues as well as participants in the HRA.

Tax practitioners, in contrast, have access to a higher level of tax expertise than do general taxpayers, through FTB's Tax Practitioner Support Team (TPST). This service offers free technical advice to attorneys, enrolled agents, and certified public accountants. The TPST program is staffed by customer service specialists and auditors.

Proposed Customer Service Changes Should Be Fine-Tuned. As a means of achieving General Fund savings, the budget proposes to reduce funding for the centralized call center by $800,000 and 21 PYs. If the Legislature agrees to a reduction in customer service, we believe cuts should be taken in a different area in order to reduce the inconvenience to taxpayers. In 2000-01, the call center received 2.9 million calls and answered 2.7 million. The proposed reduction will increase the percentage of calls that go unanswered as well as increase the waiting time per call. While the department is unable to provide us with an estimate of the magnitude of these changes, it is likely to reduce the effectiveness of this program. The budget-year reduction would come in addition to a 12 PY reduction in the current year.

Limit Public Service at District Offices. Currently, the most expensive means of taxpayer assistance is the public service activities that occur at the department's 16 field offices. In order to capitalize on the efficiencies of the call center, we recommend the department restrict or eliminate public service activities at certain field offices. For example, eliminating public service activities at 11 of its 16 offices (while still providing this service at its offices in Oakland, Los Angeles, Sacramento, San Diego, and Santa Ana) would reduce costs by at least $800,000. We recommend that this savings be redirected to the call center in order to maintain its current-year level of resources. It is our understanding that the great majority of assistance provided through the district offices can be addressed directly through the call center. We further recommend that this option be carried out on a two-year trial basis in order to monitor the effect on taxpayers and HRA participants, as well as on department costs.

Charge for Tax Practitioner Program. The board spends approximately $800,000 a year on the TPSP, which handles about 160,000 calls annually. We believe that the costs of this technical tax assistance program should be considered a "cost of doing business" for tax practitioners. Therefore, we recommend that the costs be borne, at least partially, by the professional tax business community as opposed to taxpayers in general. While a charge per call is not feasible without the board investing in more complex (and expensive) telephone infrastructure, an annual fee for a certain amount of use would be feasible, according to the department. We recommend the Legislature direct the department to explore this option and report its findings prior to budget hearings, including an estimate of an appropriate fee and a means by which to assess it.

E-Filing Requirement Should Be Expanded

We recommend that the budget proposal requiring e-filing for all tax practitioners filing 100 or more returns use a more reasonable savings estimate, and be expanded to require e-filing for those filing 50 or more returns. (Reduce Item 1730-001-0001 by $1 million.)

The budget proposes that professional tax preparers who file 100 or more tax returns be required to file these returns electronically. The savings from this requirement is estimated by FTB to range from $2.2 million to $3.4 million annually, based on an increase in e-filings of from 2.5 million to 4 million. This change would affect 10,000 of the approximately 40,000 tax professionals doing business in California. We believe that FTB's savings are underestimated since they are based on the lower bound estimate of the number of returns. If a mid-point were used, FTB would realize an additional $600,000 in savings.

In addition, we recommend that the e-filing requirement threshold be further reduced to include all those professional tax preparers who file 50 or more returns. The filing of 50 tax returns or more constitutes a significant business activity, and warrants an e-filing requirement. Assuming that this lower requirement would result in an increase in e-filings of roughly 500,000, we estimate additional savings of $440,000. Together, our estimate of the additional savngs from the administration's proposal and the savings from an expanded e-filing requirement total approximately $1 million.

Household and Dependent Care Expense Credit

We recommend that the Franchise Tax Board report prior to budget hearings regarding the actual and expected costs associated with administration and compliance activities for the Household and Dependent Care Expense Credit.

Pursuant to Chapter 114, Statutes of 2000 (AB 480, Ducheny), the Legislature approved the Household and Dependent Care Expense Credit (HDCEC) for tax years beginning in 2000 and thereafter. The program allows a refundable credit to be taken as a percent (varying with income level) of household and dependent care expenses incurred as necessary costs to sustain employment. The credit is based on a percentage of the federal nonrefundable credit known as the Child and Dependent Expenses credit, and is dependent on taxpayers' California adjusted gross income. The credit ranges from 63 percent of the federal credit for taxpayers with incomes of $40,000 or less, to 42 percent for those with income not exceeding $100,000. The credit is not available to those with incomes of greater than $100,000.

Program Administration. The FTB is budgeted $3.8 million for HDCEC program administration, fraud detection, prevention, and investigations in 2002-03. This amount is based on processing a level of claims assumed for the first year this credit was in effect. Actual experience has been much less than that originally projected amount. Thus, the board may be overbudgeted for the administrative costs of the program.

LAO Recommendation. Since the board now has access to more complete data, it should be able to provide a firmer estimate regarding its administrative costs. Therefore, we recommend that FTB report prior to budget hearings on HDCEC projected filings and associated workload.

STATE PERSONNEL BOARD
(1880)

The State Personnel Board (SPB) has the authority under the State Constitution and various statutes to adopt civil service rules and regulations. An executive officer appointed by the board is responsible for administering the merit aspects of the state civil service system. (The Department of Personnel Administration administers the nonmerit aspects of the state's personnel systems.) These duties include, but are not limited to, adopting classifications within the State Civil Service System, conducting hearings and appeals on matters of discipline for civil service employees, and developing and administering the merit-based civil service hiring and promotional process.

The board and its staff are also responsible for establishing and administering, on a reimbursement basis, merit systems for certain city, county, and civil defense employees, to ensure compliance with federal requirements. The SPB is also responsible for coordinating equal employment opportunity efforts within state and local government agencies, in accordance with state policy and federal law.

The budget proposes $70 million for SPB support in 2002-03, which is $1.6 million, or 2.2 percent, below current-year estimated expenditures. The proposed expenditures consist of $57 million from the General Fund and $13 million in reimbursements from other departments. The majority of proposed spending consists of $50 million to reimburse local governments for a mandate relating to the Peace Officer Procedural Bill of Rights.

PEACE OFFICER PROCEDURAL BILL OF RIGHTS (POBOR) MANDATE

We recommend the Legislature delete $50 million proposed to reimburse local governments for the POBOR mandate in the budget year. We recommend the Legislature refer the matter to the Joint Legislative Audit Committee (JLAC) for review and recommendation on possible

revisions to the mandate's parameters and guidelines. We further recommend that the Legislature hold an oversight hearing to review the information gained from the JLAC review and determine whether the mandate should be modified. To avoid incurring a large liability as this review is undertaken, we recommend the Legislature suspend the mandate in the budget year, pursuant to Government Code 17581. (Reduce Item 1880-295-0001 by $50 million.)

Background

Seeking to ensure stable employer-employee relations and effective law enforcement services, the Legislature enacted the Peace Officer Procedural Bill of Rights (POBOR), Chapter 465, Statutes of 1976 (AB 301, Keysor). This measure provides a series of rights and procedural protections to peace officers who are subject to interrogation or discipline by their employer.

In 1995, the City of Sacramento filed a claim with the Commission on State Mandates, alleging that POBOR (including nine subsequent legislative measures that clarified or expanded POBOR) constituted a reimbursable state-mandated program within the meaning of Article XIII B, Section 6 of the California Constitution. In 1999, the commission adopted its "Statement of Decision," finding to be a mandate certain procedural requirements of POBOR that exceeded the rights provided *all* public employees under the due process clause of the United States and California Constitutions. Figure 1 (see next page) summarizes the elements of POBOR that the commission found to surpass state and federal due process requirements. For example, the commission found that the courts have not interpreted the state and federal due process clause as requiring an administrative hearing when an employee is transferred as punishment. Thus, the commission decided that the POBOR provision that requires such an administrative hearing constituted a mandate.

To guide local agencies in their preparation of mandate claims, the commission adopted a reimbursement methodology referred to as the mandate's parameters and guidelines, or "Ps&Gs." Local agencies, in turn, submitted claims to the State Controller's Office (SCO). In March 2001, based on the claims submitted to the Controller at that time, the commission adopted a statewide cost estimate, projecting the annual costs of the POBOR mandate to be $26.5 million and prior-year costs to be $126 million.

Usually, after the commission adopts a statewide cost estimate, the administration proposes funds in the May Revision to reimburse local governments and the Legislature appropriates the funds in the annual claims bill. Last year, however, in a letter to the Joint Legislative Budget Committee, the administration proposed funding $50 million of POBOR's costs in the claims bill, with the remaining $102.5 million to be made available in future years.

Figure 1

Commission on State Mandates Decision Regarding Peace Officer Procedural Bill of Rights

Provisions Required by Due Process Clause	Provisions Found to be Reimbursable Mandates
Administrative Hearing	
• Required if a permanent employee faces dismissal or other negative employment action (demotion, suspension, salary reduction, or written reprimand). Required for probationary or "at-will" employees facing dismissal due to charges that could harm the employee's reputation and ability to find future employment (a "liberty interest").	• Makes probationary and at-will officers' rights to an administrative hearing comparable to permanent employees. Adds to the list of negative employment actions requiring a hearing: employee transfers for purposes of punishment and denying a promotion for reasons other than merit.
Interrogations—Notice and Overtime Pay	
• No notice or overtime pay requirement.	• Requires employers to notify officers before an interrogation, identify investigating officers, and pay overtime if interrogation occurs during off-duty time.
Tape-Recording of Interrogations	
• Employers may record proceedings. Employers must provide access to tape if: a permanent employee faces dismissal or other negative employment action, or a probationary or at-will employee's liberty interests are at risk.	• Requires employers to tape-record interrogations if employees record interrogations. Expands the circumstances under which the officer has access to the tape.
Documents Provided to Employee	
• Employees are entitled to copies of nonconfidential investigative materials if they are: a permanent employee facing dismissal or other negative employment action, or a probationary or at-will employee with liberty interests at risk.	• Expands officers' rights to documents in certain cases, including when the investigation does not result in disciplinary action or the officer is transferred or denied a promotion.
Adverse Comment Placed in Personnel Files	
• Employees are entitled to notice and an opportunity to respond if they are: a permanent employee facing dismissal or other negative employment action, or a probationary or at-will employee with a liberty interest at risk.	• Requires employers to obtain the officer's signature on an adverse comment, or note the officer's refusal to sign. Expands employee rights to notification and response in cases relating to promotional exams and the investigation of possible crimes.

The Legislature adopted this approach in enacting the annual claims bill, Chapter 723, Statutes of 2001 (SB 348, Kuehl). The State Controller, in turn, allocated the $50 million to local agencies on a pro-rata basis.

Budget Proposal. The Governor's budget requests $50 million for POBOR reimbursements in 2002-03. The administration indicates that it expects the State Controller to use $25 million to pay prior-year claims and $25 million to pay budget-year liabilities.

Mandate Costs Much Higher than Anticipated

In the course of our analysis, we reviewed a sample of POBOR claims submitted to SCO. Our review found a greater number of local governments submitting reimbursement claims than was anticipated by the commission in its statewide cost estimate. In addition, we noted that some local governments have amended their claims to request higher reimbursement amounts. Based on this review, we estimate that the annual state cost associated with these peace officer procedural protections is likely to be two to three times higher than the amount projected by the commission, or $50 million to $75 million annually. Mandate costs in this range would be comparable to the state's total costs to provide all peace officer training programs run by the Commission on Peace Officer Standards and Training. The mandate's cost is also noteworthy given that, at the time the Legislature enacted POBOR, the cost of providing these peace officer procedural protections was thought to be insignificant.

Wide Variation in Local Government Claims

While the scope of the reimbursable provisions discussed in the commission's decision and summarized in Figure 1 appears modest, some local governments have claimed very high costs. The City of Long Beach in 1999-00, for example, identified 310 disciplinary cases subject to mandated POBOR procedural protections and claimed more than $6,000 per case to comply with the mandate. Overall, Long Beach's costs exceeded by threefold the costs claimed by the Cities of Sacramento, Fresno, and San Jose combined. Some counties also reported unusually high costs. For example, while the population of the County of Contra Costa is 50 percent smaller than the County of Alameda, Contra Costa claimed nearly twice as many disciplinary cases and three times greater costs.

What Explains the Variation? Our review found no program or other factor to explain why some local governments claimed very high amounts. Instead, we suspect that the variation is attributable to the significant difficulty state and local agencies face in defining and estimating state-reimbursable costs when only *part* of a program is state-reimbursable. Specifically, when a portion of a program is eligible for reimbursement, drafting Ps&Gs and filing claims that accurately differentiate "base" program expenditures from "mandated" program expenditures is difficult. This is particularly true when, as in this case, the mandated requirements have been state law for a quarter century and are very similar to employer responsibilities *not* determined to be reimbursable mandates.

LAO Recommendation: Prior-Year Costs Need Review

Given the cost of the claims and the significant variation in amounts, it is possible that the mandate's Ps&Gs need clarification to strictly interpret the limited nature of the commission's Statement of Decision. It also may be possible that some local governments are claiming costs not permissible under the Ps&Gs. To the extent that local governments are claiming inappropriate costs, SCO's audits (undertaken on a selective basis after the state pays the claim) should remedy this problem. If the problem pertains to ambiguities in the Ps&Gs, however, no existing state administrative process will automatically remedy this problem. Instead, state costs associated with ambiguities in Ps&Gs tend to escalate as local governments (and the consulting firms that prepare mandate claims on their behalf) learn how to maximize state reimbursements. (Under state law, local governments may spend mandate reimbursements for any purpose. Thus, mandate reimbursements represent a valuable source of discretionary local revenue.)

Last year, the Legislature faced an analogous problem when considering the "School Bus Safety II" mandate. Specifically, some school districts submitted claims for as much as $10,000 per school bus to implement relatively modest procedural safety safeguards. To examine this matter more fully, the Legislature requested the Joint Legislative Audit Committee (JLAC) to review that mandate's Statement of Decision, Ps&Gs, and district claims. Given the cost of the claims involved in the POBOR mandate, we recommend that the Legislature again ask JLAC to conduct an audit to:

- Clarify whether the POBOR Ps&Gs accurately reflect the Statement of Decision and clearly identify reimbursable costs.
- Identify the elements of this mandate that represent the greatest costs.
- Assess whether local governments have prepared claims in a manner consistent with the Ps&Gs.

Pending receipt of this audit, we recommend that the Legislature *not* appropriate additional funding for prior-year mandate reimbursements. While the state would incur an interest penalty (at the Pooled Money

Investment Account rate, currently about three percent) on unpaid meritorious claims, the interest cost is modest compared to the dollars at stake. By comparison, if the State Controller pays claims submitted pursuant to the *existing* Ps&Gs, the state would have very limited ability to recoup funding from local agencies if the state later finds errors or ambiguities in the Ps&Gs.

LAO Recommendation: Place POBOR Mandate On "Pause" in Budget Year

In order to avoid incurring a large liability in the budget year as this mandate is reviewed, we recommend that the Legislature suspend the mandate provisions by using the procedure set forth in Government Code Section 17581. Such an action would not suspend the entirety of POBOR law, only the provisions found to be state-reimbursable mandates by the commission.

Once JLAC has completed its audit, we recommend the Legislature hold an oversight hearing to consider its findings and recommendations. We also recommend the Legislature use this hearing to revisit the policy basis for mandating enhanced procedural protections for a single category of employees. Specifically, while some of the measure's mandated provisions may be matters appropriate for state legislation, others may be appropriate for the collective bargaining process.

To suspend this mandate in the budget year, the Legislature would need to amend the budget bill to show a $0 appropriation for this mandate (Item 1880-295-0001) and replace mandate budget provisions (1) and (2) with the following:

> Pursuant to Section 17581 of the Government Code, mandates identified in the appropriation schedule of this item with an appropriation of $0 and included in the language of this provision are specifically identified by the Legislature for suspension during the 2002-03 fiscal year:
>
> (1) Peace Officer Procedural Bill of Rights (Ch 675, Stats. 1990)

PUBLIC EMPLOYEES' RETIREMENT SYSTEM (1900)

The Public Employees' Retirement System (PERS) administers the retirement benefit program for state employees (excluding the University of California) and the health benefits program for employees and annuitants. The current value of the Public Employees' Retirement Fund is about $150 billion. As a result of Proposition 162, which was approved by voters in November 1992, PERS has authority to spend funds to administer the retirement program for state employees without appropriation by the Legislature. However, because the health benefits program is separate from the retirement program, the Legislature does approve the budget for the health program. The entire PERS budget, however, is included in the budget bill as an informational item, with budget bill language that requires PERS to report specified budget information to the Legislature.

The Governor's budget shows 2002-03 expenditures for PERS of $249 million, an increase of $4.4 million, or 1.8 percent, over estimated current-year expenditures. However, this does not include an additional off-budget amount of $142 million for investment consultants, which brings proposed budget-year expenditures to $391 million. This amount reflects a continuation of existing activities and does not include any new spending proposals for 2002-03 outside of the health program. Total expenditures for the budget year, including new spending proposals, will not be known until the PERS Board approves the 2002-03 PERS budget in the spring.

PROPOSED PATIENT DATA PROJECT NEEDS ADDITIONAL OVERSIGHT CONTROLS

Background

The PERS is responsible for administering the health program for employees and retirees of the state and local governments that contract with PERS for this service. This includes negotiating annual premiums with the health maintenance organizations (HMOs) that provide healthcare to enrollees. The PERS also administers and sets premiums for two preferred provider organization (PPO) plans.

Budget Proposal. For 2002-03, the budget proposes $3.5 million and three positions for PERS to develop a Health Care Decision Support System (HCDSS). The project involves the purchase of off-the-shelf software to establish a "data warehouse" consisting of information on the use of medical services and prescription drugs by those enrolled in PERS-administered health plans. Figure 1 shows one-time and ongoing project costs. One-time acquisition costs would total $6.2 million. Beginning in 2004-05, ongoing costs to support the system would be $3.3 million per year.

Figure 1

Costs of Health Care Decision Support System

(In Thousands)

	2001-02[a]	2002-03	2003-04	2004-05
One-time procurement costs	$693	$3,672	$1,867	—
Ongoing support	—	—	1,627	$3,317
Totals	**$693**	**$3,672**	**$3,494**	**$3,317**

[a] Redirected funds.

Project Expected to Improve Patient Care, Limit Premium Increases

The Public Employees' Retirement System (PERS) plans to use medical and pharmaceutical claims data to help improve patient care and limit healthcare costs and premium increases. The PERS estimates that premium savings would outweigh project costs.

Project Aims to Improve Treatment, Limit Costs and Premium Increases. The PERS indicates that medical and pharmaceutical claims information from HCDSS would be used to improve patient care and help contain increases in health insurance premiums. For example, PERS would be able to compare treatment regimens used by its health plans for particular illnesses in order to determine the most cost-effective courses of treatment. The claims information would also be used to determine best practices for addressing particular health problems so that PERS could require the health plans it contracts with to adopt those best practices.

On the cost side, HCDSS would allow PERS to identify which diagnoses and prescription drugs are most costly or most prevalent, track historical trends, and simulate the impact of changing plan provisions regarding copayments and deductibles. This would help PERS identify elements that significantly affect enrollee health costs so that PERS can develop strategies to limit those costs when negotiating annual contracts with HMOs.

The PERS would also use HCDSS to more accurately calculate health plans' per-member costs to better assess the HMO premium proposals submitted during negotiations each year.

Anticipated Savings From Avoided Premiums. With the capabilities provided by HCDSS to improve treatment outcomes, limit costs, and evaluate HMO premium proposals based on actual cost experience, PERS estimates premium cost savings as shown in Figure 2. At 2002 premium levels, PERS estimates savings of about $22 million in avoided premium increases in the first year of operation. These premium savings would accumulate from one year to the next. Thus, the total estimated savings in 2006 would be the previous year's $22 million plus an additional $15 million, and so forth for 2007 and beyond.

Figure 2

Health Care Decision Support System Annual Premium Savings[a]

(In Millions)

	2005	2006	2007 And Forward
HMO savings	$18	$13	$9
PPO savings	4	2	2
Totals	**$22**	**$15**	**$11**

[a] PERS estimate based on 2002 premiums. Each year's savings would be realized in future years as well.

Benefits Likely to Outweigh Estimated Costs, But Costs Could Escalate. As shown in Figure 2, PERS estimates that premium savings for the first three years of system operation would total $48 million. To the extent these savings are realized, they would fully offset the estimated cost of the project. Even if savings were only half those estimated by PERS, or $24 million, they would still exceed total estimated project costs. However, in the following sections, we discuss our concerns with the proposal that, among other things, could cause project costs to escalate.

Project Has Insufficient Risk Management and Contract Oversight

We recommend that the Legislature adopt budget bill language that requires the Public Employees' Retirement System (PERS) to prepare a complete risk management plan and a contract evaluation before obligating funds for the Health Care Decision Support System contract.

