Legislative Finance Committee
Chama Middle School
181 N. Pine Avenue
Chama, New Mexico 87520
August 21, 22, 23, 2013

<u>Tuesday, August 20, 2013</u>
LFC Tour of the San Juan Chama Project, reservoirs, water meters and diversion projects.

<u>Wednesday, August 21, 2013</u>
<u>Joint Session with Legislative Education Study Committee</u>
The following members and designees were present on Wednesday, August 21, 2013: Chairman Luciano "Lucky" Varela; Vice Chairman John Arthur Smith; Representatives Henry "Kiki" Saavedra, Larry A. Larrañaga, Don L. Tripp, Edward C. Sandoval, Nick L. Salazar, James P. White, Patricia A. Lundstrom, and Donald E. Bratton; and Senators Carlos R. Cisneros, Sue Wilson Beffort, Mary Kay Papen, Steven Neville, Carroll H. Leavell, George K. Muñoz and Clemente Sanchez. Guest Legislators: Representative Bill McCamley and Thomas C. Taylor. Senator William F. Burt

The following Legislative Education Study Committee Members were present: Chairman John M. Sapien; Vice Chairman Rick Miera; Senators Gay G. Kernan, Lee S. Cotter, Linda M. Lopez, William P. Soules, Pat Woods and Richard Martinez; Representatives, Nora Espinoza, Jimmie C. Hall, Dennis J. Roch, Mimi Stewart, Alonzo Baldonado, Nathan "Nate" Cote, David M. Gallegos, Christine Trujillo and Debbie A. Rodella.

David Abbey, director, LFC, introduced new LFC staffers Kelly Klundt, new analyst for the Children, Youth and Families and Workforce Solutions departments. Mr. Abbey said Ms. Klundt worked for the Regulation and Licensing Department and has a degree from the University of Arizona. She is currently attending the University of New Mexico. Katie Chavez has graduate and masters degrees from Brown University and will be working with Charles Sallee, deputy director, Legislative Finance Committee, on performance evaluations.

Chairman Varela asked Hanna Skandera, secretary, Public Education Department, why the committee received the response to the Special Education evaluation the day the committee is to hear the presentation, stating the committee had no time to read the response. Secretary Skandera said the response had been sent electronically the day before. Chairman Varela deferred to Senator Sapien, who thanked Chairman Varela and the Legislative Finance Committee for their partnership and for allowing them to sit in on the Special Education evaluation.

<u>Program Evaluation: Cost and outcomes of Special Education Services.</u> Michael Weinberg introduced the report with information about state spending on special education and how it compares nationally along with information about how New Mexico's special education students perform.

Half a billion dollars are spent annually in New Mexico on special education. In FY13, 83 percent, or $412 million, of special education expenditures came from the state's general fund, the second highest percentage of state share nationally. While overall education outcomes in New Mexico are low, for students with disabilities they are even lower—only 17 percent perform on grade level in math and reading and 51 percent graduated from high school in four years with a standard diploma in FY12.

Numerous studies, including previous Legislative Finance Committee evaluations, have noted flaws in New Mexico's approach to special education funding. Even as initiatives to more accurately identify students for special education have proven effective, the state's funding formula continues to create incentives for school districts to qualify students for special education to receive additional support, to place students at higher service levels, and to claim excessive related services personnel. Contrary to best practices in special education policy, New Mexico's formula penalizes school districts and charter schools who invest in early intervention and placement at lower service levels. Consistent with previous studies, a census-based model encourages appropriate identification and equitably funds students with disabilities.

Also, unlike other states, New Mexico includes gifted students within its special education system. Similar to the analysis of identifying and funding students with disabilities, separating gifted students from the special education component of the formula and funding those services through a census-based approach will better serve gifted students across the state.

Additionally, because of decreasing revenues during the recent recession, the state is at risk of losing federal Individuals with Disabilities Act (IDEA) funding for failing to maintain fiscal effort at the FY09 benchmark of $412 million, not including other state agencies. Maintenance of effort (MOE) is particularly challenging in New Mexico, given the state's high share of special education funding. Different sources of the money necessary to maintain this funding level exist, including introducing supplemental appropriations or shifting funds made available to special education within the existing formula. Options also exist for how to distribute these additional funds, whether as a proportion of a school district's or charter school's special education population, its overall population, or through a revised census population. Supplemental appropriations or making a special education spending target clear through language in the General Appropriation Act appear to be simple, acceptable methods for meeting federal MOE requirements in future years.

Finally, the state could improve outcomes and save money by revising the complaint resolution process, consolidating special education systems statewide, and sharing best practices around analyzing student data; similarly, school districts could adjust salary schedules to hire more specialized personnel in-house.

Mr. Weinberg presented a major finding of the report: New Mexico's public school funding formula creates financial incentives that contradict modern special education policy.

Data supporting the finding included the following: While special education identification trends have shifted since 2003, variations between school districts and charter schools continue to point to the need to revise the funding mechanism. T state equalization guarantee (funding formula) does not control related services costs and the state has not provided clarity around expected caseloads. Census-based models minimize the link between funding and local decision-making over disability identification and placement. New Mexico has a special education high-cost fund to assist school districts and charter schools with exceptionally expensive students.

The evaluation recommended:
The Legislature should revise the funding formula to

- Use a census-based, single-weight approach to fund special education for school districts with more than 500 students;
- Use a student count, single-weight approach to fund special education for charter schools and school districts with less than 500 students; and
- Phase-in the increases and decreases in funding to provide soft landings for school districts and charter schools.

The Legislature should create a fund for school districts or charter schools serving high proportions of high-cost students with disabilities.