The PERS Does Not Have a Complete Risk Mitigation Plan. State policy requires that every automation project complete a risk mitigation plan that considers (1) the potential business disruptions that could occur while implementing the project, and (2) the actions the state will take to reduce or "mitigate" those risks. For example, the HCDSS project would receive data from health providers and if the data is not properly formatted, the system may not be able to operate. With a risk mitigation plan, PERS would predetermine (1) what to do to prevent such a problem and (2) what to do should the problem occur. To our knowledge, PERS has only completed portions of a risk mitigation plan.

For this reason, we recommend that the Legislature direct PERS to prepare a complete risk mitigation plan before obligating funds for the HCDSS contract. The plan should include contingencies for software integration, clean-up of provider data, delays in receiving accurate provider data, and system inaccessibility. The following budget bill language is consistent with this recommendation:

> It is the intent of the Legislature that the Public Employees' Retirement System (PERS) shall prepare a complete risk management plan before entering into a contract that obligates state funds for the Health Care Decision Support System (HCDSS). The plan shall include, but is not limited to, contingencies for problems related to software integration, system inaccessibility, and healthcare provider data.

Independent Evaluation of Proposed Contract Needed. The PERS is proposing to enter into a contract for the development, implementation, and maintenance of the HCDSS system. The state has historically had problems with such contracts because the contract did not include all the services that the state would need over the life of the system. As a consequence, the state has had to amend or renegotiate these contracts, resulting in increased costs and delays in implementing the system. For this reason, we recommend that an independent evaluation be conducted of the proposed contract before obligating state funds. The evaluation should:

- Compare PERS' negotiated contract with the business requirements specified in the HCDSS request for proposal to ensure all requirements are included in the contract.

- Review contract terms and conditions to ensure there is adequate legal protection in the event the contractor does not perform to specifications.
- Compare other government and private industry contracts of similar size and scope to ensure all necessary services to operate and maintain the HCDSS system have been included.
- Examine the hardware and software replacement schedules to ensure they conform to industry standards.

Specifically, we recommend that the Legislature adopt the following budget bill language:

> It is the intent of the Legislature that an independent evaluation be conducted of the proposed contract for the Health Care Decision Support System (HCDSS) before PERS enters into or obligates state funds for this project. The evaluation shall include, but not be limited to, a comparison of the business requirements in the contract and the procurement document, review of contract terms and conditions assessing protections for the state, comparison of the HCDSS contract with contracts of similar size and scope to assess coverage of necessary support services, and assessment of hardware and software replacement schedules to ensure conformance with industry standards.

Department of Corporations
(2180)

The Department of Corporations (DOC) is responsible for protecting the public from unfair business practices and fraudulent or improper sale of financial products and services. The department fulfills its responsibility through its investment and lender-fiduciary programs. The DOC is supported by license fees and regulatory assessments, which are deposited in the State Corporations Fund.

The budget proposes total expenditures of $35 million and 291.8 personnel-years (PYs) in 2002-03. This is $9 million, or 34 percent, more than estimated current-year expenditures and 16.4 additional PYs. The increase is mainly due to a $10 million request for statewide public education regarding investment and lending fraud.

Staff for Investment and Lending Fraud Pilot Are Premature

We recommend deletion of $1,571,000 and 24 positions for additional call center and enforcement staff related to the proposed public education and outreach program. (Delete $1,571,000 from Item 2180-001-0067.)

The budget proposes $10 million and 25 one-year limited-term positions to implement the Statewide Outreach on Predatory Practices (STOPP) program, which would target investment and lending fraud. According to the department, the purpose of the program is to make consumers aware of (1) DOC's responsibilities, (2) the extent of fraud and abuse in the investment and lending industries, and (3) where to get information and submit complaints. This pilot program would include the following four components:

- ***Public Education—$8.1 Million.*** Fair exhibits, mass mailings, and statewide television commercials, with focus groups and surveys before and after broadcast of the television commercials to measure the impact on public awareness of investment and lending fraud.

- ***Establish an Outreach and Education Office—$0.4 Million.*** Administer STOPP, develop brochures and public service announcements, organize outreach events, and contact community organizations.
- ***Establish a Call Center—$0.8 Million.*** Consolidate existing resources for responding to consumer complaints and increase staff for the greater number of calls expected because of the publicity campaign.
- ***Additional Enforcement Staff—$0.7 Million.*** Handle a greater number of investigations predicted to result from increased consumer complaints.

The DOC indicates that it may use results from the one-year pilot program to request ongoing funding.

Additional Call Center and Enforcement Staff Premature. The DOC currently has five staff members who respond to 40,000 consumer phone complaint calls per year. As a result of the proposed public education campaign, the department expects the number of phone calls to increase permanently by about 50 percent to 60,000 annually, with a corresponding increase in enforcement workload. Thus, the proposal includes $851,000 and 7 additional positions to handle additional consumer complaints and $720,000 and 17 positions for additional enforcement workload.

The DOC's proposal is similar to a consumer education and outreach program recently implemented by the Office of the Patient Advocate in the Department of Managed Health Care (DMHC). The DMHC program includes airing television commercials to publicize the existence of the office, developing and distributing various brochures, sponsoring regional consumer education efforts, and conducting seminars with consumer advocacy groups.

As noted above, DOC requests additional call center and enforcement staff based on a predicted increase in consumer complaints due to the proposed television advertising. However, according to DMHC, it did not experience an increase in call volume when its television commercials aired last fall. Like the DOC proposal, the DMHC commercials sought to educate the public about consumer-related issues and the department's role in addressing them. Thus, we do not anticipate that DOC will experience a significant increase in call volume. As a result, we believe that DOC's current request for additional staff is premature. Instead, the department should gauge the impact of STOPP on call volume for one year before requesting additional positions for call center or enforcement workload. Consequently, we recommend deletion of $1,571,000 and 24 positions for call center and enforcement costs.

HOUSING AND COMMUNITY DEVELOPMENT (2240)

The mission of the Department of Housing and Community Development (HCD) is to help promote and expand housing opportunities for all Californians. As part of this mission, the department is responsible for implementing and enforcing building standards. It also administers a variety of housing finance, economic development, and rehabilitation programs. In addition, the department provides policy advice and statewide guidance on housing issues.

The budget proposes expenditures of $208 million for 2002-03. The proposed General Fund expenditures of $38 million—largely for farmworker housing and emergency shelter assistance—is a 61 percent decrease from the current year. Federal funds account for $118 million of the proposed budget-year expenditures, primarily for the Community Development Block Grant and Home Investment Partnership Act programs. A number of state special funds provide the remainder of HCD's funding. The department has a proposed staffing level of 496 personnel-years.

Funding Reductions in Many Housing Programs

As shown in Figure 1 (see next page), the level of funds appropriated for housing programs since 1999-00 has varied substantially from year to year. (The amounts shown will differ from the Governor's budget display due to the timing of actual expenditures.)

Beginning with the 2001-02 budget, some unencumbered funds appropriated in earlier years were transferred back to the General Fund. Figure 2 (see page 69) shows these transfers, transfers adopted as part of the November Revision, and additional transfers proposed in the budget year. The Governor's budget largely preserves funding for the Farmworker Housing Grant Program ($14 million) and the Emergency Housing Assistance Program (EHAP, $11.3 million), while eliminating funding for many other department programs. The Governor also proposes a $6 million loan to the General Fund from the Mobilehome Park Purchase Fund (to be repaid with interest).

Figure 1

General Fund Appropriations for HCD Programs

1999-00 Through 2002-03
(In Millions)

	1999-00	2000-01	2001-02	Proposed 2002-03
Homeownership				
CalHome:				
Base program	—	$40.0	—	—
Mobilehome ownership	—	10.0	—	—
Homebuyer's Downpayment Assistance	—	50.0	—	—
Farmworker Housing:				
Base program	$3.5	35.5	$13.9	$14.0
Set-asides	—	11.0	—	—
Self-help housing	2.0	2.1	2.1	—
Multifamily Housing				
Base program	$11.0	$188.0	$23.1	—
Downtown Rebound	—	25.0	3.0	—
Homeless				
Emergency Housing Assistance Program:				
Operating Grants	$2.8	$14.0	$13.3	$11.3
Capital Grants	—	25.0	—	—
Other Programs				
Jobs-Housing Balance incentive grants	—	$100.0	—	—
Economic development grants	—	5.0	—	—
Code enforcement incentives	—	5.0	—	—
Interregional Partnership Pilot	—	5.0	—	—
Child Care Facilities	—	16.0	—	—
Central Valley Infrastructure Grants	—	—	$12.0	—
Predevelopment loans	$1.5	6.5	—	—
Totals	**$20.8**	**$538.1**	**$67.3**	**$25.3**

Figure 2

Transfer of Housing Funds Back to the General Fund

(In Millions)

	2001-02		
	Enacted Budget	November Revision	2002-03 Proposed
Homeownership			
Homebuyer's Downpayment Assistance	$18.0	—	—
Multifamily Housing			
Base program	—	$45.0	—
Downtown Rebound	—	4.1	—
Other Programs			
Jobs-Housing Balance incentive grants	40.0	59.7	$0.2
Child Care Facilities	11.0	—	1.4
Totals	**$69.0**	**$108.9**	**$1.6**

No New Funds, Reduced Existing Funds

Below, we highlight the impact of the budget's proposals by program area.

Jobs-Housing Balance Incentive Grants. The 2000-01 budget provided $100 million in one-time funds to make "incentive payments" to local governments. The funds were intended to increase housing production by making payments based on the level and type of housing permits issued in a jurisdiction during calendar year 2001. The payments were scheduled to be made in the spring of 2002. As part of the 2001-02 budget, $40 million of the program's funds were transferred back to the General Fund. The Legislature also adopted the Governor's November proposal to transfer back to the General Fund the remaining $60 million. As a result, the program will be unable to make any incentive payments in the current or budget years. For those jurisdictions which would have qualified for allocations under this program, the budget bill proposes giving application priority for federal and farmworker housing grant dollars.

Multifamily Housing Program. The Multifamily Housing Program is the department's basic funding mechanism for low-interest construction loans for multifamily housing units. In the current year, the program had a total of $87.9 million in funds available for local assistance (a combination of prior-year and current-year appropriations). In November, the Governor proposed transferring $45.1 million of this amount back to the General Fund. The Legislature approved this proposal—leaving $42.8 million available for housing projects in 2001-02. The department has received applications totaling $135 million and expects to encumber the $42.8 million this spring. The Governor proposes no funding for the program in 2002-03.

Downtown Rebound. The Downtown Rebound program is intended to promote the revitalization of urban areas through (1) multifamily project loans aimed at reusing commercial buildings as housing, the in-fill of vacant sites, and housing near transit centers and (2) planning grants to local governments. An adopted November Revision proposal transferred $4.1 million in available funds (from the prior and current years) back to the General Fund—leaving less than a million dollars in unencumbered funds. The budget proposes no additional funds for the program.

Child Care Facilities. The Child Care Facilities Financing Program provides both direct loans and loan guarantees for child care facility purchases, expansions, or renovations. The 2000-01 budget included a $16 million appropriation of funds for the program. The 2001-02 budget transferred $11 million of this amount back to the General Fund. The Governor proposes transferring $1.4 million in unencumbered funds from the loan guaranty component back to the General Fund. We discuss this proposal in more detail below.

Migrant Services Reconstruction. In 1993-94, the state began a multiyear plan to reconstruct state-owned migrant farmworker housing centers. The final year of the plan was scheduled to be 2002-03, at a cost of about $5.5 million. The Governor's budget proposes deferring this funding. The final center scheduled for reconstruction should be able to continue operation because it is expected to have a useful life until 2004-05. The budget does propose using $565,000 in unencumbered flood relief funds for minor repairs at three centers.

Budget Removes Restrictions on Existing Dollars

The 2000-01 budget included funds for several special set-asides within department programs. Few eligible applicants have been identified for two of these set-asides and the Governor proposes allowing these funds to be used for broader purposes.

Mobilehome Ownership. The 2000-01 budget included a $10 million set-aside within the department's CalHome homeownership program. The set-aside was to fund local programs that allow homeowners to repair or replace manufactured housing. Of the original appropriation, $4.2 million remains available. The Governor proposes making these remaining funds available for expenditure under the broader CalHome program for various homeownership purposes, including mobilehome ownership.

Farmworker Manufactured Housing. Within the department's farmworker housing grant program, the 2000-01 budget reserved $3 million for sites using manufactured housing for 12 or fewer agricultural employees in a cooperative arrangement between the employer and a nonprofit organization. The department has not received any eligible applications, and the Governor proposes allowing these funds to be granted under the base farmworker program.

More Child Care Facility Funds Available for Transfer

The Governor's budget proposes transferring $1.4 million in available funds from the Child Care Facilities Financing Program to the General Fund. We recommend increasing the transfer to $2.6 million to reflect the total amount of available funds (Increase Item 2240-0110-0474 by $1.2 million).

Minimal Use of Program. As described above, the Child Care Facilities Financing Program makes both direct loans and loan guarantees for the financing of child care facilities. While the direct loan component has committed all of its available funds, the guaranty component still has available funds. The 1997-98 budget provided $3.1 million in local assistance funds (General Fund) to guarantee private-market commercial loans. Since the guaranty program is able to guarantee $4 in loans for each $1 appropriated, $12.4 million in guarantees was originally available. Due to administrative difficulties and low demand, the guaranty program has made only six guarantees totaling about $2.1 million since 1997-98—including only one in the past year. (These six guarantees required the use of only about $500,000 of the appropriated funds.)

Recommend Transferring All Available Funds. The Governor's budget includes a proposal to transfer $1.4 million from the loan guaranty fund to the General Fund, with the intention of leaving no funds for additional guarantees. The calculation of available funds, however, fails to account for the ability of one appropriated dollar to guaranty four dollars in loans. Since only $500,000 of the $3.1 million in appropriated funds have been committed to guarantees, the available funds for transfer back to the General Fund is actually $2.6 million—$1.2 million higher than the proposed amount. Given the lack of activity in the program, we recommend approving the Governor's proposal and increasing the transfer amount to $2.6 million to capture the full available balance.

ENERGY RESOURCES CONSERVATION AND DEVELOPMENT COMMISSION (3360)

The Energy Resources Conservation and Development Commission (commonly referred to as the California Energy Commission, or CEC) is responsible for forecasting energy supply and demand, developing and implementing energy conservation measures, conducting energy-related research and development programs, and siting major power plants.

Proposed Funding. The budget proposes commission expenditures of $233.3 million from various state and federal funds in 2002-03 ($5.7 million General Fund). This is $131.9 million, or 36 percent, less than current-year estimated expenditures. The large 2002-03 reduction is mainly due to one-time General Fund monies appropriated in the prior year in Chapter 7x, Statutes of 2001 (SB 5x, Sher), which have been carried forward to the current year for various programs to promote energy efficiency and peak-load conservation. The carryforward amount was further augmented by the 2001-02 budget trailer bill—Chapter 111, Statutes of 2001 (AB 429, Aroner).

ERPA FUND CONDITION

Budget Underestimates ERPA Revenues

The budget assumes no increase in Energy Resources Programs Account (ERPA) revenues in the budget year. We recommend assuming 2 percent revenue growth in the budget year, thereby raising total ERPA revenues by about $900,000. We further recommend using these additional ERPA revenues to offset activities currently supported by the General Fund, for a savings of $900,000.

Background. The ERPA fund supports many of the basic programs of the CEC, including its siting and energy forecasting functions. State law directs electric utilities (both privately and publicly owned) to collect a state energy surcharge of two-tenths of one mill ($0.0002) per kilowatt-hour (kWh) of electricity consumed by all electrical customers. The commission estimated that in 2000 the average household contribution to ERPA was approximately $0.40 a month, or less than $5 annually. The Board of Equalization collects the surcharge from the utilities.

ERPA Revenues Underestimated. The CEC indicates that, because of increased conservation over the past few years, ERPA revenues have declined. However, recent electricity demand forecasts indicate that the state's electricity demand will continue to grow at a pace faster than estimated conservation growth in the budget year. California's electricity demand, assuming conservation of around 15,200 gigawatt hours, is forecast to grow around 3.4 percent from 2001-02 to 2002-03. This incorporates a slight decrease in conservation from the current year and an underlying base load growth of 2.1 percent. Even if the same higher level of conservation savings estimated for the current year is also assumed in the budget year, electricity demand would still grow nearly 3 percent.

Since the ERPA surcharge is assessed on every kWh consumed in California, we estimate that some growth in ERPA revenues should be expected in the budget year. We recommend a conservative estimate of 2 percent to take account of the multitude of recent programs funded to promote energy conservation. This assumption results in total ERPA revenues of $46.2 million in the budget year. Therefore, assuming the expenditures proposed by the budget, the ERPA fund should end the budget year with a fund balance of $1.8 million—approximately $900,000 more than estimated in the Governor's budget.

General Fund Savings Opportunity. The upward revision of the ERPA fund balance provides the Legislature with an alternative funding source for the commission's activities currently supported by the General Fund. Therefore, we recommend using the $900,000 in additional ERPA revenues to offset the commission's General Fund supported activities (see discussion below).

ENERGY FACILITY LICENSING PROGRAM

Background

The CEC's Energy Facilities Licensing Program (referred to as the siting program) is responsible for licensing thermal power plants of 50 megawatts (MWs) or greater (excluding hydroelectric, wind, and solar facilities, which are not subject to this process). After approving a proposed power plant, the commission is required to ensure that the facility is in compliance with all applicable federal, state, and local laws, as well as any conditions of certification required by the commission. The commission must also approve any modification to these plants. For plants not subject to its jurisdiction (such as those that predate the siting approval process), the commission must approve plant modifications unless the modifications meet the MW standard or type of facility exclusions mentioned previously.

Proposed Funding

The Governor's budget has proposed expenditures from all funds of \$18.8 million. This total includes expenditures of \$5.5 million from the General Fund, including \$1.1 million in ongoing spending. This proposed funding is a reduction from the current-year estimated expenditure level of \$21.3 million, due to the Governor's proposed reduction in siting contract funds in the budget year and one-time expenditures in the current year for a survey of coastal power plants. This funding supports 130 positions in the budget year, composed of 90 permanent positions and 40 limited-term positions that will expire in 2003-04. The commission also has \$6.5 million budgeted for consulting contracts (\$1.7 million General Fund).

New Fee Proposed. The Governor's budget also proposes to establish a new fee on energy licensing applications filed with the commission. The fee is proposed to be \$25,000 per filing and will partially defray the costs of licensing a new power plant. The budget assumes that there will be ten new siting applications filed in the budget year for total revenues of \$250,000. These revenues will be deposited in the commission's ERPA fund, where they will be used to support siting contracts previously supported by the General Fund.

Siting Workload Changes Frequently

Workload History. Over the past few years, the CEC's siting program workload has been volatile due to a variety of factors, including shortage of electricity supplies, high electricity prices, and uncertain market conditions. Only ten applications were filed to build new power plants in 1999-00, 36 applications were filed in 2000-01, and it is estimated that 15 applications will be filed before the end of the current year. In addition, the compliance monitoring workload has increased substantially over this time period. The workload has increased from 39 cases in 1999-00 to an estimated 86 cases in the current year to monitor power plants in both the construction and operation phases. The commission is projecting a smaller siting workload for the budget year—currently estimating around ten new siting applications in 2002-03. This volatile workload poses challenges in providing a funding level that adequately reflects the program's workload.

Factors Affecting Future Workload. There has been obvious growth in the siting workload of new electricity power plants over the past two years. However, since last summer, the recession and conservation have contributed to lower consumer demand for electricity and lower electricity prices. In addition, over 2,000 MW of new electricity generation sited by the CEC have come on-line in California over the past year. There is another 3,600 MW in construction to be on-line for next summer and 9,800 MW, comprised mostly of larger power plants, in construction and scheduled to be on-line by 2003. These combined factors have resulted in the commission receiving fewer siting applications for new power plants over the past few months. The construction of new power plants has also been slowed by the Enron Corporation's bankruptcy, which has lowered the stock prices and credit ratings of many large energy companies, making it difficult for them to raise capital for new projects. Given these factors, we believe that the siting program's future workload may be less than it is currently budgeted to accommodate.

Updated Projections Needed on Siting Workload

We recommend the Legislature approve $900,000 for ongoing energy siting contracts from the Energy Resources Programs Account instead of the General Fund. We also withhold recommendation on the remaining General Fund support of the siting program ($4.6 million) until the commission provides an updated schedule of expected application filing dates and corresponding workload projections prior to budget hearings. (Augment Item 3360-001-0465 by $900,000 and reduce Item 3360-001-0001 by $900,000.)

As noted previously, the Governor's budget proposes $5.5 million General Fund to help support activities of the siting program. These funds support 40 limited-term positions and contract funds (some of which are ongoing) that were added to the siting program in the current year to help address the increased workload.

As noted above, we have identified $900,000 in additional ERPA revenues that we recommend be used to offset the commission's General Fund expenditures in the budget year. Since ERPA traditionally supports the siting program activities, we recommend that the Legislature approve $900,000 for ongoing energy siting contracts from ERPA instead of the General Fund. This would provide $900,000 in ongoing savings to the General Fund.

We also believe there may be additional General Fund savings available pending an updated schedule of expected application filing dates and corresponding workload projections. The commission periodically updates its schedule of when it expects project proponents to file applications for the siting review process. This schedule is adjusted frequently as details often change as projects develop, requiring proponents to file the siting application later than initially expected. These adjustments then alter the commission's staffing needs. The effects of the recession and increased electricity conservation on the state's electricity demand, and the number of new electricity generators slated to come on-line in the next two years, has and will continue to reduce the number of siting applications received by the commission. Therefore, we believe additional General Fund savings could be likely. As a result, we withhold recommendation on the remaining General Fund support of the siting program ($4.6 million) until the commission provides an updated schedule of expected application filing dates and corresponding workload projections prior to budget hearings.

Funding of Siting Program Should be Changed

We recommend that the Legislature consider alternative funding sources to support the siting program, including the establishment of fees on electricity generators and/or reassessing the electricity ratepayer fees that fund the Energy Resources Programs Account.

Current Funding Source for Siting Program. The commission's power plant siting program has historically been funded from ERPA, which is supported by a surcharge on ratepayers' electricity bills. However, the budget proposes $5.5 million General Fund support for the siting program, including some ongoing support of the program. We recommend that if the Legislature finds these funds are needed in the budget year (see discussion above), they should be paid for by fees levied on power plants and/or ERPA. (The latter may require reassessing ERPA fees so that they cover all costs associated with the siting program.)

Governor's Fee Proposal. As mentioned previously, the Governor has proposed a $25,000 up-front fee for all plants submitting licensing applications to the commission. This proposed fee is a nominal amount and only covers a portion of the costs associated with licensing a power plant and supporting compliance activities throughout its lifetime. The department has indicated that the fee level was chosen based on fees levied in other states and was also set at a level that would deter applicants that were not serious about building a new power plant. As noted earlier, the budget projects the siting division will receive ten siting applications in the 2002-03 budget year for total fee revenues of $250,000. These fee revenues only defray a small portion of the $18-plus million dollars budgeted for 2002-03 siting and compliance activities. The fee revenue is also not adequate to cover ongoing General Fund costs associated with supporting siting activities. The fee revenues are proposed to be deposited in ERPA and are to fund siting contracts that were previously supported by the General Fund.

Alternatives for Funding Siting Program. We recommend two alternative funding sources for the siting program that potentially could result in $1.1 million in ongoing General Fund savings and $4.4 million in one-time savings. They include the following:

- ***Charge Generators Fees***. As proposed by the Governor, application fees could be levied on new licensing applications. These fees could be set so as to cover the costs associated with reviewing the licensing application for a new power plant. In addition, ongoing fees could also be levied on generators to defray the costs associated with ongoing compliance.
- ***Reassess ERPA Fees***. As mentioned previously, ERPA is supported by a surcharge on ratepayers' electricity bills. However, ERPA revenues are no longer sufficient to cover all of the programs supported by ERPA, including expenditures associated with the siting program. The ERPA fee could be reassessed so that it covers all costs associated with the siting program on an ongoing basis.

We believe that either the generators or ratepayers—as opposed to general taxpayers—should support the siting program since they are the entities that directly benefit from the services provided by the siting program. Therefore, we recommend the Legislature consider establishing fees on electricity generators to support the siting program and/or reassess the electricity ratepayer fees that support ERPA so that they are sufficient to support all expenditures associated with the siting program.

DEPARTMENT OF WATER RESOURCES, CALIFORNIA ENERGY RESOURCES SCHEDULING (3860)

The California Energy Resources Scheduling (CERS) division procures electricity on behalf of the state and is part of the Department of Water Resources (DWR). (Please refer to the "Resources" chapter of this *Analysis* for the remaining programs within DWR.)

Background

CERS Formed to Buy Electricity. The CERS division was created by Chapter 4x, Statutes of 2001 (AB 1x, Keeley) as the entity to purchase electricity on the wholesale market and sell it to the customers of the state's major private investor-owned utilities (IOUs). This activity was taken over by the state in January 2001 in the wake of supply disruptions and rolling blackouts in Northern California, skyrocketing natural gas prices, and wholesale electricity prices that continued to stay high throughout the traditionally low-demand season of the year. The state's IOUs found themselves purchasing electricity at prices far above what they could legally charge customers, which in turn caused their creditworthiness to deteriorate and eventually made them unable to finance further electricity purchases.

Since CERS has been purchasing electricity on behalf of the IOUs, the division has entered into long-term contracts for electricity valued at over $40 billion that extend over the next 10-plus years. The CERS division is also presently responsible for purchasing the entire "net short" on the California spot market. (The net short refers to the amount of electricity needed to serve the demand in the IOUs' service area that exceeds the IOUs' supply of retained generation resources, qualifying facility contracts, and other bilateral contracts.) This activity is set to expire at the end of calendar year 2002; however, at present, there is no agency or entity in line to take over these responsibilities.

Funding Mechanism. The electricity purchases made by CERS and its administrative expenses are paid for from DWR's Electric Power Fund (EPF), which is the depository for payments received from ratepayers for using the electricity bought by the state. Because the state was purchasing electricity during most of 2001 at prices that were well above the regulated retail rate charged to electricity consumers, these payments to the EPF have been inadequate to cover the costs of purchasing electricity on behalf of the IOUs. As a result, the EPF has also received a $6.2 billion General Fund loan and the proceeds of a $4.1 billion interim loan sale, neither of which has been repaid. To accomplish this repayment, DWR is preparing to issue a revenue bond that could total as much as $13.4 billion before the end of the current fiscal year. The proceeds of this bond sale would go to pay back the General Fund and the interim-financing note, as well as continue to support the division's ongoing electricity purchase activities.

Another revenue source of the EPF includes the California Procurement Adjustment (CPA), created by AB 1x. This adjustment is defined as the difference between the generation component of the retail rates and the average cost of the utility-retained generation and contracts. However, there continues to be confusion and controversy regarding the CPA and, at this time, the utilities have not been remitting this payment to DWR.

Governor's Proposed Spending

The Governor proposes expenditures for CERS of $7.7 billion in the current year and $5.2 billion in the budget year. The budget year amount represents a decline of over 30 percent from current-year spending levels. The CERS expenditures are split into two categories: (1) administrative expenditures subject to budgetary appropriation by the Legislature, and (2) expenditures for electricity purchases and debt financing that are off-budget expenditures.

Administrative Expenditures. The Governor proposes $28.4 million for administration of the CERS division in 2002-03. This is $33 million less than the current year, or a 54 percent reduction. This reduction is mainly due to significant one-time expenditures incurred in the current year relating to information technology projects to manage the state's electricity portfolio, and various other one-time start-up costs to establish the division's electricity purchasing activities.

Off-Budget Expenditures. The Governor's budget also proposes expenditure of $7.6 billion in the current year and $5.1 billion in the budget year for the purchase of electricity and other expenditures related to DWR's electricity debt financing. Specifically, the budget estimates expenditures of:

- $6.7 billion in the current year and $4.2 billion in the budget year for electricity purchases.
- $180 million in the current year for fees associated with the electricity revenue bond.
- $273 million in the current year for interest payments on the interim loan.
- $413 million in the current year for interest payments on the General Fund loan.
- $25 million in the current year and $15 million in the budget year for DWR's administrative costs associated with issuing the revenue bond.

Factors Affecting Off-Budget Expenditures. The amount proposed in the budget for expenditure on electricity purchases over the entire 2002-03 fiscal year is $3.1 billion less than what was spent the last six months of the 2000-01 fiscal year. This reflects the extremely high prices the state was facing when it first started purchasing electricity on the spot market on behalf of the IOUs. Since that time, the state has negotiated over $40 billion in long-term contracts and is less reliant on the spot market. The DWR estimates that it will have a larger proportion of the "net short" in long-term contracts over the next few years, with as much as 75 percent under contract by 2004. These long-term contracts average $84/megawatt hour (MWh) over the next five years and $74/MWh over the next ten years. In addition, spot market prices have declined from prices previously well over $400/MWh to around $40/MWh. The stability provided by a larger portion of the state's energy portfolio in long-term contracts and the lower spot market prices are projected to lower total expenditures on electricity purchases in the budget year. The budget-year reduction is also due in part to the assumption that the state will no longer be purchasing the net short by the end of calendar year 2002, for a half-year 2002-03 impact.

Possible Duplicative Federal Representation

We recommend that the Department of Water Resources (DWR) report at budget hearings regarding its plan to coordinate with the state's other energy agencies to avoid duplication in representing the state's energy

interests at the Federal Energy Regulatory Commission (FERC). Thus, we withhold recommendation on $750,000 requested by DWR for legal representation at the FERC until a plan has been submitted and evaluated by the Legislature.

The budget proposes $750,000 for a contract to provide CERS with legal representation before FERC—the federal agency that oversees the state's wholesale electricity market. The California Public Utilities Commission (CPUC) and the Electricity Oversight Board (EOB) both already represent the state's interests on energy matters before FERC. Therefore, it is important to ensure that further representation would not duplicate activities already being provided by other agencies. (It should be noted that DWR has represented its interests before FERC prior to the establishment of CERS on a number of issues regarding the State Water Project. This recommendation does not apply to funding for this representation, but only for the legal representation provided on behalf of CERS' operations.)

In order to avoid duplication of efforts among agencies and to present a coordinated and cohesive message before FERC, we recommend the CERS division report at budget hearings regarding its plan to coordinate with the CPUC and the EOB regarding the specific areas for which it would seek representation and determine how to attain the services needed at least cost. Therefore, we withhold recommendation on the funding for this legal representation until a plan has been submitted and reviewed by the Legislature. As indicated in "Part V" of our *Perspectives and Issues*, this is but one of several examples of why improved coordination among, and organization of, the state's energy activities is needed.

State Needs to Move Away from Contracting

We recommend that the Department of Water Resources (DWR) report before budget hearings on its progress in establishing a new personnel classification series with the Department of Personnel Administration and its ability to fill its vacant positions. Thus, we withhold recommendation on $4 million requested by DWR for personal service agreements and consulting contracts to perform daily trading and settlement activities until more information is available.

The CERS division continues to heavily rely on contracts for work that otherwise could be done by state employees. The DWR has indicated to us that, because of the unique nature of some of the CERS positions—especially those in the settlements, energy scheduling, and energy trading areas—it needs the Department of Personnel Administration (DPA) to establish new position classifications so that it can hire people with the appropriate backgrounds. The department has indicated to us that, because of processing delays, it has had to retain many high-priced contract workers in lieu of hiring civil service employees. These include $2 million in additional contracts to handle settlements with the Independent System Operator and another $2 million to schedule and dispatch electricity from DWR's long-term contract portfolio, as well as purchase electricity on the spot market (this estimate assumes that the latter activity will expire at the end of calendar year 2002).

Given the relatively high cost of retaining these contract agreements, we recommend filling the vacant positions as soon as possible to minimize the costs of running CERS' power purchasing program. However, we understand that filling these positions quickly may be difficult, given that CERS has not yet successfully established the needed new personnel classification series with DPA. Therefore, we recommend that CERS report to the Legislature before budget hearings regarding its progress in establishing a new personnel classification series and filling these vacancies. Upon receiving this information, the Legislature should be able to assess any savings that can be achieved—whether it be from salary savings relating to projected unfilled vacancies or contract savings due to filled positions at DWR. Therefore, we withhold recommendation on $4 million requested by CERS for personal service agreements and consulting contracts.

HEALTH AND HUMAN SERVICES AGENCY DATA CENTER (4130)

The Health and Human Services Agency Data Center (HHSDC) provides information technology services, including computer and communications network services, to the various departments within the Health and Human Services Agency (HHSA). The center also provides services to other state entities and various local jurisdictions. The cost of the center's operations is fully reimbursed by its clients.

The budget proposes $317.9 million for support of the data center in 2002-03, which is an increase of $10 million, or 3 percent, above estimated current-year expenditures. The budget includes a number of increases for workload, the largest of which is a request for $2.2 million for additional data processing and storage equipment. It also includes a number of increases for the continued implementation of various large information technology projects.

Increased Expenditure Authority Not Justified

We withhold recommendation on the proposed expenditure authority increase of $2.2 million and instead recommend that the Legislature direct the Health and Human Services Agency Data Center (HHSDC) to provide a revised budget proposal reflecting prior-year adjustments based on actual costs of previously purchased computer equipment.

Budget Proposal. The budget proposes to increase HHSDC's expenditure authority by $2.2 million for additional computer equipment to meet increased workload needs of its client departments.

Adjustment Proposal Not Submitted. Each year, in submitting their budgets to the Legislature, HHSDC and the Stephen P. Teale Data Center (TDC) submit technical adjustments which modify the data center's budgets based upon actual expenditures in prior years. Over the past three years, such adjustments have decreased the overall expenditure authority of HHSDC and TDC by $34.6 million.

The *2001-02 Budget Act* provided HHSDC with $7.5 million for new computer purchases based upon the estimated purchase price of the technology. This year, however, the Governor's budget does not propose to adjust the HHSDC's budget to reflect the actual price. It is important that the data center's expenditure authority be adjusted on an annual basis to reflect the actual cost of prior purchases in order to ensure that the data center does not overcharge client departments. At the time this analysis was prepared, HHSDC had not submitted the annual adjustment to reflect the actual price of technology purchased in the current year. In the absence of prior-year actual expenditure information, we are unable to determine the need for additional expenditure authority to purchase the proposed computer equipment.

Recommendation. For this reason, we withhold recommendation on the proposed expenditure authority increase of $2.2 million, and recommend that the Legislature direct HHSDC to submit a revised budget proposal which adjusts HHSDC's expenditure authority based on actual costs of previously purchased equipment.

Budget Internally Inconsistent

We recommend that the Legislature direct the Health and Human Services Agency Data Center (HHSDC) to submit a new budget request which adjusts the overhead charges to the Department of Social Services' county-based automation projects in order to reflect the proposed 5 percent reduction in HHSDC's overhead rate.

Background. In the *2000-01 Budget Act*, the Legislature approved HHSDC to charge each of the Department of Social Services' (DSS) county-based automation projects a 20 percent overhead rate to reimburse HHSDC for providing overall support to the projects.

Proposed Rate Reduction. The HHSDC now proposes to decrease the overhead rate to 15 percent. However, our review indicates that the proposed decrease has not been applied to all DSS projects. Figure 1 compares current-year overhead charges for each DSS project to proposed budget-year charges. As Figure 1 shows, two projects' overhead rates were reduced and six projects overhead rates stayed the same. The HHSDC has been unable to explain why certain projects would not have a reduction. In the absence of such information, we would expect the charges for all projects to decline consistent with HHSDC's stated policy.

Recommendation. For this reason, we recommend that the Legislature direct HHSDC to submit a revised budget request that reduces the overhead charges on the DSS projects to reflect the proposed reduction in HHSDC's overhead rate.

Figure 1

HHSDC Overhead Charges Comparison of Overhead Charges for Department of Social Services Projects

(In Millions)

Project Title	Charges: Current Year	Charges: Budget Year	Difference
Child Welfare Services/ Case Management System	$818	$818	—
Electronic Benefit Transfer	427	389	-$38
Statewide Fingerprint Imaging Project	164	164	—
In-Home Supportive Services/Case Management Information and Payrolling System	158	158	—
Interim Statewide Automated Welfare System	1,916	1,434	-482
Child Welfare Services/Case Management System Expanded Adoption System	55	55	—
Welfare Data Tracking Implementation Project	235	235	—
Statewide Automated Welfare System Oversight	441	441	—
Totals	**$4,214**	**$3,694**	**-$520**

Rate Study Needed

We recommend that the Legislature direct the Health and Human Services Agency Data Center (HHSDC) to conduct a rate study examining data center operations and recommending changes that will result in improved rates and services to client departments.

Rate Study Needed. The HHSDC provides computing services to its client departments, and is reimbursed for these services through rates it charges to these departments. The rates charged by the state's data centers are based on rate studies which historically have been conducted every two years. Rate studies are important because they provide information that allows the state to determine if its rates are consistent with state administrative policies, are equally applied to all client departments, recover full data center operation costs, and are competitive with other data centers.

The last HHSDC rate study was completed in 2000 and examined rates during the 1998-99 fiscal year. While this study provided some useful information on recommended changes to HHSDC's internal billing and accounting processes, it did not examine data center operations and practices to identify opportunities for increased efficiencies and cost reductions which could result in reduced rates.

The TDC's Financial Assessment Should Be Used as Model. In 2001, TDC conducted a financial assessment that evaluated TDC's current operation, compared TDC rates with private and other governmental entity rates, and recommended changes for improving TDC costs, rates, and services. This assessment was more comprehensive than traditional data center rate studies and provided a number of recommendations that TDC will be implementing which are aimed at improving its internal operations, thereby reducing TDC funding needs and decreasing rates to its client departments.

Analyst Recommendation. Given the data centers' historical practice of conducting biennial rate studies, it is anticipated that HHSDC will conduct a rate study within the next year. In view of this, we recommend that the Legislature direct HHSDC to conduct a rate study similar to the TDC study of its operations for the purpose of improving data center operations, thereby modifying rates and services to client departments. Specifically, we recommend the Legislature adopt the following supplemental report language:

> The Health and Human Services Agency Data Center (HHSDC), in consultation with the Department of Finance, shall conduct a rate study that evaluates HHSDC current operations and processes and identifies operations and processes that should be improved thereby resulting in reduced HHSDC costs and rates and improved services to client departments.

Increased Expenditure Not Justified for IHSS/CMIPS Project

We recommend that the Legislature (1) deny the $376,000 increase for the In-Home Supportive Services/Case Management Information and Payrolling System (IHSS/CMIPS) Project, and (2) approve the extension of three limited-term positions needed to complete the IHSS/CMIPS procurement activities. (Reduce Item 4130-001-0632 by $376,000.)

Background. The In-Home Supportive Services (IHSS) program was established in 1973 in DSS as a program to provide in-home supportive services to qualified aged, blind, and disabled persons. In 1979, DSS contracted with Electronic Data Systems for the development and operation of a system known as the IHSS/CMIPS Project. The IHSS/CMIPS system was implemented statewide in 1979. In 1998, DSS was directed by the Department of Information Technology and the Department of Finance to conduct a competitive procurement for a new contract for the system. As with other DSS-related projects, HHSDC was assigned responsibilities for the procurement activities.

Budget Proposal. Last year, the Legislature authorized an increase of $309,000 for three one-year limited-term positions to enable HHSDC to complete the procurement. The positions were authorized for the period of January 2002 through December 2002. Due to delays in the contracting process, the budget requests an increase of $376,000 to extend the positions for six additional months through June 2003. Procurement activities are expected to be completed and a new contract in place by November 2003.

Analyst Findings and Recommendations. Based on our review, we conclude that the proposal double budgets funds for the IHSS/CMIPS staff positions. This is because in building the 2002-03 budget, the administration failed to reduce the data center's baseline expenditures for the three limited-term positions before adding funds for the extension of these positions. Accordingly, based on our analysis we would recommend that the Legislature deny the proposed $376,000 increase and approve the continuation of the three limited-term positions to complete the procurement activities in the budget year.

Additional Funding for SFIS Not Justified

We recommend that the Legislature reduce the Health and Human Services Agency Data Center's (HHSDC) expenditure authority for the Statewide Fingerprint Imaging System (SFIS) by $464,000 since (1) the proposed consulting services are duplicative of activities that state staff can perform and (2) HHSDC cannot identify specific legal and legislative activities that SFIS legal services are currently supporting or will perform in the budget year. We withhold recommendation on the proposed consulting services pending receipt of additional information justifying these services in the budget year. (Reduce Item 4130-001-0632 by $464,000.)

Background. The SFIS is a system that automates the collection, interpretation, and storage of fingerprints for persons applying for public benefits. The purpose of the system is to reduce welfare and food stamp fraud. The system was implemented statewide in December 2000. The SFIS project is the only DSS county-based project funded entirely from the General Fund.

Budget Proposal. The Governor's budget proposes total funding of $11.4 million for the ongoing maintenance and operations for the SFIS Project. This amount includes a proposed augmentation of $561,000 in 2002-03. The proposed increase has three components:

- ***Software Independent Verification and Validation (IV&V) Services.*** Software IV&V is the review of software development processes and practices to ensure compliance with project standards and policies. The budget requests $293,000 to continue IV&V services on the SFIS project.
- ***Legal Services.*** The budget proposes to increase HHSDC's expenditure authority by $78,000 for additional legal services resulting in a total of $171,000 for SFIS legal services. (There is currently $93,000 in the baseline.) The HHSDC indicates these additional legal services are needed to support SFIS lawsuits and legislative issues.
- ***Fingerprint Expert Consulting.*** The budget proposes to increase HHSDC's expenditure authority by $190,000 for additional consulting services to review proposed equipment replacements scheduled for 2003-04.