Valerie Crespin-Trujillo, program evaluator, Legislative Finance Committee, presented a major finding of the report: The state can meet its federal maintenance of effort requirements within the current formula and funding level.

Information supporting the finding included the following: The federal IDEA requires states to provide children with special education services as a condition of receiving federal funds. The LFC estimates the MOE target at $412 million. Two types of MOE waivers are available to states. The PED submitted two separate waiver requests for FY10 and FY11, each citing a precipitous and unforeseen decline in the financial resources of the state as the reason for the waiver from the MOE requirements. The department was granted a waiver for FY10, but denied a waiver for FY11. New Mexico is not the only state that has requested a MOE waiver from the USDE but is among four states denied a waiver for FY11.

Mr. Weinberg continued to present the finding using the following information: Moving forward, when New Mexico's special education appropriation falls short of the FY09 target of $412 million, the state has several options for funding the gap and distributing those funds. A free and appropriate public education (FAPE) waiver could significantly reduce New Mexico's MOE liability in prior as well as future years, and school districts and charter schools appear to meet local MOE requirements and have flexibility to adjust spending.

The evaluation recommended:
The Legislature should monitor the USDE's ruling on the PED's appeal and, based on that outcome, identify a method for maintaining effort that meets federal criteria while preserving the state's public school funding formula.

The PED should pursue FAPE waivers for FY11, FY12, and FY13 as well as subsequent years when the total number of special education units is less than the FY09 benchmark of 106 thousand.

Mr. Weinberg presented a major finding of the report: New Mexico's approach to identifying, serving, and funding gifted services is costly and inefficient.

Information supporting the finding included the following: Unlike most states, New Mexico considers gifted students within its special education population. School districts and charter schools use similar practices for identifying gifted students. The current unit weight likely over-estimates the true cost of educating gifted students. Census-based funding will create incentives to more accurately identify and serve gifted students.

The evaluation recommended:
The Legislature should

- Revise state law to separate giftedness from special education; and
- Revise state law to a census-based, single-weight approach for funding gifted units that more accurately reflects costs.

Valerie Crespin-Trujillo presented the last major finding of the report: The PED can improve special education outcomes and save money by proliferating best practices across the state.

Examples of best practices included the following: Limiting the need for due process hearings and containing the time required will help school districts and charter schools reduce non-instructional special education expenditures. Purchasing a statewide system for creating individual education plans (IEP) could save money and increase consistency. School districts and charters could benefit from more state-level resources to help improve special education opportunities for students and aid in ensuring the proper amount of effort is being maintained at the local level. New Mexico's schools are developing and using innovative and successful homegrown practices the PED could share and replicate across the state. Contractual services, a large cost-driver within special education, could be contained with adjustments to salary schedules for related services personnel.

The evaluation recommended the PED should

- Revise the dispute resolution administrative code so school districts are not solely responsible for the entire cost of due process hearings for which they are not found liable;
- Create administrative rule or set guidelines by which the time dedicated to a due process hearing is limited in an effort to contain school district and charter expenses;
- Clearly promote alternatives to the due process hearing through educational materials on the PED website, at school locations, and through special education advocacy groups;
- Implement statewide special education systems, such as IEP software, to reduce costs and improve consistency; and
- Provide additional opportunities to proliferate successful practices, such as use of student data to drive decision-making, across schools.

Following the presentation of the program evaluation, members of the LESC and LFC asked questions and provided supplemental information. Representative Roch stated, the census-based approach to funding is familiar and has been recommended previously. In the analysis presented, several weights are used. How was the 2.16 weight determined? This weight is higher than the current D-Level weight. Mr. Weinberg explained he calculated the total units and related services and divided that by K-12 membership, it would be lower if we separated out related services. Representative Roch asked if it make sense to use an average percentage and cap related services units. Mr. Weinberg said that is an option; there are several things including the weight that are subjective, and the hard work comes after this report to determine the best possible approach for New Mexico. Even if a cap is placed on related services, it may not eliminate the double counting because some schools include these services to determine a student's level (A-D), even though they are a separately funded component. Representative Roch said, in separating gifted from special education, there is a discrepancy between the LFC report and PED's response. Is the link statutory or is it in the administrative code? Mr. Weinberg said we believe that there is a statutory link, but the question is how to we split it out. Do we split everything, or do we just pull out pieces. Denise Koscielniak, director, Special Education Bureau, stated there is a statutory link, but the code takes it further. Representative Roch asked about the existing high cost fund. This recommendation seems redundant since we already have one. Would we revise the current fund or rebuild completely? Mr. Weinberg said revise is most likely the right word. The current fund works on a student-by-student basis, and some districts serve more students and do not receive funding on a recurring basis; this is one revision that needs to happen. Representative Roch stated the state does not want to encourage chronic underfunding then asked about the statewide IEP System. This is not a data issue because districts are using a variety of systems and shifting the data into STARS. This is a cost-efficiency issue. It is important the districts retain the ability to opt into the system. Secretary Skandera said, yes, districts would have the choice to participate.