Analyst Findings and Recommendations. We have several concerns with this proposal. First, the Legislature approved additional state staff in 2000-01 to review proposed SFIS changes. Based on our review, we conclude that these positions can also conduct reviews to ensure compliance with project standards. Accordingly, we recommend that the Legislature deny the request for additional IV&V services because it is duplicative of activities that should be performed by existing state staff. Second, HHSDC is unable to identify any specific pending lawsuits, or legislative activities that legal staff would work on in either the current or budget years. In view of this, we recommend the Legislature deny the proposed $78,000 increase and further reduce Item 4130-001-0632 by $93,000 for the unspecified legal services to the project. Finally, we withhold recommendation on the proposed expenditure authority increase of $190,000 for fingerprint consulting services pending receipt of additional information demonstrating (1) the need to pursue these activities during the budget year, and (2) the consequences to the ongoing support of the SFIS system should these activities be deferred one year.

Undefined Oversight on Statewide Automated Welfare System

We recommend that the Legislature reduce the Health and Human Services Agency Data Center's expenditure authority by $2.3 million for undefined consulting activities on the Statewide Automated Welfare System Oversight Project. (Reduce Item 4130-001-0632 by $2.3 million.)

The purpose of the Statewide Automated Welfare System (SAWS) is to provide improved and uniform information technology capability to county welfare operations. The system is being delivered through a state partnership with the counties, each of which has chosen to be in one of four consortia. Figure 2 shows the four consortia, the participating counties, and the status of each.

Figure 2

Statewide Automated Welfare System Consortia

	Status	Proposed Budget Change
Interim SAWS		
35 counties: Alpine, Amador, Butte, Calaveras, Colusa, Del Norte, El Dorado, Glenn, Humboldt, Imperial, Inyo, Kern, Kings, Lake, Lassen, Madera, Marin, Mariposa, Mendocino, Modoc, Mono, Monterey, Napa, Nevada, Plumas, San Benito, San Joaquin, Shasta, Sierra, Siskiyou, Sutter, Tehama, Trinity, Tuolumne, Yuba	Working in all 35 counties.	$5.2 million
Los Angeles Eligibility Automated Determination, Evaluation, and Reporting System		
1 county: Los Angeles	Operational county-wide.	None
Welfare Client Data System		
18 counties: Alameda, Contra Costa, Fresno, Orange, Placer, Sacramento, San Diego, San Francisco, San Luis Obispo, San Mateo, Santa Barbara, Santa Clara, Santa Cruz, Solano, Sonoma, Tulare, Ventura, Yolo	Software pilot to begin in 2002. Consortium wide implementation to begin 2003.	None
Consortium IV		
4 counties: Merced, Riverside, San Bernardino, Stanislaus	Software development in progress. Pilots and consortium wide implementation to begin 2003.	None

The data center provides oversight for the four SAWS consortia by preparing project documents and budget proposals, reviewing consortia deliverables, managing project risk on the four SAWS consortia, and approving and tracking expenditures. These oversight activities are performed by both state staff and contractors.

Undefined Oversight Consulting Services. The budget includes a total of $7 million for SAWS-related oversight activities, including $2.3 million for consulting services. However, HHSDC is unable to provide details on the consulting services that are to be provided by the contractors. Specifically, the budget request does not indicate what specific activities and tasks will be performed during the budget year. In the absence of this information, the Legislature has no basis for providing the $2.3 million in expenditure authority in the budget year. Therefore, we recommend that the Legislature reduce HHSDC's expenditure authority by $2.3 million.

DEPARTMENT OF INDUSTRIAL RELATIONS
(8350)

The mission of the Department of Industrial Relations (DIR) is to protect the workforce of California, improve working conditions, and advance opportunities for profitable employment. These responsibilities are carried out through three major programs: the adjudication of workers' compensation disputes; the prevention of industrial injuries and deaths; and the enforcement of laws relating to wages, hours, and working conditions. In addition, the department regulates self-insured workers' compensation insurance plans, provides workers' compensation payments to injured workers of uninsured employers and other special categories of employees, offers conciliation services in labor disputes, and conducts and disseminates labor force research.

The Governor's budget proposes expenditures totaling $259 million for the department in 2002-03. This is 4.1 percent less than estimated expenditures for the current year. The request includes $156 million from the General Fund, 11 percent less than 2001-02 estimated expenditures. The budget proposes to offset portions of this General Fund reduction with various special fund augmentations.

In the following sections, we discuss the effectiveness of DIR's business inspection programs and a supplemental report submitted by the department. The *Supplemental Report of the 2001 Budget Act* required our office to (1) analyze DIR's workload estimate for 20 additional positions authorized for the Division of Labor Standards Enforcement in the current year and (2) recommend standards for determining the adequacy of funding for DIR's various enforcement programs.

EFFECTIVENESS OF ENFORCEMENT INSPECTION PROGRAMS

Background

Among its several duties, DIR is responsible for preventing work-related injuries and deaths through its Division of Occupational Safety and Health (DOSH). The department also is responsible for establishing standards for wages, hours, and working conditions through its Division of Labor Standards Enforcement (DLSE).

These responsibilities are carried out through a number of activities. These include issuing permits to businesses for particular activities, consulting with businesses to identify and correct workplace hazards, investigating workers' complaints about their employers and workplace conditions, and inspecting and issuing citations to businesses for violations of employment and workplace statutes and standards. In 2001-02, the budget provided $74 million for about 740 personnel-years (PYs) for DOSH and $42 million for around 460 PYs for support of DLSE activities.

Business Inspections Are Key Enforcement Tool. This analysis focuses specifically on enforcement inspections performed by DOSH and DLSE. Inspections of businesses are a primary tool DIR uses to enforce existing laws regarding workplace safety, health, and labor standards. These inspections not only reveal companies that are not complying with state law, but they can also be used to identify emerging problem areas or trends in industries as they relate to compliance with workplace health, safety, and labor standards. Both DOSH and DLSE devote a significant portion of their staff to these inspection activities. The DOSH has about 225 investigators while DLSE has around 80.

Typically, DOSH inspectors examine the workplace for compliance with safety requirements, interview employees and supervisors about work conditions, take workplace pictures and samples (air quality and noise level in the work area, for example), and review various documents such as injury logs. For DLSE, inspectors check the company's records including business registration, proof of workers' compensation insurance, payroll records to ensure wages have been paid and appropriate taxes deducted, and tax returns. Inspectors also investigate the worksite and interview employees about working conditions. After an inspection, the employer is notified of any violations, and citations are issued and penalties assessed. Depending on the severity of a violation, DIR staff may return to the worksite to confirm that the business has corrected cited violations.

On average, DOSH and DLSE conduct 9,000 and 5,000 inspections a year, respectively. About three-quarters of the inspections are investigations in response to workplace complaints or reported accidents. The remaining inspections are "programmed," or planned visits to preselected businesses. The divisions target industries for these inspections based on past complaints, known problems, or to implement new workplace standards.

How Does DIR Assess Effectiveness of Inspection Programs?

The Division of Occupational Safety and Health and the Division of Labor Standards Enforcement each use a variety of measures to assess the effectiveness of their inspection programs. In general, the focus is on activity measures such as the number of inspections performed, as opposed to outcome measures or progress toward achieving the core goals of the programs to improve workplace safety, health, and compliance with labor laws.

Measures of Effectiveness. As noted above, business inspections are a key tool for DIR's enforcement of existing law. There are three main ways to measure the effectiveness of inspections.

- *Activity* measures show the type and number of inspections conducted by the program. Often, these are workload- and input-oriented. These measures can include the number and type of inspections conducted, the number of violations cited, as well as penalties and back wages found due.
- *Outcome* measures attempt to gauge what resulted from the inspections. As such, they are better than activity measures for determining program effectiveness. Examples include penalties and back wages paid.
- *Benchmark* measures gauge progress toward achieving the core goals of the inspection programs to improve workplace safety, health, and compliance with labor laws. Examples of benchmarks include the number of workdays lost due to injury and overall workplace compliance with labor standards.

The DOSH Uses a Variety of Measures. Our review shows that DOSH uses a combination of measures to assess the effectiveness of its inspection program. This includes activity and outcome measures related to inspections of individual businesses. In addition, for the businesses inspected, DOSH measures the percentage of cited violations that are serious in nature and calculates a violations-per-inspection ratio. The division tracks these measures over time, and uses the information to assess the effectiveness of the division's effort in targeting specific industries for programmed inspections. While the division monitors these data, there are no established goals for these measures.

The DOSH also uses benchmark measures to assess workplace health and safety over time for particular industries, as well as across industries. For instance, for high hazard industries (that is, industries with higher than average injury rates), DOSH utilizes the lost workday incidence rate (LWDI) as a benchmark measure. The LWDI is a widely used injury indicator that measures the rate of missed or restricted-activity workdays associated with injury and illness per 100 employees. The DOSH tracks this indicator over time for the companies it inspected to see if the division's intervention is associated with a decline in this measure. For the high hazard, agriculture, and construction industries, DOSH also sets percentage goals for reducing industry-wide (that is, all businesses in the state within a particular industry) LWDI, as well as fatalities, in its annual performance plan developed for the U.S. Occupational Safety and Health Administration (OSHA), as required by federal law.

The DLSE Relies Only on Activity Measures to Assess Effectiveness. Our review shows that DLSE, unlike DOSH, focuses only on activity measures to assess the effectiveness of its inspection program. The division relies exclusively on the number of inspections performed as the key indicator of program effectiveness. As we discuss later in this analysis, this measure does not provide an indicator of compliance or indicate whether DLSE is effective in its inspections program.

Statutory Reports Focus on Inspection Activities. Current law requires both DOSH and DLSE to report on their inspection activities annually. Figure 1 summarizes the respective reporting requirements as they relate to the inspection programs. Based on the information provided in the reports, the Legislature can be informed of basic inspection activities and outcomes. However, the current reports do not address progress against any goals or benchmarks to demonstrate the impact on inspected businesses. We discuss the need for such information in the following sections.

Figure 1

Statutorily Required Inspection Data

Division of Occupational Safety and Health

- ✓ Funds appropriated and spent for enforcement.
- ✓ The number of inspections made and citations issued.
- ✓ The number of penalties assessed and the total amount of fines collected.

Division of Labor Standards Enforcement

- ✓ The enforcement plan and the rationale for priorities.
- ✓ The number of inspections made and types of violations found.
- ✓ The amount of back wages found due and paid.
- ✓ The amount of penalties collected.

DOSH Program Needs Overall Program Goals And Improved Reporting

We find that the Division of Occupational Safety and Health (DOSH) inspection program appears to have a positive impact on workplace safety. Nevertheless, DOSH should establish program goals to allow for better assessment of the effectiveness of the inspection program. We recommend the enactment of legislation to amend the statutory reporting requirement to include program goals and results.

Workplace Violations and Injuries Have Declined, Increased DOSH Enforcement Appears to Have an Impact. Our review of activity and outcome measures for DOSH inspections shows that increased inspection efforts in recent years have been associated with a drop in violations of workplace health and safety laws. As Figure 2 shows, the number of programmed inspections increased 40 percent between 1996 and 2000, with an accompanying decline in serious violations of 24 percent. While there has been some recent concern regarding the timeliness of the division's response to accidents and complaints, the data on inspections and violations for the last five years, when considered together, *suggest* that businesses have increased their compliance with workplace safety and health standards.

Figure 2

Division of Occupational Safety and Health Inspections and Violations

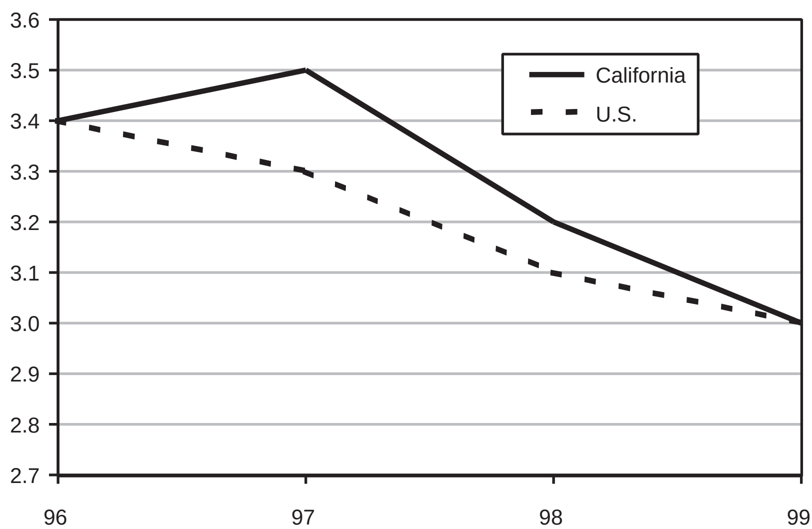
	1996	1997	1998	1999	2000
Reason for Inspection					
Accident/complaint	5,976	6,283	6,208	5,950	5,656
Programmed	1,851	1,981	1,698	2,270	2,594
Follow-up	249	259	240	163	189
Other	1,027	1,008	1,176	1,054	859
Totals	**9,103**	**9,531**	**9,322**	**9,437**	**9,298**
Type of Violation					
Serious	5,824	5,417	5,292	4,628	4,410
Not serious	16,002	17,088	15,597	15,652	16,468
Totals	**21,826**	**22,505**	**20,889**	**20,280**	**20,878**

The increased compliance is also evidenced by statistics compiled by the U.S. Department of Labor (U.S. DOL) for California and the nation for various industries. Figures 3 and 4 show California industry's performance versus the nation for workplace injuries that result in lost workdays (LWDI discussed above) and injuries that do not result in lost workdays, respectively. Although California LWDI exceeded the U.S. level in the middle of the period, the state rate declined more rapidly than the nation's after 1997. For injuries without lost workdays, the California rate was better than the U.S. over the period. While these results are not entirely attributable to DOSH activities, they also suggest that the combination of state laws and DOSH enforcement improves workplace safety and health.

Figure 3

Lost Workday Injury Incidence Rate

Per 100 Employees



Data System Allows Trend Analysis. Our review also shows that in addition to monitoring inspection-related data, DOSH has a data system that tracks collection of assessed penalties. For each year's assessed penalties, the system tracks the year of collection so that the division knows how long it takes to collect penalties. Inspection staff are notified when an assessed penalty is paid in full. The system thus helps to ensure payment of penalties so that citations have the intended effect of penalizing noncompliance.

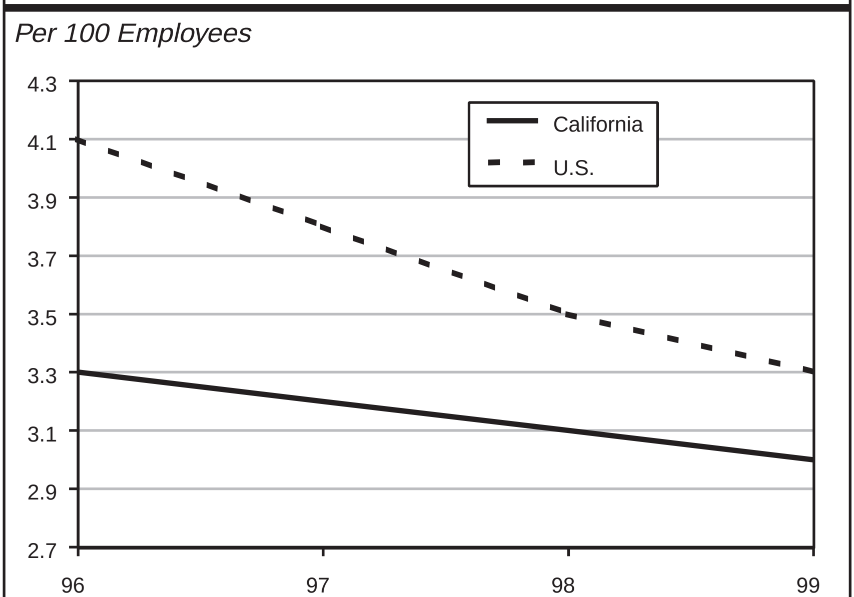
The DOSH Should Set Overall Goals for Inspections. While DOSH sets goals for programmed inspections that target specific industries, our review finds that the division lacks goals for its inspection program overall. This includes the 61 percent of inspections that result from accidents or complaints, as Figure 2 shows.

Currently, DOSH includes industry-specific goals in its federal performance plan for high hazard, agricultural, and construction industries. These goals include reducing LWDI and the number of fatalities.

However, DOSH does not set specific goals for the entirety of inspections conducted—whether accident, complaint, programmed, or follow-up. As a result, the effectiveness of the majority of inspections cannot be evaluated against established goals. Without overall goals, it is also difficult for DOSH and the Legislature to determine the total workload for the inspections program and to set priorities for resource allocation.

Figure 4

Non-Lost Workday Injury Incidence Rate



We think that overall goals could be set based on standards established by existing law or in DOSH's policies and procedures. For example, statute currently specifies timeframes within which DOSH must respond to complaints and fatalities, perform follow-up inspections, and verify that inspected businesses have abated cited violations. Similarly, the division's policies and procedures currently establish five inspection priority levels as well as mandatory and discretionary follow-up inspections.

Setting goals based on these requirements would provide a basis for both DOSH and the Legislature to determine the workload of the division relative to the established priorities and requirements and allocate its resources accordingly.

The DOSH Should Report on Available Data. Although DOSH compiles a substantial amount of data, our review shows that often these data are not provided in a readily accessible way that facilitates legislative oversight of the inspection program. For example, the division uses LWDI to assess high hazard companies' injury and illness experience before and after an inspection. However, DOSH does not compare this measure for the inspected companies with that for all California businesses in those industries, information that is available from U.S. DOL's injury data. Such a comparison would more readily demonstrate the impact attributable to the inspection program.

In addition, while both DOSH and federal OSHA evaluate the division's progress toward its goals set in the federal performance plan, the results of these evaluations are not made known to the Legislature.

The DOSH Should Include Information on Goals and Results in Its Annual Report. In order to facilitate legislative review and oversight, we recommend that current law be amended to require DOSH, as part of its annual report, to include the following data on program goals and effectiveness:

- The number of inspections performed in each priority level, as established by the division's policies and procedures.
- The number of mandatory and discretionary follow-up inspections performed compared to the number of follow-up inspections planned.
- Goals and results for meeting statutory timeframes for inspections.
- Goals established in the federally approved annual performance plan and actual attainment of the goals.

These changes would improve the ability of DOSH and the Legislature to assess program effectiveness.

DLSE Effectiveness Limited by Lack of Case Tracking System

Although overall labor standards compliance appears to have improved among businesses inspected by the Division of Labor Standards Enforcement, the effectiveness of the division's inspection program cannot be determined because it lacks a data management system to provide detailed inspection-related information.

Compliance Appears to Have Improved. Our review of summary inspection activity and citation data provided by DLSE suggests that among businesses inspected by DLSE, labor standards compliance appears to have improved. Figure 5 shows the number of inspections conducted by DLSE from 1996 through 2000 and the citations issued. As the figure shows, inspections increased by 16 percent from 1996 through 2000, while the number of citations issued declined by 23 percent. This suggests a generally higher level of compliance among inspected businesses, in particular in the workers' compensation insurance area where citations dropped by about 31 percent. However, citations for violation of child labor laws and regulations increased by about 21 percent over the five years.

Figure 5

Division of Labor Standards Enforcement Inspections and Citations

1996 Through 2000

	1996	1997	1998	1999	2000
Number of Inspections	**5,089**	**5,689**	**4,876**	**5,299**	**5,892**
Type of Citation					
Workers' compensation	1,357	1,381	1,099	1,136	937
Child labor	293	256	213	299	355
Others	1,316	1,570	1,182	1,026	987
Totals	**2,966**	**3,207**	**2,494**	**2,461**	**2,279**

Lack of Data System Makes Effectiveness of Inspection Program Hard to Determine. While summary data are suggestive of improved compliance in general, we cannot readily determine how effective the DLSE enforcement inspection program is in targeting particular areas of concern or industries. For instance, we cannot tell whether the improvement in workers' compensation insurance is the result of concentrated inspection efforts in particular industries or an overall general increase in compliance. This is because the division lacks a data system that provides detailed information on inspections, violations, and penalties.

For example, while the division knows the total number of inspections per year, DLSE does not keep track of the type of inspections conducted—complaint, programmed "sweep," or follow-up. In fact, the division had to manually count files to tally complaint and programmed inspections for 2000, while the data for previous years were not available at all because the division had thrown away the case files. In addition, the division has never tracked the number of follow-up inspections. The DLSE also does not track the type of citation—child labor, workers' compensation, overtime, and minimum wage, for example—for specific industries, except for garment manufacturing and agriculture, industries on which the division focuses particular attention.

Without this type of information, DLSE cannot easily identify noncompliance trends, repeat violators, or problem industries so that the division can target resources to those areas. This limits the most effective deployment of resources.

Similarly, the division's ability to secure payment of back wages and penalties is also limited by the lack of an adequate data system. For instance, data on collected penalties cannot be tied to assessed penalties because DLSE does not have an accounts receivable system to track when penalties are paid. Also, DLSE cannot track whether back wages assessed to individual businesses have been paid. This limits DLSE's ability to ensure that citations have the intended effect of penalizing noncompliance and that workers receive wages due them.

Case Management System Proposal Under Review

Pending approval of the feasibility study report by the Department of Information Technology, we withhold recommendation on the $1.1 million General Fund request for the first-year costs of a Division of Labor Standards Enforcement case management system.

As we indicated above, DLSE does not have an information management system to track inspection cases. Recognizing the need for such data, the division has submitted a feasibility study report (FSR) to the Department of Information Technology (DOIT) to develop a case tracking system at an estimated cost of $3.9 million over three years, with $0.6 million in ongoing costs. The Governor's budget includes $1.1 million to begin development of this system in 2002-03, although DOIT has not yet approved the FSR.

We think that it is important for the department to have the capability to track and identify inspection and citation data at the level of detail described above in order to maximize the effectiveness of its enforcement program. However, pending DOIT's review and approval of the system, we withhold recommendation on the budget proposal.

DLSE Should Include Information From Data System In Annual Report

We find that the Division of Labor Standards Enforcement 's (DLSE's) reliance on the number of inspections as a measure of program impact is deficient because it does not measure compliance with labor laws. The division should establish industry- and citation-specific compliance targets. We recommend that current law be amended to require DLSE, as part of its annual report, to include compliance goals and results.

Upon the development of a case management system, DLSE will be able to use the data made available by the system to better track businesses' compliance with labor standards. The DLSE should also use the data provided by such a system to develop benchmarks to assess performance over time. As discussed above, currently DLSE measures the effectiveness of its inspection program in terms of the extent to which it met the number of inspections the previous year. This, however, does not measure compliance. In contrast, U.S. DOL determines compliance levels in various industries by measuring over time the percentage of inspected businesses in each of the industries that did not have any violations. We think that DLSE should consider setting compliance targets similar to those used by U.S. DOL. This would provide DLSE with more meaningful and effective measures to direct the allocation of resources to target problem industries or violations.

Accordingly, we recommend that the Legislature amend the current reporting requirement in statute to include industry- and citation-specific compliance goals and results, in a manner similar to that of U.S. DOL. The additional information would help to focus DLSE's evaluation efforts on benchmark measures, instead of activity data, to assess the effectiveness of the inspection program.

ENFORCEMENT WORKLOAD

Supplemental Report on Current-Year Augmentation For DLSE Enforcement

We find that the department's methodology for reporting and evaluating workload for the new investigator positions is appropriate. We recommend that in preparing its March 15, 2002 update report, the Department of Industrial Relations also include proposed workload measures for its new supervisor and administrative positions. In addition to workload measures, the department should set compliance targets and compile data on whether it meets these goals to determine the adequacy of funding for its enforcement programs.

Other Enforcement Programs. In addition to the inspection program we reviewed above, DLSE also investigates complaints regarding workplace discrimination and failure to pay the prevailing wage rate, as required by law, on construction projects receiving public funds. In the current year, DLSE received a $1.6 million augmentation and 20 additional enforcement positions for these three programs.

The *Supplemental Report of the 2001 Budget Act* requires DIR to report to the Legislature by December 15, 2001 and March 15, 2002 on its progress in filling these positions and their workload. The supplemental report also requires our office to (1) analyze the December 15, 2001 report and (2) recommend standards for determining the adequacy of funding for DIR's various enforcement programs. The supplemental report requires these standards to consider the department's statutory requirements and ensure sufficient enforcement presence in the workplace.

Hiring Halted for a Time Due to Hiring Freeze. In its first report, DIR indicates that once the new positions were established on October 1, 2001, it immediately began filling them using existing eligibility lists from recently administered civil service tests. After filling seven positions—three investigators, three administrative staff, and one supervisor—the Governor imposed a hiring freeze at the end of October, leaving 13 positions unfilled. Subsequently, at the beginning of December, the Department of Finance granted DIR an exemption from the hiring freeze for these positions. Consequently, the department has begun the hiring process again.

According to the report, DIR has allocated the 20 positions and assigned duties for the filled positions as follows:

- ***Bureau of Field Enforcement.*** Five of 17 positions are filled. The bureau inspects businesses for compliance with labor law. Filled positions include one supervisor to ensure staff training, assign complaint inspections, and schedule programmed "sweep" inspections; one inspector; and three administrative positions to perform inspection- and appeals-related clerical work.
- ***Discrimination Complaint Investigation Unit.*** One position allocated is filled. This unit investigates claims of employment discrimination based on personal characteristics (like race, gender, or age) or reporting substandard working conditions, for example. The filled position is an investigator.
- ***Public Works Unit.*** One position allocated is filled. This unit enforces prevailing wage law for construction projects that receive public funds. The filled position is an investigator.
- ***Headquarters.*** One administrative position allocated is not filled.

The DIR's Measures to Evaluate Workload Are Appropriate, But Not Complete. The supplemental report required DIR to establish measures to evaluate the workload of these new positions. Our review shows that DIR did not propose measures for evaluating the workload of the supervisor and administrative positions. However, the department plans to evaluate *investigator* workload by tracking activity and outcome data, as discussed previously. For the Bureau of Field Enforcement, these measures include the number of inspections conducted and citations issued, as well as the amount of penalties and back wages collected. For the Discrimination Complaint Investigation Unit, measures include the number of cases assigned, under investigation, and closed. For the Public Works Unit, measures include the number of cases opened, pending, and closed, as well as the amount of penalties and wages collected.

Based on data for these activity and outcome measures for January through September 2001, DIR estimated the work that would have been completed on an annual basis per investigator. This becomes the basis for the department's workload standard. Using this standard, the department estimates the additional workload that can be accomplished with the new investigator positions.

We find that the methodology used by DIR to report and evaluate workload is appropriate. However, the methodology does not cover supervisor or administrative positions as required by the supplemental report language. Therefore, we recommend that in preparing its March 15, 2002 update report, DIR prepare proposed workload measures for these positions as well.

Funding Standards Should Focus on Compliance, Not Just Program Activities. The goal of enforcement programs is to ensure compliance with laws. As such, workload measured in terms of activity should not be the only factor in determining the level of funding for enforcement programs. Rather, the level of compliance should also be used as a factor. As discussed in the previous section, the department, in particular DLSE, should establish compliance goals and targets to meet statutory requirements. The department should then compile data on whether these targets are met. Based on actual compliance data, the department can then determine whether resources are adequate to achieve the compliance targets.

PUBLIC UTILITIES COMMISSION
(8660)

The California Public Utilities Commission (CPUC) is responsible for the regulation of privately owned "public utilities," such as gas, electric, telephone, and railroad corporations, as well as certain passenger and household goods carriers. The commission's primary objective is to ensure adequate facilities and services for the public at equitable and reasonable rates. The commission also promotes energy and resource conservation through its various regulatory decisions.

Proposed Funding. The budget proposes total CPUC expenditures of $1.3 billion in the budget year from various special funds and federal funds. This is a $329 million reduction from the current year. The large 2002-03 reduction is mainly due to one-time General Fund monies appropriated in Chapter 7x, Statutes of 2001 (SB 5x, Sher), which have been spent in the current year for various programs to promote energy efficiency and provide discounted electricity service to low-income customers. The Governor's budget also proposes 25.7 new personnel-years (PYs) to administer five universal service telephone programs, bringing the commission's budget-year staffing level to 921.9 PYs.

New Programs in Budget Totals. In the current year, spending on five existing universal service telephone programs was included in the budget of the CPUC pursuant to Chapter 677, Statutes of 1999 (SB 669, Polanco). The remaining universal service telephone program, the Deaf and Disabled Telecommunication Program (DDTP), is proposed to transition "on budget" in 2002-03. These programs account for roughly $1.1 billion of the CPUC's total expenditures in the budget year, which is roughly 90 percent of the commission's total support. These programs are now subject to appropriations in the budget act. In addition, the CPUC's funding also includes the proceeds from a new natural gas surcharge for natural gas public purpose programs. These funds are continuously appropriated and not subject to budget act appropriation.

UNIVERSAL SERVICE TELEPHONE PROGRAMS

Background

The CPUC currently administers five universal service telephone programs that seek to expand access to basic telephone services. It does so by subsidizing the cost of service for certain people (such as low-income persons and persons living in remote areas) through surcharges on all telephone users' monthly bills. These programs include:

- ***Universal Lifeline Telephone Service.*** Program subsidizes basic telephone service for low-income persons.
- ***California High Cost Fund-A.*** Program subsidizes basic telephone service provided by 17 small local telephone companies servicing high-cost, predominantly rural areas in the state.
- ***California High Cost Fund-B.*** Program subsidizes basic service in high-cost areas of the service territories of four large local telephone companies, including Pacific Bell, Verizon California, Inc., Roseville Telephone Company, and Citizens Telcommunications of California.
- ***California Teleconnect Fund.*** Program subsidizes telephone service for various entities, including schools, libraries, community-based organizations, and city- and county-owned hospitals and clinics.
- ***Public Payphone Programs.*** Program regulates payphones and provides public payphones and hearing impaired phones in places where phones are needed.

In addition to the above programs, the DDTP program will be administered by the CPUC in the budget year. This program provides a variety of services for hearing-impaired and disabled persons. With the enactment of Chapter 677, the CPUC annually approves a budget for each of these programs that is subject to appropriation in the budget act.

Reporting Requirements Needed for Public Payphone Programs

We recommend approval of the 13 two-year limited-term positions for the support of three public payphone programs. However, we further recommend the adoption of supplemental report language that directs the California Public Utilities Commission to report on the workload and effectiveness of these programs by December 1, 2003. This will enable the Legislature to determine the number of permanent positions that will eventually be needed to administer these programs.

Background. The CPUC administers three public payphone programs that are funded through utility customer bills. These programs include: (1) the Public Policy Payphone Program, which places public pay phones in areas that would otherwise not be served; (2) the Payphone Service Providers Enforcement Program, that ensures payphones are in acceptable working order and charging approved rates; and (3) the Telecommunications Devices for the Deaf Interim Placement Committee, which ensures that the hearing impaired have access to communications devices in public places. All three of these programs will be administered by the CPUC's Consumer Services Division under the guidance of the Payphone Service Provider Committee, which is an advisory board created by Chapter 677. Prior to this program being under the control and direction of the CPUC, 15 non-civil-service positions were involved in administering these programs.

Budget Proposal. The 2002-03 budget proposes about $750,000 for 13 new two-year limited-term positions to support the three public payphone programs described above. Since these are new programs under the CPUC administration, there is little workload data available to justify these positions and the effectiveness of these programs in meeting their goals. Nevertheless, we recommend approval of the 13 positions on a two-year limited-term basis. We further recommend that the Legislature adopt supplemental report language directing the commission to provide information that justifies its staffing needs for the public payphone programs. This information would assist the Legislature's consideration of permanent positions for these programs in the 2004-05 budget. Without the information identified in the language below, the Legislature will not be in a position to determine the effectiveness of these programs or the level of ongoing support needed to administer them. We recommend the following supplemental report language in Item 8660-001-0491:

> On or before December 1, 2003, the California Public Utilities Commission shall submit, to the Chairs of the Joint Legislative Budget Committee and the fiscal committees of both houses of the Legislature, a report that justifies its staffing needs for its public payphone programs based on actual workload data. In addition to the staffing levels of each program, this report should include the following information:
>
> ***1. Public Policy Payphone Program.*** The number of applications received for new public policy payphones, the number of public policy payphones placed in California, the location of the public policy payphones, and the number of hours spent on each application and payphone placement case.
>
> ***2. Payphone Service Providers Enforcement.*** The number of payphones inspected, the percentage of total phones inspected, the number of payphones not in compliance, the number of payphones disconnected, and the number of hours spent on each inspection and compliance case.

3. Telecommunications Devices for the Deaf Interim Placement Committee. The number of phones placed, the number of applications/ requests for the placement of these phones, and the number of hours spent on each phone placement case.

California Consumer Power and Conservation Financing Authority (8665)

Background

The California Consumer Power and Conservation Financing Authority (hereafter referred to as the California Power Authority, or CPA) was created by Chapter 10x, Statutes of 2001 (SB 6x, Burton), to assure a reliable supply of power to Californians at just and reasonable rates, including planning for a prudent energy reserve. The CPA was also created to encourage energy efficiency, conservation, and the use of renewable resources.

In order to meet these goals, the CPA is authorized to purchase, lease, or build new power plants to supplement private and public sector power supplies. It may also finance energy conservation programs and renewable energy projects. The financing for these projects is provided by $5 billion in revenue bonding authority, with any bonds issued being secured by the revenues generated from the specific projects being financed by the CPA. In addition, the CPA has also been given the authority to finance natural gas transportation and storage projects that have been recommended by the California Public Utilities Commission, as well as provide financing to retrofit old and inefficient power plants.

Repayment Plan Needed for General Fund Loan

We withhold recommendation on the proposed expenditure of $5.5 million loaned from the General Fund to support CPA start-up activities. Furthermore, we recommend that the CPA report before budget hearings on specific projects and financing arrangements supporting its financial plan, including the planned repayment of its General Fund loan.

Proposed Budget. The CPA was provided a $10 million General Fund loan to be allocated upon notification of the Legislature in the *2001-02*

Budget Act. To date, $4.5 million has been allocated to the CPA for current-year expenditures. The budget proposes to allocate the remaining balance, $5.5 million, in the budget year.

Plan for Repayment Needed. Since the CPA was established last fall, it has been working on what its role will be in the state's electricity market. It has also been working on its statutorily mandated Energy Resource Investment Plan (ERIP) that is due to the Legislature in mid-February. A draft of its ERIP has been released and summarizes a financial plan over the next four years. However, few details are available regarding specific projects or financing arrangements that support this plan, including the planned repayment of the state in the budget year. Therefore, we withhold recommendation on the $5.5 million proposed in the budget year until supporting documentation of the CPA's financial plan is received and reviewed.

California Department of Food and Agriculture (8750)

The California Department of Food and Agriculture (CDFA) promotes and regulates the state's agriculture industry through marketing programs and industry inspections. The department is responsible for developing California's agricultural policies and assuring accurate weights and measures in commerce. The department also provides financial oversight to county and district fairs.

The budget proposes expenditures of about $259 million and 1,936 positions in 2002-03 for the department, including $97 million from the Department of Agriculture Fund and $103 million from the General Fund. The proposed expenditures are $73 million, or 28 percent, below estimated current-year expenditures. One-time federal funds totaling $63 million that are included in the current year but do not appear in the budget year make up most of the reduction for the coming year.

Industry Should Contribute to Medfly Control

We recommend the enactment of legislation authorizing the department to assess the agricultural industry through fees for 50 percent of the state's cost of the Medfly Preventative Release Program. For 2002-03, we recommend that the General Fund support 50 percent of the program cost and that the remaining 50 percent be structured as a General Fund loan repayable on or before June 30, 2004 from fee assessments on industry. (Reduce Item 8750-001-0001 by $4.6 million.)

Background. The Governor's budget proposes $9.2 million from the General Fund and 138 positions to provide funding for Mediterranean Fruit Fly (medfly) control on an ongoing basis. The department began efforts to control the impact of the medfly on California's agricultural industry in 1975. Since 1980, the state has spent around $140 million from the General Fund to support this effort, with a similar amount provided by the federal government. The department has used aerial and ground spraying, and sterile medfly releases to fight the pest.

The current Preventative Release Program (PRP) began in 1996 and involves raising sterile medflies and releasing them throughout a 2,100 square mile area of the Los Angeles Basin. Total program costs are $18 million annually, shared equally between the state and the federal government. The Legislature approved this as a five-year program with a June 30, 2001 sunset date. The *2001-02 Budget Act* extended the program for an additional year.

Department Directed to Examine Different Funding Mechanism; But Has Not Responded. During the 2001-02 budget hearings, the Legislature expressed concern over the General Fund obligation for the program and directed the department, through supplemental report language, to provide information detailing how the funding source for the PRP could be shifted in whole, or in part from the General Fund to the Agriculture Fund. This report, due January 10, 2002, is to include various funding options for the Legislature to consider. At the time this analysis was prepared, the department had not submitted the report to the Legislature.

Industries That Benefit Should Share in Cost. Field data indicate that the PRP is successfully controlling the medfly population in southern California. By preventing the establishment of medfly populations, the PRP protects a variety of fruit growing industries including peaches, pears, lemons, limes, and oranges. The CDFA estimates that in the absence of such a program the direct crop losses as a result of medfly damage could range between approximately $150 million to $300 million annually with a like amount lost to urban gardeners. Clearly, control of medfly populations and damage on agriculture generates benefits to the consumers of the state. Thus, there should be some General Fund support of this program. However, it is equally clear that specific agricultural industries benefit from this state-run program. We think that it is reasonable, therefore, that both the General Fund and the agricultural industries that most benefit from the program contribute equally to its support.

Accordingly, we recommend enactment of legislation, to direct CDFA to develop an assessment program that will equitably distribute half the cost of the PRP across those industries that most benefit from the absence of the medfly. This assessment should be distributed in such a manner as to maximize participation thereby minimizing the economic impact on any individual industry.

For 2002-03, we recommend that the General Fund provide half the amount requested for the program—$4.6 million—and the other half be structured as a General Fund loan, to be repaid from the program assessments no later than June 30, 2004.

Additional Funding for Multistate Coalition Not Warranted

We recommend deletion of $130,000 from the General Fund requested for the department's support of a multistate agricultural policy coalition because the department currently has resources for these activities. (Reduce Item 8750-001-0001 by $130,000.)

The budget requests $130,000 in General Fund money for the department to coordinate efforts with four other states in order to influence national agricultural policy.

In February 1999, the department, in conjunction with the agriculture departments in four other states—Florida, New Mexico, Texas, and Arizona—established a coalition to influence national agricultural policy in specific areas of concern to the five states. This coalition was established at a meeting of the National Association of State Departments of Agriculture (NASDA) and to date the coalition has been scheduling meetings to coincide with NASDA meetings to save on travel and other costs. Since 1999, CDFA has funded coalition-related activities from its base budget.

We believe the requested augmentation is not warranted. This is because the department has resources in its base budget to participate in a number of multistate groups to influence national agricultural policy. On an annual basis, it is up to the department to assess the priority of the various policy areas and allocate funding to participate in these meetings and conferences accordingly. Thus, coalition-related activities should be funded from the department's base budget, as it has been thus far.

Use Surplus Funds for Pierce's Disease Program

We recommend that General Fund support for the Pierce's Disease Control Program be reduced by $1.5 million and be replaced with a like amount from the reserve in the Pierce's Disease Management Account. We further recommend that the department report by the time of the May Revision on the amount of additional federal funds it has received, or anticipates receiving, for the current and budget years. Based on that information, we further recommend that the Legislature adjust the General Fund support for the program.

Background. In August 1999, an outbreak of Pierce's Disease, a bacteria that infects several plant species and can be particularly devastating to grape vines, was confirmed in the Temecula area in southern Riverside

County. It was determined that the cause for the spread of the disease was due to a nonnative insect—the Glassy-Winged Sharpshooter. In response to the potential harm this disease poses to the wine grape industry, the Legislature has appropriated $25 million to combat the spread of the disease through 2001-02. In addition, the federal government has provided about $19.7 million and the wine industry has contributed about $7.2 million. Thus, through 2001-02 $52 million has been committed to this program.

Budget Proposal. The budget includes $18.8 million from the Pierce's Disease Management Account (PDMA) for support of the Pierce's Disease Control Program. Of this amount, $8 million will be supported by the General Fund and $4.9 million by federal funds. The remaining $5.9 million will come from anticipated contributions from the wine and grape industry.

Account Reserve Not Needed. Our review shows that the projected program expenditure level would leave the PDMA a reserve of $1.6 million at the end of 2002-03, about the same amount estimated to be in the account at the end of the current year and 2000-01. (This reserve has accumulated from unexpended General Fund support provided to the program in 1999-00.) We see no reason why the account needs to maintain a reserve of this magnitude on an ongoing basis. As such, we think that the budget-year request of $8 million from the General Fund could be reduced by drawing down the reserve. Accordingly we recommend the amount of General Fund transfer into the PDMA support for the program be reduced by $1.5 million, leaving a reserve of $100,000.

Additional Federal Funds May Be Forthcoming. The department indicates that it is seeking additional funding for the program and has identified other possible federal funds above the amount projected in the budget. These funds, which would be made available through the federal Animal and Plant Health Inspection Services (APHIS) in the current year, could range from $2.4 million to $8 million depending on the outcome of negotiations between CDFA and APHIS. The 2002-03 federal budget proposes to increase APHIS funding by $162 million, mainly to combat pest outbreaks. Some of this money could be directed to the state's control of Pierce's Disease. To the extent the department receives these funds, we think they should be used in place of the remaining General Fund support provided for the budget year. Therefore, we further recommend that the department report to the Legislature by the time of the May Revision on the amount of federal funds it has received in the current year, or expects to receive in the budget year, that are not included as part of the Governor's budget. We recommend that the Legislature, based on that information, further reduce the General Fund support for the program.