Representative Lundstrom asked if we move to a census-based funding model, can we adjust the percentage (the census value)? And how many states that have a census-based model encountered MOE issues? Mr. Weinberg said the percentage could be adjusted. It is a challenge to fund high cost students as is, so adjustments need to be made if needed. And yes, some of the states that applied for USDOE waivers use a census-based model. This model alone does not ensure that you will not need a waiver. Valerie Crespin-Trujillo provided a table on page 30 of the evaluation that shows two states, New Jersey and Alabama, are using census-based funding and requested a MOE waiver. Representative Lundstrom asked how the appropriations would be made available for special education. Would this be under Section 4? Charles Sallee, deputy director, Legislative Finance Committee, said it would be done through Section 4. Language in the bill would make a special education amount available. Representative Lundstrom asked why do districts have the whole responsibility for dispute resolution. Ms. Koscielniak stated federal statute prohibits us from using IDEA-B funds for dispute resolution, so it falls to the districts. If the district is found to have violated FAPE, then the district must pay all fees. Representative Lundstrom asked if it needed any sort of a statutory fix. Ms. Koscielniak said we can look at it, but the IDEA-B requirements are pretty clear. Representative Lundstrom asked why the USDOE assumed the state had money for the second waiver and denied it after approving the first waiver request. Secretary Skandera said the federal department decided that we were not under the same hardship. Representative Lundstrom asked for a copy of the waiver denial.

Senator Soules said the recommendation to move to a census-based funding model is based on the concern that the current system incentivizes schools and districts to game the system and asked if the evaluators had evidence of gaming. Mr. Weinberg said he was reluctant to use "gaming the system" but evaluators found districts good at generating additional revenue during site visits. Districts that do a good job at intervening before a special education classification is given get penalized through the current formula, so there is an incentive to identify students. Senator Soules expressed concerns the decrease in identification resulting from a switch to a census-based model could result in an under-identification issue. Small districts can have their proportions of special education students influenced by small increases or decreases. The small sample size complicates things. Mr. Weinberg said charter schools are in the same situation, and a census-based model is only a viable option for big districts and charters. Senator Soules asked about the disadvantages of a census-based model. Mr. Weinberg said the main disadvantage comes in ensuring that services are received. These services are a civil right. Also, a census-based model could give more money to districts that do not need it. Currently, poor districts are more likely to identify a lower percentage of special needs students even though the expectation is that poor districts would have larger populations of special education students because of the connections between early childhood health care and educational outcomes. Senator Soules said an issue with the census-based model it its assumption that special education students are evenly normal distributed. How do we manage the differences between poor districts and more affluent districts? Mr. Weinberg stated this is a problem of the current system. More affluent districts have more identification resources. California uses a census-based funding approach tied to regions. This is done to better get at the normal distribution. Senator Soules spoke about the census-based model being a blunt instrument that does not address the specific needs of. Regarding gifted students, I am a gifted teacher. I teach 32 students. For these students, the district receives about an extra $80,000. This is a loss for the district. It does not cover my salary and benefits, nor does it cover the cost to screen students for giftedness. One of the state's strengths is that gifted falls under the special education category because this ensures that the high-end gifted students receive funding. A 130 IQ is just as different from average as a 70 IQ Mr. Weinberg said the cost of funding gifted students is over-estimated. The $80,000 is on top of base funding of approximately $115,000 for those 32 students.

Representative Trujillo stated she was a classroom teacher, and there is a high cost to educating special education students. It takes extra funding, more energy, and parents expect a high level of attention. This is not just about the dollars.

Senator Kernan asked if the state average for special education of 12.7 percent includes 2- and 4-year-olds. Mr.. Weinberg said the state average does not include because the evaluation was an attempt to net out K-12 funding. He said he did not know how the federal average is calculated. Responding to Senator Kernan, Mr. Weinberg said prekindergarteners are included in the state's 83 percent share of special education funding. .

Representative Stewart said the 83 percent state share for special education funding is a little misleading because the state funds education generally Mr. Weinberg said New Mexico's statewide funding of public education makes it harder to meet the MOE. Representative Stewart New Mexico does well on educating special education students with supports and hard-working teachers. She said she has been part of the IEP process for 30 and does not believe districts are over-identifying special education students. She said a previous study found some manipulation of the system but mostly in the area of ancillary services. She asked why PED is not providing more oversight. Ms. Koscielniak stated this was one of the audit fixes, and now STARS is used to try to track this. Representative Stewart said census-based funding does not accommodate fluctuations in special education populations. She said, while at first she thought it was a good idea, she has since concluded special education is being funded appropriately. She said the state needs to provide students with what they need. Mr. Weinberg stated the report includes special education identification rates for all districts and attempts to identify outliers at both ends of the spectrum. Representative Stewart asked for year-to-year data that shows trends that highlight over-identification.

Vice Chair Representative Miera, LESC, said the Legislative Education Study Committee looked at this in the late 1990s and was concerned about the over-use of due process hearings. Mr. Weinberg said the evaluation looked at both the number of people who were involved and the length of time for the hearings. He said the hearings are costly but failure to hold them would be a violation of the student's civil rights. Ms. Koscielniak said changes to the due process hearing process would take time to enact. Time is currently the responsibility of the hearing officer.

Senator Sapien thanked the panel for the presentation and expressed his appreciation for the recommendations being about meeting MOE and still providing the correct services.

Lessons Learned from the University of Virginia. LeAnn Buntrock, director of the Woodrow Wilson MBA Fellowship in Education Leadership, stated New Mexico has an opportunity to make an impact both in the state and nationally with regard to training effective school leaders. Through the University of Virginia School Turnaround Specialist Program (UVA-STSP), New Mexico is working toward building the capacity to be able to serve educators in the state and educators in other states.

Ms. Buntrock noted the Darden/Curry Partnership for Leadership in Education (PLE) was designed to expose education leaders to the same kind of executive training military and business leaders receive. She stated leadership is essential to the development of a successful school and is generally the primary reason high quality teachers leave a school. Five years ago, emphasis was on attracting the best principals; focus now includes central office staff at the district level. The UVA-STSP supports a systemic approach that includes protocols and infrastructure necessary to scale and sustain school turnaround. The program engages districts up front to identify existing and needed capacity. The UVA-STSP program is not prescriptive, but rather builds leadership capacity. Ms. Buntrock noted there are a few important requirements such as infrastructure, support, and resources, including the use of an interim assessment to diagnose student performance. Selection into the program is based on a competency-based interview which focuses on key behaviors such as drive, ability to influence, and confidence, rather than experience and credentials.