ELECTRICITY OVERSIGHT BOARD (8770)

The Electricity Oversight Board (EOB) was created by Chapter 854, Statutes of 1996 (AB 1890, Brulte), which deregulated California's wholesale electricity industry. The board was created to oversee the California Independent System Operator (ISO), which manages the transmission grid serving most of California, and the Power Exchange (PX), which for a time was the marketplace in which all electricity in the state was bought and sold. The EOB was also given very broad authority over ensuring reliability of the state's supply of electricity.

The budget includes $4.2 million ($730,000 General Fund) for the board's activities in the budget year, which is roughly $260,000 less than the estimated current-year expenditures. The decline in 2002-03 is due to the use of one-time funds in 2001-02 to reduce or remove market constraints on the state's electrical transmission and distribution system. Proposed 2002-03 funding would support 25.9 personnel years. (We would note that the activities of all of these positions should be considered in examining the issue of reorganizing and coordinating the state's various energy-related activities. This issue is discussed in more detail in "Part V" of our *Perspectives and Issues.*)

EOB's Original Role Has Been Modified

Central to the original role of the EOB was overseeing the activities of the ISO and the PX and determining the composition of the governing boards of these two organizations. However, among the many developments associated with the 2001 energy crisis was the bankruptcy of the PX in January, and the replacement of the EOB-appointed ISO stakeholder board with a board of gubernatorial appointees. Thus, the EOB's original duties have been drastically curtailed. However, subsequent legislation has given it authorization to conduct certain other activities. These include the following:

- ***Petition the Federal Energy Regulatory Commission (FERC) on Specific Transmission Matters.*** Chapter 1040, Statutes of 2000 (SB 1388, Peace), requires the EOB, in conjunction with the California Public Utilities Commission (CPUC), to petition FERC to allow the recovery of certain expenses of investor owned utilities relating to the replacement and expansion of the state's electricity transmission grid.

- ***Communicate ISO's Rule Changes to FERC***. Chapter 1x, Statutes of 2001 (AB 5x, Keeley), requires the EOB to require the ISO to amend its bylaws in response to FERC decisions, and to communicate this action to FERC.

- ***Investigate Wholesale Market***. Chapter 766, Statutes of 2001 (SB 47, Bowen), authorizes the EOB to investigate any matter related to the wholesale market for electricity.

In addition, legislation has been proposed that would provide the EOB with oversight over scheduling planned power outages as well as over monitoring, investigation, and enforcement activities relating to unplanned outages. An executive order was also issued in February 2001 that directed the EOB to maintain records of unplanned generation facility outages.

Representation at FERC. The EOB has also generally been involved in representing the state's interests at FERC on various matters. Budget bill language in the *1999-00 Budget Act* provided that the EOB would enter into a memorandum of understanding with the CPUC in deciding which agency would represent what issues before FERC. While this budget bill language only provided guidance to expenditures made in that particular budget year, it is our understanding that the EOB has continued to represent the state at FERC under this memorandum of understanding. Furthermore, the EOB has been given several directives by FERC as a result of its representation, including oversight over some decisions made by the ISO.

Current Activities

The EOB is currently involved in many activities related to the different statutory authorizations listed above. The EOB has indicated that its current assignments and near-term anticipated work cover the following areas:

- ***Market Monitoring.*** This includes market investigation, market rate complaints, and market redesign proceedings.

- ***Litigation.*** This primarily includes litigation involving refunds from generators to the state.

- ***Grid Reliability.*** This includes analyzing transmission terms and rate cases, transmission planning review, interconnection issues, rules for the scheduling and curtailing of energy deliveries, reliability contract proceedings, and selecting which generation units will provide back-up generation.
- ***Generation Outage and Maintenance.*** This includes specific work on the development and implementation of outage scheduling protocols and of generator availability standards, as well as related FERC filings. Funding for this activity, however, is contingent on legislation that has not yet been approved by the Legislature.

About 50 percent of the EOB's resources are dedicated to market monitoring activities, while 30 percent are involved with grid reliability. The remaining 20 percent, which represents the EOB's only General Fund resources, are dedicated to generation outage and maintenance activities.

Funds to Monitor Energy Transmission and Generation Outages

We recommend deleting $730,000 requested to undertake specific activities to monitor energy transmission and generation equipment outages because the board lacks the authority to undertake these activities. (Delete $730,000 from Item 8770-001-0001.)

The 2002-03 budget proposes funding for the EOB to oversee scheduling planned power outages, as well as the monitoring, investigation, and enforcement activities relating to unplanned outages. However, legislation to authorize these new duties for the EOB has not been enacted. Therefore, we recommend deleting the budget bill support for this activity. If the Legislature wishes to support these activities, the funding could be included in legislation authorizing the EOB to perform these functions.

DEPARTMENT OF VETERANS AFFAIRS AND VETERANS' HOMES OF CALIFORNIA (8955-8966)

The Department of Veterans Affairs (DVA) provides services to California veterans and their dependents, and to eligible members of the California National Guard. The principal activities of the DVA include: (1) providing home and farm loans to qualifying veterans using the proceeds from the sale of general obligation and revenue bonds; (2) assisting eligible veterans and their dependents to obtain federal and state benefits by providing claims representation, subventions to county veterans service offices, and direct educational assistance to qualifying dependents; and (3) operating veterans' homes in Yountville, Barstow, and Chula Vista with several levels of medical care, rehabilitation services, and residential services.

The budget proposes total expenditures of $339 million in 2002-03. This is $2 million less than estimated current-year expenditures. Expenditures of $65 million from the General Fund are proposed for the budget year, which is $2 million, or 3 percent, less than the estimated current-year level.

FAILURE TO RECEIVE REIMBURSEMENTS CAUSING SHORTFALLS

We find that the Department of Veterans Affairs is not making sufficient efforts to collect reimbursements for services provided at the Yountville home. The resulting cash shortfalls have forced the department to obtain General Fund loans that it is finding difficult to repay, and at times have required the home to reduce services for home residents.

What Are Reimbursements and Why Are They Important?

The DVA bills and collects reimbursements to help support the operation of the veterans' homes. At the veterans' homes, the majority of reimbursements come from five sources: (1) Medicare, a federally funded program which pays hospital inpatient and outpatient care, and some skilled nursing care; (2) Medi-Cal, funded by the federal and state governments, which pays skilled nursing facility daily rates and various healthcare costs; (3) member fees, which veterans' home residents pay in accordance with their income and level of care; (4) so-called "aid and attendance," which are federal payments for veterans who need personal care assistance; and (5) the U.S. Department of Veterans Affairs (U.S. DVA), which pays a per diem rate for each veteran in the homes.

Reimbursements are an integral part of the homes' operating budget. As Figure 1 shows, reimbursements are estimated to comprise 51 percent of Yountville's budget in 2001-02 and 2002-03. They are projected to comprise 23 percent of the other homes' budgets in 2001-02, and would increase to nearly 40 percent of their budgets in 2002-03.

Figure 1

Reimbursements Are a Significant Source Of Funds for the Veterans' Homes

(Dollars in Millions)

Home	Reimbursements[a]	Total Budget	Reimbursement Share of Total
2001-02			
Yountville	$34.4	$67.4	51%
Barstow	5.0	21.5	23
Chula Vista	3.5	15.5	23
All Homes	**$42.9**	**$104.4**	**41%**
2002-03			
Yountville	$34.3	$67.2	51%
Barstow	8.4	22.1	38
Chula Vista	7.3	20.4	36
All Homes	**$50.0**	**$109.7**	**46%**

[a] Includes United States Department of Veterans Aaffairs per diem.

Failure to collect reimbursements, then, can create a greater dependency on the General Fund (a problem in times such as now when the state faces fiscal problems), results in cash shortfalls for the homes, and has a potentially significant effect on the services provided at the homes for residents.

Homes Not Collecting All Reimbursements

Yountville's Difficulties With New Computer System. The Yountville home, which has been operating in Napa County since 1884, provides five levels of medical and residential care. Its nursing facility cares for about 350 veterans, and its residential and domiciliary facilities care for another 735 residents. Yountville operates a small hospital offering acute care and an outpatient clinic, which provide many services that are billable to Medicare, Medi-Cal, and other, private insurers.

In 1999-00, Yountville implemented a new computer system designed by a company named Meditech to assist the veterans' homes in claiming federal funds and insurance reimbursements to offset the state's costs of operating the homes. The feasibility study report justifying the system estimated that the system would generate $1.5 million in increased revenues from federal funds and reimbursements in the first year of implementations and $6.9 million in the second year. In addition to this billing function, the Meditech system provided a clinical component for documenting and tracking patient care.

Due to the importance of reimbursements as a funding source, it was critical that Yountville staff input patient care data into the new system in order to generate bills for services provided. The home, however, failed to use the new system effectively, and the promised increase in reimbursements did not occur. Moreover, Medicare reimbursements in particular fell dramatically. Figure 2 (see next page) illustrates that Medicare payments to the home dropped in 1999-00 by more than $2 million from the prior year, and continued to drop another $2 million in 2000-01. The home also has failed to collect budgeted reimbursements in the current year. The increase in current-year budgeted reimbursements was based upon the expectation that the department would be able to use the Meditech system effectively and that the promised increase in reimbursements finally would be realized.

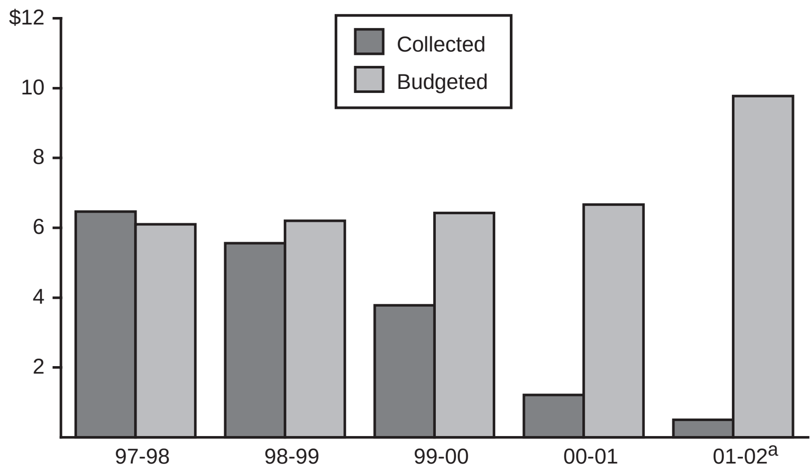
The department's past difficulty in collecting reimbursements prompted the Legislature to request the Bureau of State Audits (BSA) to review the cash management of the department and the homes. The BSA's report, published in December 2001, found serious data deficiencies, general lack of oversight tools, and poor billing practices. The department generally agreed with the findings of the report and indicated that it was working aggressively to implement stronger managerial controls in this area.

Reimbursements Limited at Barstow and Chula Vista. The Barstow home opened in February 1996 with a capacity to serve 400 veterans. It provides four different levels of skilled nursing and residential care. Currently, the home is half full, serving about 90 veterans in its skilled nursing facility and about 125 veterans in its residential units.

Figure 2

Yountville Medicare Reimbursement Collections Drop

(In Millions)



[a]Reflects partial year collections through December 2001.

Nursing facilities such as the one operated at the Barstow home can bill Medicare and Medi-Cal for services only if certified to do so by the state's Department of Health Services (DHS).

In July 2000, the Barstow home lost its Medicare and Medi-Cal certification along with U.S. DVA per diem payments for skilled nursing residents. The home had been cited for a number of deficiencies in quality of care standards. Therefore, from July 2000 to January 2002, Barstow was not permitted to bill for any federal reimbursements, resulting in a significant loss of anticipated federal funds. We discuss the consequences of this situation further below.

Barstow's reimbursements also have been below expectations in part because of its low occupancy levels. Even when Barstow was certified, a quarter to a third of the beds remained vacant. Once Barstow lost certification, the home generally did not admit new nursing residents, and occupancy dropped even more. With so many empty beds, the home has not been able to maximize revenue from member fees, U.S. DVA per diem, or Medi-Cal per diem payments.

Due to the problems at Barstow, the department's third and newest home in Chula Vista has not been able to open its skilled nursing facility.

Like Barstow, that home has the capacity to serve 400 veterans in skilled nursing and residential facilities. While Chula Vista has received member fees and U.S. DVA per diem for the 200 veterans receiving residential care at the home, it does not yet have services to bill to Medi-Cal or Medicare.

Reimbursements accounted for less than 25 percent of the 2001-02 budgets for Barstow and Chula Vista. For 2002-03, the budget assumes federal certification of both facilities for the full year. Reimbursements thus are estimated to comprise closer to 40 percent of the expenditures of these homes in the budget year.

Member Fees and U.S. DVA Payments Generally Collected. Although the department has serious problems in its ability to bill for Medicare, Medi-Cal and other, private insurance reimbursements, the department appears to be fairly successful at collecting member fees and U.S.DVA payments for which it is eligible. These reimbursements require only a simple calculation of the number of residents and a rate in order to bill for services.

Effect of Reimbursement Deficiencies

General Fund Usually Pays. The homes have one year to bill Medi-Cal for services rendered, and 18 months to bill Medicare, but do not always adhere to those time limits. For example, the department will not be able to bill for $2 million in reimbursements it expected to realize for services provided in 1999-00, because the time limits for billing Medicare and Medi-Cal have passed.

When problems in achieving budgeted reimbursement levels have occurred in the past, the department has obtained a loan from the General Fund to meet its cash needs and the home continues to spend up to its budgeted authority. The department is obligated to pay back such a loan within six months. As Figure 3 (see next page) shows, the Yountville home currently has $5.3 million in outstanding General Fund loans. (The home would have had $7.3 million in loans for 2000-01 had it not reduced its expenditures by $2 million that year.) The department was not able to repay the loans within the six-month period.

In 2000-01, a delay in recertification of the Barstow facility made it impossible for that home to collect budgeted Medicare and Medi-Cal reimbursements. In order to be able to continue the home's operations for 2000-01, the shortfall was backfilled with $3.7 million from the General Fund through deficiency legislation, and another $1.8 million was provided through separate legislation. Barstow's decertification therefore cost the state General Fund an additional $5.5 million during that year.

Outside Contractors Hired. The department has hired outside contractors to address both Yountville's failure to collect reimbursements and the administrative problems at Barstow that led to its decertification. During the calendar years of 2001 and 2002, the department paid for about $2 million in consultant services.

Figure 3

Yountville General Fund Loans Still Outstanding

(In Millions)

Fiscal Year	Loan	Paid	Balance
1999-00	$7.8	$5.8	$2.0
2000-01	5.2	1.9	3.3
Totals	**$13.0**	**$7.7**	**$5.3**

At the time this analysis was prepared, Barstow had just been recertified by DHS, and was authorized to resume billing Medicare and Medi-Cal as of January 17, 2002. Yountville, on the other hand, did not appear to have made any significant improvements in collecting reimbursements. It is unclear how long it will take the department to implement the changes required to generate the additional dollars needed to operate the home. As Yountville continues to have trouble collecting reimbursements, it becomes more unlikely that the home will be able to repay its General Fund loans any time soon, or that the home will be able to achieve its budgeted level of reimbursements in the current year.

CASH FLOW ISSUES

We recommend the adoption of supplemental report language directing the department to report to the Legislature on its cash flow management for an additional fiscal year. We further recommend that the department report at budget hearings on its projected cash needs for the homes in the current year. In addition, we recommend enactment of legislation requiring that any future collections of reimbursements that exceed budgeted levels be used to repay General Fund loans provided in prior years.

Supplemental Report Requirements

The *Supplemental Report of the 2001 Budget Act* directs the department to submit to the Legislature a series of three reports in the current year regarding how the department is managing its cash flow for the department and its homes. Those reports were due August 31, 2001, December 31, 2001, and February 28, 2002. The supplemental report further directs the Legislative Analyst to evaluate the reports, and to report its findings in the *Analysis of the 2002-03 Budget Bill*.

On January 25, 2002, we received the reports due in August and December 2001. The February 2002 report follows the publication of the *Analysis*. Accordingly, this section provides our findings on this subject as specified in the supplemental report.

LAO Findings

August 31 Report. This report did not provide sufficient information to complete an analysis of the department's and the homes' cash needs. The report allocated the 2001-02 budget evenly over 12 months, and therefore represented estimated—not actual—cash needs.

December 31 Report. The December report shows actual cash receipts (General Fund dollars and reimbursements) and expenditures for July through November for the homes. It does not provide data for the department. Actual cash receipts are shown for current-year expenses only, however, so that any cash flow needs resulting from the prior year's activities cannot be determined from the report.

The report shows no reimbursement collections during the month of July. It does, however, display expected cash receipts through December 2002 to account for services that are provided through June but billed after the close of the fiscal year. We would note that the December report contains four months of data on which to assess cash needs for the current year.

Yountville's Current-Year Cash Shortfalls. The department's report provides both best-case and worst-case scenarios for Yountville's current-year cash flow needs, but predicts that actual cash needs will fall somewhere between these extremes. The outcome would depend on the effectiveness of efforts to improve reimbursements with the assistance of a contractor.

According to the report, *at best* the home will face a $1.7 million cash shortfall in April 2002 that would worsen to $7 million in June. The shortfalls would be covered by loans from the General Fund. The home, however, would be able to achieve its budgeted reimbursements in total and repay any outstanding loans by December 2002.

The *worst case* is that the home will face a $3.8 million cash shortfall in April 2002 that would worsen to about $10.7 million by June. The department would obtain loans from the General Fund to cover the shortfall. A portion of the shortfall would be paid, but the home would end the current year with a $6.6 million deficiency.

Based upon our review of the report, we concur that Yountville is likely to experience serious cash shortfalls in the current year, primarily because of its failure to improve its collections of reimbursements. An exact estimate of the anticipated cash shortfall is difficult to determine at this time, however, due to the availability of only a few months of cash receipt data and the uncertainty of the performance of the department's new contract to improve reimbursement collections. Based upon the data available to us at this time, we estimate that the home will probably need a loan in the range of $2 million to $4 million by April or May.

Based on our additional review of collections for prior-year services, we estimate that the home will not have the cash that would be needed to pay the total $5.3 million balance on the loans that cover previous years' cash shortfalls. Therefore, it is possible that by December 2002 the department could have a cumulative total of about $10 million in outstanding loans.

According to the report, the department does not plan to reduce purchases to accommodate a cash shortfall at Yountville in the current year, as it did in the prior year. The department indicated that because cuts have already been made in the department budget to reduce statewide spending in the current year, no further cuts would be identified for this purpose.

Barstow. Barstow's budgeted cash for operating costs amounts to $20 million in the current year, including about $5 million in expected reimbursements. The report shows that Barstow faces a potential shortfall in June of about $500,000, most of which would be paid by December. If current cash receipt and spending trends continue, Barstow would have a current-year shortfall of $128,000 at the end of December. The shortfall results primarily from a delay of about six weeks in the date the department was recertified for U.S. DVA per diem payments for nursing facility residents. The department asserts that a cost-of-living increase in the U.S. DVA per diem rates should offset these losses. We agree that a potential operating deficit for this home can be avoided.

Chula Vista. Chula Vista's budget provides about $14 million in cash during the current year, including $3.5 million in reimbursements. The report indicates that Chula Vista will end the current fiscal year with a positive cash balance. We would note that the 2001-02 budget assumes that Chula Vista's nursing facility will open by March and that U.S. DVA reimbursements will be available at that time for new residents. The budget also assumes that Medicare and Medi-Cal reimbursements will be available in May. The report assumes that Chula Vista will meet this schedule.

Any delay in the upcoming months in Chula Vista's ability to bill for or collect these reimbursements, however, could affect that home's cash flow. It is not clear at this time whether the home could reduce purchases or personnel costs to offset such cash flow problems. Should no such delays occur in the current year, it would be unlikely that Chula Vista would encounter any cash flow problems in the current fiscal year.

No Recommendations in Report. The supplemental report directed the department to make recommendations for accommodating any cash flow problems in future budgets. The department reported that it was deferring such recommendations until a department contractor could identify the maximum feasible level of collections of Medicare and Medi-Cal claims.

Analyst's Recommendations

Continued Legislative Oversight. Because the department's cash flow problems have persisted, we recommend that the department report for an additional year on its cash flow management. We recommend the adoption of the following Supplemental Report language under Item 8955-001-0001, which is similar to that in the language for the *Supplemental Report to the 2001 Budget Act:*

> The Department of Veterans Affairs shall submit the following reports to the Chair of the Joint Legislative Budget Committee and the chairs of the fiscal committees of both houses of the Legislature:
>
> (a) On December 31, 2002, the department shall report on the cash flow needs of the department and veterans' homes. The report shall detail the expected expenditures and expected receipts of reimbursements and U.S. Department of Veterans Affairs per diem. The department shall notify the Legislature on what actions it would take to accommodate any cash shortfalls, including any plans to reduce purchases.
>
> (b) On February 28, 2003, the department shall update the report pursuant to paragraph (a). The department shall describe the causes and fiscal implications of the differences between the February 28 and December 31 reports. The department shall notify the Legislature on what actions it would take to accommodate any cash shortfalls, including any plans to reduce purchases.
>
> (c) The reports pursuant to paragraphs (a) and (b) shall provide the status of any outstanding loans for shortfalls occurring in prior fiscal years.

In addition, we recommend that the department report at budget hearings on the magnitude of any cash shortfalls anticipated in the current year.

Legislation for Repayment of Loans. In prior years, the department has sometimes collected reimbursements in excess of budgeted levels, and then submitted a request for the authority to spend the excess money for certain projects. In anticipation that the department's collections might exceed budgeted levels in future years, we recommend enactment of legislation requiring that any future collections of reimbursements that exceed budgeted levels be used to repay General Fund loans provided in prior years. Absent such a provision, the department bears no consequences for its failure to repay its loans. As we noted earlier, the Yountville home currently has outstanding loans of $5.3 million for which payment is late.

COLLECTIONS AT YOUNTVILLE DEPEND ON CONTRACT OUTCOMES

We withhold recommendation on the Governor's proposed budget for the Yountville home, until the Legislature is provided information on the outcomes of a contract to improve collections of reimbursements at the facility. We further recommend that the department report at budget hearings on certain measures that will document whether it is improving its ability to collect reimbursements.

Supplemental Report Requirements

The *Supplemental Report of the 2001 Budget Act* directed the department to report to the Legislature by December 15, 2001 and March 15, 2002 regarding an effort to maximize its reimbursement billings and collections at the Yountville home through the hiring of an outside consulting firm. The December report also was to identify any augmentations needed to the 2002-03 budget to improve the collections.

The Legislature further directed the Legislative Analyst to review the department's December 15, 2001 report and publish its review in the *Analysis of the 2002-03 Budget Bill*. In the event the department failed to make its report by December 15, 2001, the Legislative Analyst was to recommend specific budget adjustments for the 2002-03 budget intended to improve collections and to consider the cost-effectiveness of shifting the collections activity from the department to a private collector.

The 2001-02 budget contained $800,000 for the department to hire a consultant in July 2001 to improve collections of reimbursements during the 2001-02 fiscal year, particularly Medicare reimbursements for services provided at Yountville. The contractor, Health Management Services

(HMS), was hired in December 2001 to provide the required services from January through December 2002.

At the time this analysis was prepared, the department had not submitted the December 15, 2001 report related to this issue. Because the consultant was not selected until late 2001, the department's report would not have been able to provide information on the outcomes of the contract or the cost-effectiveness of the contract, as directed by the supplemental report language.

We address the issues specified in the supplemental report below. In addition, we provide our recommendations for improving collections of reimbursements.

Contract to Improve Reimbursements

The *2001-02 Budget Act* provided $800,000 for DVA to hire an outside contractor to enhance collection of reimbursements at the Yountville home by helping to improve the collection process and providing training related to this effort to home staff. As indicated above, the department hired HMS in late 2001 to provide consultant services from January through December 2002. The HMS will assist directly in the billing of reimbursements for medical services. It will also assess the level of reimbursements the homes should be receiving. Based on an initial assessment of Yountville conducted by HMS, it appears that significant training and process improvements are necessary to ensure the collection of all of the reimbursements owed to the home.

The delay in hiring a contractor for this purpose decreases the likelihood that the department will achieve the budgeted reimbursement levels established for 2001-02.

Privatizing Collections

The supplemental report directs the Legislative Analyst to assess the cost-effectiveness of shifting collections activity from department staff to a private collector. This is an approach already being adopted at the Yountville home on a limited basis. In the fall of 2001, the department hired Certus Corporation to recoup uncollected reimbursements for services provided at the Yountville home between October 1, 1999 and June 30, 2001. Certus billed Medicare nearly $1.3 million in services, of which the department has actually collected about $550,000 so far.

Certus' billings are not enough to solve the home's cash flow problems or enable the home to pay off its $5.3 million loan balance. Certus has indicated that its ability to bill was limited by deficiencies it found in the home's billing processes. For example, insufficient data about medical services provided reportedly precluded the submittal of payable claims.

Given the $64,000 cost for Certus' services, the cost for privatizing these billings was about 12 percent of the total returns to date. However, the Certus contract was intended only to address a backlog of billings, not to provide collections expertise to the home on an ongoing basis. Because of its limited purpose, the Certus contract does not provide an adequate measure of the cost-effectiveness of shifting the entire collections activity from the department to a private collector.

A better such measure may be provided by the HMS contract. The cost-effectiveness of the HMS contract can be evaluated based upon the comparison of the additional collections generated with the assistance of the contractor and the cost of the contractor. If HMS determines that the home's maximum billing potential is significantly above historical collections, privatization of these activities could become a more attractive option.

Analyst's Recommendations

2002-03 Budget. The Governor's proposed budget assumes that the Yountville home can achieve the same level of reimbursements that were budgeted for 2001-02. Specifically, the proposed budget estimates that the home will collect about $23 million in reimbursements (including about $11 million in member fees, $9 million in Medicare reimbursements, almost $2 million in Medi-Cal reimbursements, and $1.5 million in aid and attendance collections) and about $11 million in U.S. DVA per diem dollars.

Given the insufficient data available at this time regarding ongoing efforts to improve the collection of reimbursements, we withhold recommendation on the Yountville home's budget. We believe that significant information regarding those efforts should be available before the May Revision. This information can be used to reassess the proposed budget for Yountville.

Further contracting for billing assistance may be possible in the budget year without budget augmentations. The 2001-02 spending plan included $800,000 for the contract to improve reimbursement collections that was redirected from Yountville's personnel budget. The Governor has proposed to maintain that funding for Yountville in the budget year. If this contracting effort proves to be successful, the Legislature could direct that these funds again be used to contract out for billing services beyond the contract period, which ends December 2002.

Establishing Benchmarks. As we previously discussed, both the BSA and the department's new contractor, HMS, have recently reviewed Yountville's billing practices. Both the BSA report of December 2001 and the new contractor's initial assessment of Yountville's accounts receivables management process recommend specific improvements in collections efforts, including better documentation of the provision of medical services in an accurate and timely manner, and the establishment of standard billing policies and procedures. An internal control review of Yountville's accounting practices conducted by the Inspector General for Veterans Affairs also noted the need for the implementation of better policies and procedures for cash receipts and disbursements.

Given these findings, we recommend that the department report at budget hearings regarding its performance in collecting reimbursements according to certain improvement measures that we specify below. These measures should serve as a "benchmark" for judging the department's performance in this area. This information should also help the Legislature determine whether any adjustments should be made to the proposed budget.

Accordingly, we recommend the department report during budget hearings on:

- *Accountability.* The department's plan for implementing the BSA recommendations, including staff positions and qualifications of staff responsible for carrying out this plan.
- *Timeliness of Billing.* (1) Average number of days to submit bills to Medicare and Medi-Cal, (2) timeframe for reducing the average number of days to 60, and (3) potential for reducing the average number of days to 30.
- *Private Insurance Collections.* (1) Amounts (if any) billed to and collected from private insurers as of January 2002, and (2) plan and timeline for ensuring the home bills private insurance providers.
- *Prior-Year Collections.* Dollar amount of claims submitted for services rendered in 2000 and 2001 since the expiration of the Certus contract.
- *Process Improvement.* (1) Current practices for creating "charge slips" which document medical services provided, including established timeframes for submitting charge slips, and (2) how management ensures that charge slips are created for services provided.

We note that the department has also been directed to submit a report to the Legislature by March 15, 2002 regarding the performance of its contract in improving billings and collections. This report requires information that also will be necessary to evaluate the department's collections activity.

OPTIONS FOR PRIVATIZATION AT VETERANS' HOMES

We do not recommend privatizing the administration of the skilled nursing facilities at the existing homes at this time because of the fiscal and operational difficulties of making such a change.

Supplemental Report Requirements

As we discussed in a previous section, Barstow's skilled nursing facility lost its federal certification in July 2000 due to a number of serious deficiencies in its operations. The home's administrative problems prompted DHS to appoint a temporary manager of the facility to improve the quality of care. The DVA subsequently contracted with Country Villa Health Services to provide such services from January 2001 through October 2001. Country Villa assisted Barstow in meeting federal compliance standards to thus regain certification for its skilled nursing facility.

The *Supplemental Report of the 2001 Budget Act* directed the department to submit to the Legislature by December 1, 2001 its evaluation of the Country Villa contract. That report was to include recommendations as to whether the homes should contract out the administration of its skilled nursing facilities. The Legislature also directed the Legislative Analyst to (1) review and comment on the department's findings and recommendations in the *Analysis of the 2002-03 Budget Bill*, or (2) in the event the department failed to provide the report, to make recommendations about the utility of contracting for the administration of the skilled nursing facilities at the homes.

We had not received the report that DVA was directed to prepare at the time this analysis was prepared. Accordingly, we provide below our findings and recommendations regarding the potential for privatizing the homes' skilled nursing facilities.

Continuum of Options for Privatizing

A number of options exist for privatizing the homes' skilled nursing facilities. The Legislature could direct DVA to outsource management (either financial or medical) of the facilities, or it could fully outsource its skilled nursing facility operations, including nursing staff. Alternatively, the department could outsource the entire operation of the home, which includes levels of care other than skilled nursing. Federal law requires only that at least one state department employee oversee a state's veterans' home in order to qualify for federal support.

So far, California's experience with private contracting for the administration of the homes has been limited to the Barstow model, where the department contracted on a temporary basis for the management of the facility, and the current Yountville model, where the department is contracting only for the financial billing function of the facility. (We discussed the issue of privatizing the billing function of the homes in an earlier section.) Food service, laundry, and specialty medical services, among others, have also been provided through contracting.

Some states have gone further in their contracting, however. The California Research Bureau reported in November 2001 that some states such as Oregon, Texas, and Alabama contract out all of their nursing and residential services.

Pros and Cons of Privatizing

Privatizing the administration of skilled nursing could enhance the quality of care and lower state costs, although such an option is not without its own limitations as we discuss below.

As the state has discovered with Barstow, contracting out for management of the home provided the expertise necessary to ensure quality of care to residents and to avoid further loss of federal funds. The General Fund is at risk for backfilling any loss of federal dollars from the loss of certification when quality of care problems arise.

Contracting for all staff needed to operate the skilled nursing facilities could also have the effect of holding down the cost of such facilities. Our review indicates that costs of operating the skilled nursing facilities in the state's veterans' homes clearly exceeds the costs of operating comparable facilities in the private sector—and may be as much as two to three times higher. The average annual costs for skilled nursing residents in the private sector range from $40,000 to $45,000, while the average annual costs for nursing residents in the state's veterans' homes range from $110,000 to $130,000.

However, while such a shift to private contracting may make sense in theory, there are significant legal constraints involved in replacing civil service employees with privately contracted staff at the existing homes.

Another disadvantage is that expertise acquired by the staff through training would be lost.

Privatizing the management portion of the skilled nursing facilities also raises the risk that the state would pay twice for the same management service. A state employee would be required to oversee the home in some capacity, even as a contract manager. Notably, contracting for private management services at Barstow under the Country Villa contract did not reduce state operating costs for the home. The contract cost the state about $900,000 over a period of ten months. The contractor was critical to restoring quality of care as well as federal funding. However, during the period of the contract, the state continued to incur costs for the administrator of the entire home, as well as other managerial staff.

Analyst's Recommendations

When Barstow was decertified, the home reportedly did not have any licensed nursing home administrators managing the facility. We are advised that Barstow now has several managers who are licensed nursing home administrators. As long as Barstow's managers can ensure quality of care standards, we believe the additional costs of contracting for that purpose are not warranted.

There is evidence that Barstow can meet quality of care standards. Barstow was recertified and found to be in substantial compliance with federal standards. There are also indications at this time that Chula Vista and Yountville, which also have licensed nursing home administrators as part of their management staff, can provide adequate care to the veterans at these homes. Given the indications that the homes can be operated in compliance with federal standards, and the potential legal issues associated with privatizing the full operations of the existing nursing facilities, we do not recommend that the state contract for the administration of the skilled nursing facilities at the homes at this time. However, we would recommend that the Legislature review the idea in the future, particularly if any of the homes again demonstrates an inability to meet federal and state quality of care standards that would jeopardize the state's certification for Medicare and Medi-Cal.

BARSTOW AND CHULA VISTA BED ACTIVATIONS

We recommend that the Legislature reassess budgeted reimbursement levels for the Barstow and Chula Vista homes at the time of the May Revision. At that time, more information should be available about whether the homes can activate the additional beds as proposed.

Barstow. Now that Barstow is recertified, the home should be able to increase its occupancy of skilled nursing and intermediate care beds. The budget assumes that the number of residents in skilled nursing care beds will increase from 90 residents to 110 residents in the budget year. The budget also assumes that 50 intermediate care beds become operational by October.

In addition, the budget assumes that 80 additional residential and domiciliary beds will be occupied at Barstow by October. Because Barstow historically has had difficulties both in filling resident spaces and in hiring staff, it is unclear whether the home will be able to meet all of these occupancy targets in the budget year. The home has had problems in the past achieving its budgeted occupancy levels.

Chula Vista. Chula Vista's ability to meet budgeted reimbursement levels will depend on its success in bringing its new nursing facilities on line. First, the facility must be licensed for operation and certified to receive Medicare and Medi-Cal reimbursements. Second, the facility must be able to hire a workforce to provide care to the veterans needing skilled nursing. Third, the facility must have an effective system in place to bill for services and ensure that budgeted reimbursements are collected.

The budget assumes 110 nursing facility beds and an additional 50 intermediate care beds will be occupied by October 2002. These projected occupancy levels would make the home fully operational by October 2002. At this time, there is no apparent reason why Chula Vista should not to able to obtain a license for operation of its nursing facility and to bring its new nursing facilities on line.

Analyst's Recommendations

In view of the above, we recommend the Legislature assess the department's ability to activate the additional beds at the two homes at the time of the May Revision.

TAX RELIEF
(9100)

The state provides tax relief—both as subventions to local governments and as direct payments to eligible taxpayers—through a number of programs contained within this budget item. The budget proposes total relief of $4.4 billion, of which almost $700 million is appropriated in the budget bill.

The largest program contained in the tax relief budget item pays for the costs of reimbursing local governments for reductions in the vehicle license fee (VLF). The VLF is an annual fee on the ownership of a registered vehicle in California, levied in place of taxing vehicles as personal property. The revenues are distributed to cities and counties. Since 1998, the Legislature has reduced the VLF by 67.5 percent. For all VLF reductions, cities and counties continue to receive the same amount of revenues as under prior law, with the reduced VLF amounts replaced by General Fund spending. This spending—known as the "VLF backfill"—is continuously appropriated and, therefore, does not appear in the budget bill. The budget proposes expenditures of nearly $3.8 billion for the VLF backfill in 2002-03.

The largest program appropriated in the budget bill is the homeowners' exemption. This provision, which is required by the State Constitution, grants a $7,000 property tax exemption on the assessed value of owner-occupied dwellings, and requires the state to reimburse local governments for the resulting reduction in property tax revenues. The exemption reduces the typical homeowner's taxes by about $75 annually. The Governor's budget proposes an expenditure of $410 million on this program in 2002-03. This is an increase of $6 million, or 1.5 percent, which reflects the expected growth in the number of homeowners claiming the exemption.

No Information on Manufacturing Property Tax Rebate

The manufacturing property tax rebate program is due to sunset at the end of 2002. No information is currently available on the use of this program. If the Legislature chooses to extend the program, we recommend that local governments report their data to another state agency, such as the Board of Equalization.

Tax Rebate Sunset Extended. Chapter 868, Statutes of 1993 (AB 1823, Alpert), created a manufacturing property tax rebate program. The program allows cities, counties, and special districts to provide businesses a rebate of some or all property taxes paid on "economic revitalization manufacturing property." Local governments can rebate taxes for up to five years for property which helps create at least ten new manufacturing jobs. Chapter 943, Statutes of 1999 (SB 943, Dunn), extended the program through calendar year 2002. As required by Chapter 943, those local governments electing to use the property tax rebate program beginning in 2000 are required to submit an annual report to the Legislative Analyst's Office (LAO). In turn, the LAO is required to prepare a report evaluating the effectiveness of the program.

No Reports Received. To date, our office has not received any reports from local governments using this program. We also have not been able to identify any local governments that have opted to use the program since the extension of its sunset. While it is possible that no local government continues to use the program, it is also possible that some local governments have used the program but failed to file a report.

Recommend Changing Reporting Requirement. Without any information on the extent to which the tax rebate program is used, we are unable to evaluate its merits or provide a recommendation on extending its sunset. If the Legislature chooses to extend the property tax rebate program again this year, we would recommend changing the reporting mechanism. We would suggest requiring any local government using the program to provide the required data to an agency which it has regular contact on property tax issues, such as the State Board of Equalization. This agency could then compile the submitted reports and provide the information to the LAO for analysis.

Health and Dental Benefits For Annuitants (9650)

The state contributes toward health and dental insurance premiums for annuitants of the Judges', Legislators', District Agricultural Employees', and Public Employees' Retirement Systems, as well as specified annuitants of the State Teachers' Retirement System. Annuitants have the option of selecting from up to 15 state-approved health plans depending on where an annuitant lives.

Budget-Year Costs Not Completely Determined Yet

We withhold recommendation on the $554 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2003.

The budget proposes total expenditures of $554 million from the General Fund for health and dental benefits for annuitants in 2002-03. This is $68 million, or 14 percent, more than estimated expenditures for this purpose in the current year. This increase reflects expected growth in the number of annuitants. It does not include any changes in health insurance premiums that would go into effect January 1, 2003. Figure 1 displays General Fund expenditures for annuitant health and dental benefits for the three fiscal years starting with 2000-01. Although these costs are initially paid from the General Fund, the state recovers a portion of these costs (about 33 percent) from special funds through pro rata charges.

The actual amount needed in the budget year is dependent on negotiations over health insurance premiums currently underway between the Public Employees' Retirement System and providers. These negotiated premium rates, which will cover the 2003 calendar year, should be available for review during legislative budget hearings. Pending receipt of the new rates, we withhold recommendation on the amount requested under this item.

Figure 1

Health and Dental Benefits For Annuitants

(In Millions)

Program	2000-01 Actual	2001-02 Estimated	2002-03 Budgeted
Health	$364.2	$436.2	$504.0
Dental	44.8	49.5	49.6
Totals	**$409.0**	**$485.7**	**$553.6**

AUGMENTATION FOR EMPLOYEE COMPENSATION (9800)

A significant portion of state government's operating costs is for compensation of state employees. The Governor's budget projects $17 billion in salary and wage expenditures for nearly 327,000 authorized personnel-years (PYs) in 2002-03 (including $5.9 billion and almost 113,000 PYs in higher education). Including benefits (such as contributions to retirement and health insurance), estimated employee compensation expenditures are projected to be about $20 billion for the budget year.

Employee Pay and Benefit Increases

The budget includes $209.7 million ($130 million General Fund) to fund for state employees, except higher education, the compensation package the administration has negotiated with most bargaining units. We estimate that ongoing General Fund costs of this package will grow from about $325 million in 2003-04 to $900 million annually by 2006-07.

State Civil Service Employees. The administration has negotiated, and the Legislature has approved, new memoranda of understanding (MOUs) for 9 of the 21 employee bargaining units, as shown in Figure 1. Of the remaining 12, 7 have reached agreements with the administration and await legislative approval of the proposed MOUs, and the remaining 5 still have not concluded negotiations. Figure 2 (see page 140) shows a history of general salary increases for state civil service employees and the consumer price indices for the United States and California since 1991-92.

The basic compensation package that most bargaining units have agreed upon (1) increases take-home pay by reducing employee retirement contributions and (2) pays for a portion of health insurance premium increases. The administration approved a similar package for supervisors, managers, and other employees not subject to collective bargaining.

Figure 1

Status of Memoranda of Understanding (MOUs)

Unit Number	Bargaining Unit
MOUs Approved[a]	
5	Highway Patrol
6	Corrections
7	Protective Services and Public Safety
8	California Department of Forestry Firefighter
10	Professional Scientific
12	Craft and Maintenance
16	Physician, Dentist, and Podiatrist
18	Psychiatric Technician
19	Health and Social Services/Professional
MOUs Pending	
1	Professional Administrative, Financial, and Staff Services
2	Attorney and Hearing Officers
3	Education and Library
4	Office and Allied
11	Engineering and Scientific Technician
15	Allied Services
21	Educational Consultant and Library
MOUs Being Negotiated	
9	Professional Engineers
13	Stationary Engineer
14	Printing Trades
17	Registered Nurse
20	Medical and Social Services

[a] Approved by Legislature and Governor. Unit 6 MOU not yet approved by union members.