Ms. Buntrock also stated it is important to build a pipeline of turnaround principals. She noted she joined the Woodrow Wilson Fellowship because she believes the root cause of the problem is not being addressed. States need a more rigorous leadership selection and preparation process to address the particular needs of a school turnaround principal.

Hanna Skandera, secretary designee of the Public Education Department, noted that, on average, schools participating in the UVA-STSP have seen a 36 percent increase in math proficiency and 33 percent increase in reading proficiency. Ms. Skandera stated the PED selected the program because of its documented success and generally participants are pleased with the program.

Ms. Buntrock emphasized there are leadership best practices that are applicable to any situation, business or education. For example, data analysis and data-driven decision-making are important to all organizations.

Ms. Skandera noted it takes at least six years for a New Mexico educator to become a principal; it takes less time to become a principal in surrounding states. As a result, New Mexico teachers are moving to surrounding states.

Members of the two committees discussed New Mexico's unique diversity and asked how it is addressed through the UVA-STSP. Ms. Buntrock responded the program has a history of working with diverse school populations, but the emphasis is on leadership. She emphasized characteristics of leadership are similar no matter the context. The idea is to prepare leaders who can go back into their context and can figure out how to respond to that situation.

Representative Larrañaga asked how people are selected for the program and how stronger school accomplishments can be achieved. Ms. Buntrock talked about the competency-based interview. She noted principals often have strong soft skills but struggle with leadership skills. She also noted the UVA-STSP trains district teams to use the competency-based process. As a result, leaders are thinking differently and are beginning to look for people who exhibit leadership characteristics rather than relying on individuals to self-select into leadership positions. Participants are required to develop and articulate a vision and an action plan and build a strong team. Ms. Buntrock noted educators have traditionally struggled with execution and the UVA-STSP site visits focus on execution. She also noted the Public Education Department has also been helping participants with execution. Ms. Buntrock noted participants can be asked to leave the program if they are not actively doing what the program requires. UVA-STSP works with the district team to establish performance targets and credentials are awarded to those participants that meet those standards. The program's ultimate focus is improving student achievement.

Members of the committees voiced concerns about breaking the cycle of holding potential principals and administrators back. They also mentioned the potential to develop a program in state that adequately addresses New Mexico's unique population. Members also discussed stability, especially in relation to local elected school boards, and superintendents that generally have a high turn-over rate – 30 percent last year. Ms. Buntrock again emphasized her belief that New Mexico can develop a similar program because the state has people who are willing to go after this systemically in a way that isn't happening in any other state. In terms of the school boards, she noted issues with stability exist. To date, UVA-STSP has not adequately addressed preparing superintendents to deal with school boards. She noted superintendents have not been trained to present data, rather than soft information, to school boards, nor have they been adequately trained to communicate a clear plan. Ms. Skandera noted the department is working with the superintendents association.

Members of the committee discussed potential plans to launch a leadership training program in New Mexico and asked who had been included in planning discussions. Skandera answered it was just education leadership of the universities and the Higher Education Department up to that point.

Senator Beffort stated it would be productive to have leaders participate in the UVA-STSP program concurrent with working with local business schools and colleges of education to develop a New Mexico-based program. She also stated New Mexico institutions and the New Mexico Coalition of Education Leaders (NMCEL) need to participate in the UVA-STSP to better understand the program. Gloria Rendon, executive Director of NMCEL, stated NMCEL members are interested in participating.

Senator Lopez asked what kind of research PED conducted prior to selecting the UVA-STSP program. Ms. Skandera responded that PED looked across the state for programs and found many good partnerships, but didn't find a program that provided data.

Senator Trujillo asked where funding from this program is coming from. Ms. Skandera responded that the state made funds available for those who opted in. She noted participation is voluntary – principals and school districts do not have to participate in the program. Ms. Buntrock added that this process started with districts approaching the state with an interest in this program.

Chairman Varela closed by commenting on the need to work together.

Preliminary General Fund Revenue Report for FY13 and Estimates for FY14 and FY15. Tom Clifford, secretary, the Department of Finance and Administration, began the presentation by describing the group of economists that comprise the consensus revenue-estimating group (CREG). Mr. Clifford noted that, compared with the December 2012 CREG estimate, personal income taxes and oil and gas revenues have come in above estimate, while gross receipts and corporate income tax revenues fell below the forecast, adding federal cutbacks appear to be a major factor causing the below-forecast growth. After the revisions, he reported, recurring revenue is estimated to have fallen 3.3 percent in FY13 but is projected to grow 4.5 percent in FY14 and 5.5 percent in FY15. Mr. Clifford reported that new money, FY15 revenue less FY14 appropriations, is estimated at $296 million, equivalent to 5 percent of FY14 appropriations. Mr. Clifford added the new money will provide the state with adequate revenue to accommodate modest spending growth while adding to reserves, which saw a reduction resulting from federal spending cutbacks.

Addressing the national economic outlook, Mr. Clifford stated gross domestic product (GDP) growth was slowed by fiscal drag of spending cuts and tax increases, including the increase in the payroll tax. He added that low inflation persists, allowing the fed to keep a lax monetary policy and inject cash into the economy. Economic risks have diminished significantly, and the state economy has turned the corner, evidenced by an improving housing market, growing taxable gross receipts, especially in construction and oil and gas sectors, and unemployment is lower than the national average, although this is influenced by reduced labor force participation.

Mr. Clifford discussed changes in the energy forecast – gas prices are down due to a national volume glut. However, drilling is down, which will negatively impact supplies and tighten up the market. Natural gas export may be another outlet for domestic supply. Mr. Clifford reported oil production increased by 50 percent over the last three years, and production volume reached 90 million barrels.

Demesia Padilla, Secretary, Taxation and Revenue Department, discussed the consensus revenue outlook, reporting that GRT was coming in lower than anticipated. She cited fewer federal contracts, noting professional and technical services contracts are about down 9 percent. She added the increase in the payroll tax reduced disposable income approximately $500 million. She added that taxable gross receipts attributable to construction are up 8 percent. Finally, Secretary Padilla discussed the negative impact on revenues of tax credits, explaining that $90 million in high wage jobs tax credit claims were paid out in FY13. The department estimates the credit will cost the general fund $15 million in FY14 and subsequent fiscal years.

Addressing risks to the forecast, Mr. Clifford noted the CREG economists reduced the insurance premium tax estimate because of uncertainty in the timing of the implementation of the mandate. He added that energy markets are volatile and therefore present a risk. Mr. Clifford explained the personal income and corporate income tax estimates were conservative, adding DFA considers those revenue sources an upside risk to the forecast. Interest rates are expected to increase but not for a year or two. Their eventual increase is an upside risk for the earnings on state balances.

Mr. Clifford pointed out the downward revisions would require transfers from reserves, resulting in a 7.6 percent balance at the end of FY14. He added the administration considers 10 percent reserves an important goal and proposed reserving some new money to build reserves closer to the 10 percent target level. Mr. Clifford also briefly reported on bonding capacity, noting net senior severance tax bonding (STB) capacity is estimated to reach $196.1 million in FY15. Supplemental severance tax bonding capacity, reserved for public school capital needs, is estimated at $175 million. After adjusting for previously authorized unissued projects totaling $38 million and set-asides for the water project, tribal infrastructure, and colonias infrastructure project funds, total STB capital capacity is estimated at $361.1 million. Flat-mill general obligation bonding (GOB) capacity is estimated to be $165 million. The question of whether to issue general obligation bonds would be put to voters in the 2014 general election.

Elisa Walker-Moran, chief economist, the Legislative Finance Committee, explained that the LFC's report reflects mid-session adjustments made in February 2013, adding these changes are not included in the DFA/TRD report. Reporting additional risks to the forecast, Ms. Walker-Moran noted that uncertainty persists regarding the federal mineral leasing (FML) revenue. The nearly $25 million sequestered during federal fiscal year 2013 may be returned to New Mexico in FFY14. However, a further sequester in FFY14 could further reduce FML revenues. She added the tobacco settlement legal challenge should be complete by the end of FY14, and the maximum downside risk to the general fund is $34 million in settlement payments from cigarette manufacturers participating in the tobacco master settlement.

Ms. Walker-Moran summarized the general fund appropriation outlook, which projects future revenue surpluses or deficits based on the revenue estimate and certain assumptions for increases in appropriations. She also summarized the general fund financial summary (GFFS), which shows revenue, appropriation, and reserve detail. She added that the projection for tobacco settlement permanent fund investment income was shown in the GFFS, noting that the investment returns in the fiscal year appear to be nearly twice the projected level ($21 million).

A committee member asked where the $70 million SHARE-cash reconciliation contingency was reported in the general fund financial summary. Mr. Clifford noted this adjustment was made to the operating reserve in FY12, which is not depicted in the GFFS. Mr. Clifford added DFA accountants are working on the comprehensive annual financial report (CAFR), adding their methodology does not include any further reserving related to the reconciliation.

A committee member asked whether federal spending reductions, including potential continuation of the FML sequester, were part of the downward adjustment in the forecast. Director Abbey responded that, in terms of FML, the economists assumed the sequester ends in September 2013, one quarter into state FY14. The best-case scenario would be the return of FFY13 sequestered funds and no FFY14 sequester. The worst-case scenario would be the cancellation of FFY13-sequestered funds, and the sequester (and permanent cancellation) of FFY14 FLM transfers.

In response to a committee member's question how the estimate for the insurance premium tax is affected by Affordable Care Act (ACA) implementation, Mr. Clifford stated that requirement of taxable insurance coverage would increase tax revenue. He added the FY14 revenue estimate shows growth over FY13 to reflect ACA implementation, but the estimate was reduced in out years.

A committee member asked whether there should be concern about the corpus of the severance tax permanent fund after the low June transfer to that fund. Mr. Clifford responded that there was a transfer of about $100 million in December, meaning a decent-sized transfer for the whole fiscal year. He stated the contributions to the funds can be low because 95 percent of the severance tax bonding fund revenue is intercepted for the bonding programs. Growth in the fund is limited to investment earnings.

In response to a committee member's question concerning the administration's intention to use new money to raise general fund reserves, Mr. Clifford stated the long-term, rather than the short-term goal is to get reserves back to ten percent. Limiting current spending growth at population and consumer inflation growth would limit spending growth to $240 million, leaving $60 million to contribute to reserve growth of around one percent of recurring appropriations.