As shown in Figure 2, the take-home pay provision does not provide a salary increase in the current year or budget year. Rather, the provision increases employees' take-home pay by reducing employee retirement contributions from the 5 percent paid by most employees to 2.5 percent upon approval of the MOUs. Employee retirement contributions will be further reduced to zero effective July 1, 2002. On July 1, 2003, the previous employee retirement contribution will be reinstated and employees will receive a 5 percent increase in their base salary. Because of the manner in which the Public Employees' Retirement System sets state retirement contribution rates, this provision would not impact the state budget until 2003-04. At that time, state retirement contributions will be higher than they otherwise would have been because the state must make up for the reduction in retirement contributions coming from employees in the current year and 2002-03.

Figure 2

State Civil Service General Salary Increases

1991-92 Through 2002-03

Fiscal Year	State General Salary Increases	Consumer Price Indices: United States	Consumer Price Indices: California
1991-92	—	3.2%	3.6%
1992-93	—	3.1	3.2
1993-94	5.0%	2.6	1.8
1994-95	3.0	2.9	1.7
1995-96	—	2.7	1.4
1996-97	—	2.9	2.3
1997-98	—	1.8	2.0
1998-99	5.5	1.7	2.5
1999-00	4.0	2.9	3.1
2000-01	4.0	3.4	4.3
2001-02[a]	—	2.5	2.8
2002-03[a]	—	2.4	2.3

[a] Legislative Analyst's Office estimate of consumer price indices.

Under the health insurance premium provision, the state will continue to pay half of the premium increases that went into effect January 2001 and will pay two-thirds of premium increases effective January 2002 and January 2003.

Chapter 366, Statutes of 2001 (AB 933, Migden), appropriated $69.5 million ($45.5 million General Fund) for the current-year costs of the nine agreements the Legislature has approved. In addition, the Governor's budget includes a current-year adjustment (to be appropriated through separate legislation) of $64.3 million ($41.8 million General Fund) for the 12 bargaining units that do not have approved MOUs at the time this analysis was prepared. These funds would pay for the costs of the basic compensation package discussed above.

The budget also proposes $209.7 million ($130 million General Fund) for budget-year costs of the compensation package for state employees, excluding higher education. This includes $111 million ($58 million General Fund) to pay for the state pick-up of 2002 and 2003 health premium increases.

If the remaining bargaining units receive the basic compensation package discussed above, we estimate the ongoing General Fund cost of collectively bargained provisions will be around $325 million in 2003-04 when the 5 percent salary increase becomes effective, growing to about $900 million annually by 2006-07.

Employees in Higher Education. Employees of the University of California (UC) and the California State University (CSU) systems are not part of the 21 bargaining units discussed above. Instead, they negotiate with the universities' administration to determine terms of employment. The Governor's budget proposes General Fund expenditures of $47.6 million for UC and $37.7 million for CSU for, among other things, employee compensation to provide salary and benefit increases to faculty and staff. Figure 3 shows how UC and CSU propose to allocate the majority of these amounts for employee compensation. The remaining funds for the CSU system would be used for various expenditures including facility maintenance and insurance.

Figure 3

Higher Education
2002-03 Salary and Benefit Increases

General Fund (In Millions)	
University of California	
Merit salary increases	$44.8
Full-year cost of 2001-02 salary increases	2.6
Other employee compensation costs	0.2
Subtotal	($47.6)
California State University[a]	
1 percent compensation pool	$22.4
Health benefit cost increases	10.5
Subtotal	($32.9)
Higher Education Total	**$80.5**

[a] The remaining $4.8 million of the $37.7 million allocation would be used for various expenditures including facility maintenance and insurance.

CONTROL SECTION 3.60

This control section specifies the contribution rates for the various retirement classes of state employees in the Public Employees' Retirement System (PERS). The section also authorizes the Department of Finance to adjust any appropriation in the budget bill as required to conform with changes in these rates. In addition, the section requires the State Controller to offset these contributions with any surplus funds in the employer accounts of the retirement trust fund.

State Contribution Rates to PERS Undetermined

We withhold recommendation on 2002-03 state contribution rates for retirement benefits pending (1) the outcome of the proposed deferral of retirement contributions and (2) final determination of the actual rates to be applied in the budget year.

Under current law, PERS is responsible for developing employer contribution rates each year based on actuarial analyses. Normally, PERS would not determine 2002-03 rates until spring. But as we discuss in the Crosscutting Issues section of this chapter, the Governor's budget proposes deferring state retirement contributions for the budget year. This would reduce budget-year contribution rates to those currently listed under this item in the *2002-03 Budget Bill.*

However, if the Legislature does not approve the proposed retirement deferral, then 2002-03 contribution rates would increase from their present level. Although PERS would set these rates in the spring, PERS has estimated that retirement costs would increase from the current-year level of $677 million to about $1 billion in the absence of the proposed deferral. This includes an increase in General Fund costs of $183 million.

Pending the outcome of the proposed retirement deferral and final determination of 2002-03 rates, we withhold recommendation on this item.

FINDINGS AND RECOMMENDATIONS

General Government

Analysis Page

Crosscutting Issues

State Retirement Contributions

F-15 ■ **Proposals to Defer State Retirement Contributions.** The budget proposes deferring about $1 billion of the state's General Fund retirement contributions to PERS and STRS in exchange for administration support of additional retirement benefits.

F-19 ■ **Proposals are Costly; Costs Stretch Far Into Future.** Recommend that the retirement proposals be rejected because they are very costly. These costs would total over $13 billion, be paid over many years, and tie up future state revenues. In present value terms, the proposal is equivalent to getting about $2 billion worth of fiscal flexibility at a cost of well over $4 billion.

Software Enterprise License Agreements

F-21 ■ **Enterprise License Agreements Offer Potential Statewide Benefits.** The use of Enterprise License Agreements (ELAs) could reduce state costs, improve automation cost estimates, and provide more consistent software support levels. We provide a number of suggestions and recommendations that can help the Legislature ensure ELAs are cost effective and beneficial to the state.

Clean Energy Green Team

F-27 ■ **Eliminate Green Team Funding One Year Early. Delete $100,000 and 1 personnel-year (PY) From Item 8660-001-0461 and $132,000 and 1 PY From Item 3940-001-0001.** Recommend deleting funding for the Green Team because it is no longer actively involved in activities relating to expediting power plant siting.

Analysis Page

Department of Information Technology

F-29 ■ **Reauthorization of the Department of Information Technology (DOIT).** Recommend that the Legislature (1) reauthorize DOIT for two years, (2) clarify DOIT's responsibilities, and (3) direct Bureau of State Audits, prior to 2004, to assess the extent to which DOIT has addressed its mandated activities.

Office of the Inspector General for Veterans Affairs

F-35 ■ **Office Workload and Staffing Issues.** The report submitted to the Legislature by the Office of the Inspector General for Veterans Affairs does not provide sufficient information to determine whether its staffing is adequate to meet its statutory responsibilities.

F-37 ■ **Internal Control Reviews Not A Clear Priority.** Recommend that the office report at budget hearings specifically on the relative priority the office is placing on completing internal control reviews, and that the office provide the Legislature with its schedule for completing internal control reviews in the current fiscal year and the budget year.

Department of Insurance

F-38 ■ **Shift Funding for Tax Collection and Audit Program. Reduce Item 0845-001-0001 by $1,131,000 and Augment Item 0845-001-0217 by $1,131,000.** Recommend that the baseline of $1.1 million for the Tax Collection and Audit program be funded from the Insurance Fund instead of the General Fund. Further recommend the enactment of legislation to provide funding for the tax collection and audit function from the Insurance Fund on an ongoing basis.

F-39 ■ **Augmentation for Tax Collection and Audit Program Not Necessary. Reduce Item 0845-001-0001 by $636,000.** Recommend that the General Fund request for $636,000 and seven positions to increase the number of gross premiums tax audits be rejected because it is not cost-effective to audit all insurers each year. Further recommend the enactment of legislation to (1) eliminate the requirement that DOI audit all tax returns filed by insurance companies and brokers and (2) direct the department to prioritize tax audits.

F-40 ■ **Additional Funding Authority Should Await Progress on Staffing.** Withhold recommendation on budget bill language that authorizes additional expenditures related to filling vacant positions until the Department of Finance provides the following at budget hearings:

Analysis Page

(1) information on DOI's progress in filling vacancies, (2) an estimate of the funding level needed to support the filled positions as well as DOI's need for positions that are still vacant, and (3) whether the proposed language is needed in 2002-03.

Board of Equalization

F-41 ■ **Audit and Compliance Activities.** Recommend supplemental report language for the Board of Equalization to report annually to the Legislature regarding its audit and compliance activities, so that the Legislature can better identify appropriate staffing levels.

F-44 ■ **Keep an Eye on Investigations.** Recommend that Legislature require that the board monitor shifts in investigations activity closely to protect the sales and use tax revenue stream, and report its findings to the Legislature by December 1, 2002.

State Treasurer

F-45 ■ **Positions For Tobacco Securitization Not Justified. Reduce Item 0950-001-0001 by $220,000.** Recommend deletion because additional positions are not needed to implement and manage the administration's proposed Tobacco Securitization Bond Program.

Franchise Tax Board

F-47 ■ **New Audit Activities.** Withhold Recommendation on $4.6 Million From Item 1730-001-0001. Recommend that the Legislature require the Franchise Tax Board (FTB) to report at budget hearings with additional information regarding the feasibility of hiring and training the proposed staff on a timely basis, in order to generate the estimated increase in revenue. Further, recommend that the proposed shift of existing staff from audits with longer-term benefits to those having near-term revenue impacts be limited to a two-year temporary period, so as to preserve the effectiveness of the audit program and ensure a high rate of tax compliance.

F-49 ■ **Expand Settlement Activities. Augment Item 1730-001-0001 by $520,000 and Recognize Additional General Fund Revenue of $14.1 Million.** Recommend that the Legislature increase support for settlement activities that are expected to result in reducing the existing inventory of cases and increase revenues in the budget year.

Analysis Page

F-50 ■ **Increased Collection Activities.** Withhold Recommendation on $6.2 Million in Item 1730-001-0001. Recommend that the Legislature require the FTB to report at budget hearings regarding the timing and feasibility of hiring additional staff for the proposed collection activities.

F-51 ■ **Customer Service Programs. Redirect $800,000 Within Item 1730-001-0001.** Recommend that the department redirect $800,000 from district office operations to the call center to reflect the relative efficiencies associated with different modes of assistance. Recommend that the department investigate funding the Tax Practioners' Hotline by establishing a fee for this service.

F-52 ■ **E-Filing Requirement for Tax Practitioners. Reduce Item 1730-001-0001 by $1 million.** Recommend that the budget proposal requiring e-filing for all tax practitioners filing 100 or more returns use a more reasonable savings estimate, and be expanded to require e-filing for those filing 50 or more returns.

F-53 ■ **Household and Dependent Care Expense Credit (HDCEC).** Recommend that FTB report prior to budget hearings regarding the anticipated costs associated with administration and compliance activities for the HDCEC.

State Personnel Board

F-54 ■ **Peace Officer Procedural Bill of Rights (POBOR) Mandate. Reduce Item 1880-295-0001 by $50 million**. Recommend Legislature delete $50 million proposed to reimburse local governments and refer matter to the Joint Legislative Audit Committee. Recommend Legislature hold oversight hearing to determine whether the mandate should be modified. Recommend Legislature suspend mandate in the budget year.

Public Employees' Retirement System

F-61 ■ **Project Expected to Improve Patient Care, Limit Premium Increases.** The Public Employees' Retirement System (PERS) plans to use medical and pharmaceutical claims data to help improve patient care and limit healthcare costs and premium increases. The PERS estimates that premium savings would outweigh project costs.

F-63 ■ **Project Has Insufficient Risk Management and Contract Oversight.** Recommend that the Legislature adopt budget bill language that requires PERS to prepare a complete risk management

Analysis Page

plan and a contract evaluation before obligating funds for the Health Care Decision Support System contract.

Department of Corporations

F-65 ■ **Staff for Investment and Lending Fraud Pilot Are Premature. Reduce Item 2180-001-0067 by $1,571,000.** Recommend deletion of 24 additional call center and enforcement staff related to the proposed public education and outreach program.

Housing and Community Development

F-71 ■ **Increase Child Care Facilities Transfer to General Fund. Increase Item 2240-0110-0474 by $1.2 Million.** Increase amount of Governor's proposal in order to reflect total available funds from the child care facility guaranty program.

Energy Resources Conservation and Development Commission

F-72 ■ **Energy Resources Programs Account (ERPA) Revenues Underestimated.** Recommend assuming 2 percent growth in ERPA revenues in the budget year, which is a reasonable estimate, based on current electricity demand growth projections. Recommend offsetting $900,000 proposed General Fund costs in the budget year with these additional ERPA revenues.

F-75 ■ **Updated Projections Needed on Siting Workload. Augment Item 3360-001-0465 by $900,000 and reduce Item 3360-001-0001 by $900,000.** Recommend the Legislature approve $900,000 for ongoing energy siting contracts from ERPA instead of the General Fund. Withhold recommendation on the remaining General Fund support of the siting program ($4.6 million) until the commission provides an updated schedule of expected application filing dates and corresponding workload projections prior to budget hearings.

F-76 ■ **Alternative Funding for Siting Program Should Be Considered.** Recommend the Legislature consider alternative funding sources to support the siting program, including establishing fees on electricity generators and/or switching ongoing support to ERPA.

Analysis Page

Department of Water Resources, California Energy Resources Scheduling

F-80 ■ **Possible Duplicative Federal Representation.** Recommend that the Department of Water Resources report at budget hearings regarding coordinating with other state agencies in representing the state's interests before the Federal Energy Regulatory Commission (FERC). Withhold recommendation on $750,000 requested for legal representation at the FERC until need is justified.

F-81 ■ **State Needs to Move Away from Contracting.** Recommend that the Department of Water Resources report before budget hearings on progress in establishing new personnel classifications and its ability to fill vacant positions. Withhold recommendation on $4 million for personal service agreements and consulting contracts.

Health and Human Services Agency Data Center

F-83 ■ **Increased Expenditure Authority Not Justified.** Withhold recommendation on proposed increase of $2.2 million and recommend that the Legislature direct Health and Human Services Agency Data Center (HHSDC) to provide revised proposal based on previously purchased computer equipment.

F-84 ■ **Budget Internally Inconsistent.** Recommend the Legislature direct HHSDC to submit a new budget request which reflects proposed 5 percent reduction in overhead charges on county-based automation projects.

F-85 ■ **Rate Study Needed.** Recommend the adoption of supplemental report language requiring HHSDC to conduct a comprehensive rate study examining data center operations and recommending changes that will result in improved rates and services.

F-86 ■ **Increased Expenditure Not Justified for IHSS/CMIPS Project. Reduce Item 4130-001-0632 by $376,000**. Approve the extension of three limited-term positions, and deny the proposed increase of $376,000 since the funds have been double budgeted.

F-87 ■ **Additional Funding for SFIS Not Justified. Reduce Item 4130-001-0632 by $464,000.** Reduce expenditure authority by $464,000 since consulting services are duplicative of activities that state staff can perform and HHSDC cannot identify specific legal and legislative issues that legal services are currently supporting.

Analysis Page

F-88 ■ **Undefined Oversight on Statewide Automated Welfare System. Reduce Item 4130-001-0632 by $2.3 Million.** Reduce expenditure authority by $2.3 million for undefined consulting oversight activities.

Department of Industrial Relations

Effectiveness of Enforcement Inspection Programs

F-93 ■ **How Does DIR Assess Effectiveness of Inspection Programs?** The Division of Occupational Safety and Health (DOSH) and the Division of Labor Standards Enforcement (DLSE) each use a variety of measures to assess the effectiveness of their inspection programs.

F-95 ■ **The DOSH Program Needs Overall Program Goals and Improved Reporting.** Recommend the enactment of legislation to amend the statutory reporting requirement to include program goals and results.

F-98 ■ **The DLSE Effectiveness Limited by Lack of Case Tracking System.** The effectiveness of DLSE's inspection program cannot be determined because the division lacks a data management system to provide detailed inspection-related information.

F-100 ■ **Case Management System Proposal Under Review.** Pending approval of the feasibility study report by the Department of Information Technology, withhold recommendation on the $1.1 million General Fund request for the first-year costs of a DLSE case management system.

F-101 ■ **The DLSE Should Include Information From Data System in Annual Report.** Recommend the enactment of legislation to amend the statutory reporting requirement to include industry- and citation-specific compliance goals and results.

Enforcement Workload

F-101 ■ **Supplemental Report on Current-Year Augmentation for DLSE Enforcement.** The department's methodology for reporting and evaluating workload for the new investigator positions is appropriate. Recommend that in preparing its March 15, 2002 update report, DIR include proposed workload measures for its new supervisor and administrative positions. In addition to workload consideration, the department should set compliance targets and compile data on whether it meets these goals to determine the adequacy of funding for its enforcement programs.

Analysis Page

Public Utilities Commission

F-105 ■ **Reporting Requirement Needed for Public Payphone Programs.** Recommend approval of the limited-term positions requested for the support of three public payphone programs. Recommend the adoption of supplemental report language that directs the California Public Utilities Commission to report on the workload and effectiveness of these programs prior to establishing permanent positions.

California Consumer Power and Conservation Financing Authority

F-108 ■ **Repayment Plan Needed for General Fund Loan.** Withhold recommendation on the proposed expenditure of $5.5 million loaned from the General Fund to support CPA start-up activities.

California Department of Food and Agriculture

F-110 ■ **Industry Should Contribute to Medfly Control. Reduce Item 8750-001-0001 by $4.6 Million.** Recommend the enactment of legislation authorizing the California Department of Food and Agriculture to assess the agricultural industry for 50 percent of the cost of the Medfly Preventative Release Program. Further recommend that the General Fund support 50 percent of the program cost with the remaining 50 percent being structured as a General Fund loan to be repaid by June 30, 2004.

F-112 ■ **Additional Funding for Multistate Coalition Not Warranted. Reduce Item 8750-001-0001 by $130,000.** Recommend deletion because the department currently has resources in its base budget to participate in various multistate agricultural policy coalitions.

F-112 ■ **Use Surplus Funds for Pierce's Disease Program. Reduce Item 8750-004-0001 by $1.5 Million.** Recommend the General Fund support for the Pierce's Disease Control Program be reduced by $1.5 million and be replaced with a like amount from the Pierce's Disease Management Account. Further recommend that the department report by the May Revision on the additional amount of federal funds it has received, or anticipates receiving, for the current and budget years.

Analysis Page

Electricity Oversight Board

F-116 ■ **Monitoring of Energy Transmission and Generation Outages. Delete $730,000 From Item 8770-001-0001.** Recommend deletion of funds because the board lacks the authority to perform this function.

Department of Veterans Affairs

F-117 ■ **Reimbursement Shortfalls.** The Department of Veterans Affairs is not making sufficient efforts to collect reimbursements for services provided at the Yountville home. Resulting cash shortfalls have forced the department to obtain General Fund loans that it is finding difficult to repay, and at times have required the home to reduce services for home residents.

F-122 ■ **Cash Flow Issues.** Recommend supplemental report language directing the department to report to the Legislature on its cash-flow management for an additional fiscal year. Also recommend the department report at budget hearings on its projected cash needs for the homes in the current year, and enactment of legislation requiring that any future collections of reimbursements that exceed budgeted levels be used to repay General Fund loans provided in prior years.

F-126 ■ **Contract Outcomes.** Withhold recommendation on the Governor's proposed budget for the Yountville home until the Legislature is provided information on the outcomes of a contract to improve collections of reimbursements at the facility. Recommend that the department report at budget hearings on certain "benchmark" measures that will document whether it is improving its ability to collect reimbursements.

F-130 ■ **Options for Privatization at Veterans' Homes.** Do not recommend privatizing the administration of the skilled nursing facilities at the existing homes at this time because of the fiscal and operational difficulties of making such a change.

F-132 ■ **Barstow and Chula Vista Bed Activations.** Recommend the Legislature reassess budgeted reimbursement levels for the Barstow and Chula Vista homes at the time of the May Revision. At that time, more information should be available about whether the homes can activate the additional beds as proposed.

Analysis Page

Tax Relief

F-135 ■ **Change Manufacturing Property Reporting Requirement**. If the Legislature chooses to extend the manufacturing property tax rebate program, recommend that local governments using the program provide the required data to an agency with which it has regular contact on property tax issues.

Health and Dental Benefits for Annuitants

F-136 ■ **Budget-Year Costs Not Completely Determined Yet.** Withhold recommendation on the $554 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2003.

Augmentation for Employee Compensation

F-138 ■ **Employee Pay and Benefit Increases.** The budget includes $209.7 million ($130 million General Fund) to fund for state employees, except higher education, the compensation package the administration has negotiated with most bargaining units. We estimate that ongoing General Fund costs of this package will grow from about $325 million in 2003-04 to $900 million annually by 2006-07.

Control Section 3.60

F-142 ■ **State Contribution Rates to PERS Undetermined.** Withhold recommendation on 2002-03 state contribution rates for retirement benefits pending (1) the outcome of the proposed deferral of retirement contributions and (2) final determination of the actual rates to be applied in the budget year.