Objection to Human Services Department Budget Adjustment Request (BAR) Number 140042 – Transfer $10.35 million in Medicaid Budget from Other Services to Contractual Services for Five Arizona Based Behavioral Health Providers. LFC Principal Analyst Greg Geisler provided an overview of the LFC objection to the Human Services Department budget adjustment, which would transfer $10.35 million in the Medicaid program other costs category to contractual services to fund five Arizona-based behavioral health contractors. These contractors were hired on a sole source contract basis as part of the HSD audit of 15 behavioral health providers and are to provide technical assistance or in some cases assume the operations of the New Mexico providers that are going out of business due to HSD's freezing their reimbursements. Mr. Geisler noted six key factors behind the LFC objection: 1) The BAR is premature given that a BAR for $7.5 million was approved on July 23. 2) The HSD has not responded to significant LFC information requests, in particular information requested about the audit. 3) HSD has not addressed LFC concerns about their approach, which is to replace 12 of the 15 New Mexico providers with the Arizona-based providers. 4) The provider transitions are disrupting client services, despite HSD assurances.; 5) The transition is rushed, leading to quality concerns. 6) The transition contractors are expensive, with some hourly rates approaching $300.

Representative Varela provided an overview of how the BAR objection hearing process works and noted his concern with the direction taken by HSD with the BAR request. He said the Legislature might have to tighten agency BAR authority.

Deputy Secretary Brent Earnest testified HSD respects the role of the Legislature in the oversight of agencies. In dealing with the behavioral health provider audits, he noted the department's priorities were to ensure client access and continuity of care and to ensure security of Medicaid dollars. As to the contracts being funded by the BAR request, Mr. Earnest noted that they were temporary in nature but necessary to continue continuity of care. He reminded the committee the BAR was for a transfer of existing budgetary authority and did not represent a request to increase the agency budget. He provided an update on the status of the transitions, stating that one entity had funding restored and was receiving technical assistance, negotiations were continuing with Presbyterian Medical Services and Youth Development Incorporated (YDI) to continue with operations with technical supervision, and the balance of providers were in various stages of transitioning their clients to Arizona-based providers.

Mr. Earnest explained that when providers under a pay-hold tell the Human Services Department that they will no longer be able to provide services at a certain point due to financial difficulties, the HSD will work with the provider to ensure continuity of services by fronting payroll to those providers in return for cooperation with transitioning clients. Mr. Earnest stated HSD had established a crisis line to assist clients having issues with behavioral health services and scheduled a teleconference with federal officials to hear concerns from New Mexico citizens about the behavioral health transitions. In terms of spending so far with the Arizona providers, Mr. Earnest noted about $3.1 million had been spent to date, with $2.8 million spent on payroll for current employees at New Mexico behavioral health firms, $100 thousand for lease costs, and about $232 thousand in professional services. Finally, Mr. Earnest noted HSD appreciated the earlier approval of the $7.5 million BAR approval but wanted the entire $17.85 million from the very beginning.

Evan Blackstone, chief of staff, Office of the State Auditor, explained the interest of the State Auditor in the PCG report. The State Auditor is responsible for overseeing financial statement audits of state agencies and as part of this process the auditors must examine compliance with federal laws as well as assess the internal controls of agencies over financial reporting. In agreement with HSD and the Attorney General, a stipulated order allowed the State Auditor to get a copy of the PCG audit but the State Auditor is required to adhere to confidentiality of certain information. As part of that agreement, HSD is to fully provide supporting documentation from the PCG report to the State Auditor. Mr. Blackstone reported that State Auditor staff are working very closely with the contract certified public accountant (CPA) firm working on the HSD financial statement audit and is conducting audit test work related to the findings in the PCG report.

Senator Smith noted that there was a lot of uncertainty, especially in Southwest New Mexico about the future of behavioral health providers following the PCG report and pay-hold implementation. He asked Mr. Earnest to clarify the full potential amount needed for the Arizona providers' contracts. Mr. Earnest stated HSD does not anticipate the Arizona providers will use the entire $18.75 million in contract authority, but HSD needs the BAR to establish the budget authority to spend up to that amount. In response to a question about an Arizona provider potentially purchasing property in the Deming area for $1.7 million, Mr. Earnest noted generally agencies are leasing, not purchasing, property. Senator Smith noted he is not sure leasing will work in all cases. Mr. Earnest noted the transition contracts with the Arizona providers allow them to cover lease costs but not property acquisition.

Senator Smith stated he has a difficult time accepting that all 15 providers met the culpability level for fraud charges and the implementation of pay-holds on reimbursements. Senator Smith noted the State Auditor, Attorney General and the executive branches all have more information about the PCG audit report than the New Mexico Legislature. If the Legislature had more information it might be easier to understand why all 15 met this criteria for a Medicaid fraud referral in the view of the department. Senator Smith noted that legislators are the lead contact with state government for their constituents.

Senator Munoz asked for an explanation of the timing of the audits versus the timing of seeking new contractors in Arizona. Mr. Earnest stated the process started with OptumHealth referral of potential fraudulent activity to HSD. Based on prior experience, HSD knew it might need help from outside contractors to be available before the PCG audit was completed. Originally, HSD started with two new contractors but then realized, based on how the PCG report, was progressing it would need another three providers for a total of five. The significance of the findings in the OptumHealth referral led to the need for the PCG audit report for an independent review before referral to the State Attorney General. HSD picked the 15 firms for PCG to review based on Optum input.

Senator Munoz asked about other audit findings in the amount of $5 million from other areas and asked whether or not they had been referred to the Attorney General. Mr. Earnest said he believed that the senator was referring to the personal care option and that those findings from the federal inspector general had been included in HSD financial statement audit. Senator Munoz noted there appeared to be a double standard with fraud referrals. Senator Munoz requested a complete timeline of transitions including dates of negotiations and dates of licensure of the Arizona providers in New Mexico. In response to Senator Munoz about the cost of the Arizona contractors, Mr. Earnest noted they were negotiated separately and given the extraordinary circumstance the rates were warranted. In a response to a question from Senator Munoz, Mr. Blackstone stated there would be no conflict of interest with the Legislature undertaking its own audit. Senator Munoz concluded that there were a lot of questions about how the Arizona firms were selected and concerns over expedited licensing.

Senator Clemente Sanchez asked how HSD picked Arizona providers over other available providers. Mr. Earnest responded the Arizona providers served demographically similar populations, including Native American, urban, and rural populations. These firms also have had experience transitioning other priorities. Senator Sanchez asked for a prioritized ranking of the Arizona providers; Mr. Earnest said the HSD would see what they could do on the list if it existed. In response to a question about whether or not New Mexico providers could have helped, Mr. Earnest noted the state had a difficult time with the Carlsbad transition and, given the statewide nature of the findings, HSD felt it was necessary to go out of state for contractors.

In response to the a question from Senator Sanchez on what type of audit the PCG conducted, Mr. Blackstone responded it was not a financial statement of fraud, waste, and abuse audit approved by the State Auditor but added that HSD was in the process of having a FY13 financial statement audit completed, which would look at internal controls over identifying fraud and safeguarding federal funds. Senator Sanchez asked if OptumHealth's role would be examined. Mr. Earnest responded that OptumHealth role will be examined as part of financial statement audit. In response to a question about the cost basis on the PCG contract, Mr. Earnest noted it was time- and labor-based and not based on Medicaid fraud recoveries.

Senator Sanchez stated he was bothered by a lack of transparency; there were a lot of rumors and innuendo going on and that if there had been more transparency this would not be the case. This whole process has been handled poorly by HSD, the Attorney General, and the State Auditor. There has been a lot of disruption of services and the frontline employees at the New Mexico providers have suffered.

Senator Lopez noted Secretary Squier said the state has a culture of corruption, but the Senator did not agree with this notion. The senator noted that she has done an Inspection of Public Records Act request on documents relating to transition. Senator Lopez asked about the OptumHealth referral process and Mr. Earnest answered it happened in the January timeframe using a standard referral process and that the contract with PCG followed the OptumHealth referral and was needed as additional due diligence. Mr. Earnest stated there was not an internal committee at HSD that looked at provider culpability, but there was a committee that looked at "good cause" exceptions for release of pay-holds. Mr. Earnest noted there were discussions about what to do with the referral, but not to judge culpability on the New Mexico providers. He noted that negotiations with the Arizona providers began in the February/March timeframe but the HSD would provide a timeline. Senator Lopez noted that OptumHealth bore some culpability as the state behavioral health contract manager.

Senator Lopez asked how could agencies do a good job on "good faith" appeals on pay-holds if they don't have information on what they are accused of doing. Mr. Earnest noted the companies appealing pay-holds have specific points, including six federal criteria, to address in their appeals but the HSD evaluation process did not find merit in lifting the pay-holds. In closing, Senator Lopez noted that there had been a lot of disruption in patient services, such as prescriptions, and the state needs to have more concern about the disruptions and do a better job overseeing its contractors and providing assistance.

Representative James White asked about the need for the PCG audit. Mr. Earnest noted the serious nature of OptumHealth referral led to the audit, and HSD is required to suspend payments due to acceptance of the audit referral by the Attorney General. Mr. Blackstone clarified the role of the State Auditor was not to re-audit PCG's work but to use the report as part of the State Auditor's financial statement audit process. Failure to have access to the report could lead to a scope limitation on the financial statement audit. Mr. Blackstone then provided additional information about the financial statement audit process in regards to looking at fraud. Representative White stated it is important to not to jump to conclusions about the outcome of the investigation based on media coverage of the allegations.

Mr. Earnest explained in response to Senator Papen that the $18 million was a transfer of existing budget to contractual services and there was not a request for proposals process used to procure the five companies. In response to a question about the decision to hire the Arizona companies, Diana McWilliams, director of the HSD Behavioral Health Services division, stated she visited La Frontera in Tucson and SW Behavioral Health Services (AGAVE) in Phoenix. She was accompanied by the CEO of OptumHealth New Mexico, one additional OptumHealth staffer, and a PCG auditor. There was a list of companies with clean records and good outcomes in Arizona. Senator Papen asked how the contract rates were negotiated and if they were reasonable. Mr. Earnest noted these are short-term contracts and the rates are not going to be paid on a 40-hour basis and were necessary given the gravity of the situation. Mr. Earnest noted that about $3.5 million has been spent to date and the contracts terms are short, ending on December 31, 2013. The Arizona providers that decide to stay will be billing Medicaid.

Senator Papen stated that legislators want bad actors out but can't believe all 15 providers were that culpable. Given OptumHealth's $45 million annual contract, Senator Papen asked about their responsibility to exercise appropriate oversight of these companies. Mr. Earnest noted that OptumHealth made the referral as part of their oversight role. Senator Papen asked if OptumHealth had a responsibility for errors in making those payments to the 15 providers. Mr. Earnest stated that OptumHealth regularly dealt with provider billing issues.

Senator Papen stated the audit process was not fair and not done using a typical process. The providers were not given an opportunity to respond to the findings in the report. Senator Papen added that being branded as criminals from day one is appalling. Mr. Earnest noted that HSD made no determination of fraud but only reported credible allegations of fraud.

Representative Rodella noted she has been hearing about service disruptions and problems with the Teambuilders transition in particular with some of the Pueblos with in her district. Diana McWilliams from HSD noted that OptumHealth is monitoring phone calls to the behavioral health crisis line and that consumer referrals to CMS are being referred to HSD. Ms. McWilliams then covered HSD's activities in monitoring and responding to current issues with providers. Representative Rodella next who made the decision to lift the pay-hold to Service Organization for Youth (SOY). Mr. Earnest responded that HSD made the call on lifting the pay-hold with Attorney General input. Representative Rodella stated she was concerned with the uncertainty of the current situation and the widespread accusations of fraud with the New Mexico providers.

Representative Bratton asked about the change in federal law that impacted the criteria for fraud referrals. Mr. Earnest noted that the standard of evidence for referral was lowered to the credible allegations of fraud determination leading to suspension of payments. Representative Bratton asked why there was three-year period reviewed in the audit. Diana McWilliams noted it was to cover the period back to the start of the OptumHealth in January 2009. Mr. Earnest noted that this referral was different because it involved the new program integrity process. Representative Bratton next engaged Mr. Blackstone in a discussion over the role of the State Auditor in detecting fraud as part of the financial statement process.

Senator Beffort asked if jobs had been lost at the New Mexico providers. Mr. Earnest noted that if employees want to stay they have been retained. HSD has not heard about denials of service, although there may be disruptions. Senator Beffort stated it was important to note how the change in the regulation in the Affordable Care Act impacted the fraud referral. Senator Beffort also noted that OptumHealth had been previously sanctioned for billing issues so they had an interest to do a good job with oversight.

Senator Cisneros asked Mr. Earnest why in the HSD written response to the LFC BAR objection the department in effect states that HSD does not really need the approval of the Legislature for the BAR and that the BAR objection has no practical effect other than creating more paperwork. Mr. Earnest stated the no practical effect sentence means the BAR will move forward and the additional paperwork related to the requirement to submit a second BAR. Senator Cisneros asked if the budget adjustment request had been processed and Mr. Earnest stated it would go in effect after the hearing. Senator Cisneros noted that he supported the LFC director's objection and that even if the BAR could not be stopped now the Legislature had the ability to take other action during the upcoming legislative session.

In response to a question from Representative Sandoval, Mr. Earnest explained the use of the BAR funds and the implications of the pay-holds on reimbursements due to providers.

Representative Varela noted that the HSD response in writing to the LFC BAR objection was disturbing in tone and the BAR objection had a purpose. He noted the broad authority of the Legislative Finance Committee including subpoena power. The motion to accept, disapprove, or not take a position on the BAR objection was considered, and by a 15-1 vote the members supported the BAR objection.

Thursday, August 22, 2013

The following members and designees were present on Thursday, August 22, 2013: Chairman Luciano "Lucky" Varela; Vice Chairman John Arthur Smith; Representatives Henry "Kiki" Saavedra, Larry A. Larrañaga, Don L. Tripp, Edward C. Sandoval, Nick L. Salazar, James P. White, Donald E. Bratton and Thomas C. Taylor; Senators Carlos R. Cisneros, Sue Wilson Beffort, Mary Kay Papen, Howie C. Morales, Steven Neville, Carroll H. Leavell, and Clemente Sanchez. Guest Legislators: Representative Bill McCamley, Debbie A. Rodella, and Jimmie C. Hall. Senators William F. Burt, and William E. Sharer.

Welcome Remarks and Community Input. Members and designees introduced themselves. Chairman Varela thanked Chama's elected officials for their hospitality. David Abbey, director, LFC, introduced himself and staff members and recognized Robert Herron, regional manager of New Mexico Public School Facilities Authority, stating he is working hard to finish two projects in Chama.

Michael Branch, Northern New Mexico College Board chairman, welcomed the committee, stating he appreciates the help Northern New Mexico College has received over the years. He said he has worked with the Public Education Department over the last three years and the college's finances are in good shape. Mr. Branch said Northern New Mexico College awarded 200 degrees and certificates to students in the last year, citing a 90 percent graduation rate that is positively affecting northern New Mexico.

Anthony Casados, superintendent, Chama Valley Independent School District, welcomed the LFC and thanked David Abbey and staff for their support of the Chama Valley School District. He spoke about the district's accomplishments and its partnership with Northern New Mexico College. He said students have participated in dual credit and concurrent credit programs with Northern New Mexico College for a number of years and some high school seniors have graduated with between 60 and 80 college credits. He also stated his purpose was to continue to provide an excellent education for his students.

Darren DeYapp, mayor, Village of Chama, welcomed the committee on behalf of the village and governing body. He thanked the committee for their support of the railroad, emphasizing its importance to the community, which included jump-starting the economy, attracting tourism and infrastructure needs.

Danny Griego, Rio Arriba County Commission, welcomed the committee and stated he is the commissioner for district three. He outlined the borders of his district and spoke about funds needed for repairs of local bridges and roads.

Thomas Campos, Rio Arriba County manager, gave a brief summary of Rio Arriba County. He spoke about gross receipts taxes, stating when the tax on food was repealed it did away with the majority of the gross receipts tax in Rio Arriba County. Mr. Campos said areas without industry rely on food tax receipts, and when the bottom dropped out of oil and natural gas, it left San Juan and Rio Arriba counties suffering

Senator Neville asked the panel what their current status and philosophy is on oil and gas after a moratorium against drilling occurred in the past. Mr. Campos said the moratorium was against drilling on the east side of the county, leaving the west side unregulated. He stated the county is friendly with the oil and gas industry. What the county didn't allow was the speculators drilling wells near the Chama Canyon that are unregulated and open pit. The county opposes drilling that will pollute the water. Senator Neville spoke about the jobs generated by oil and gas. He stated New Mexico needs a cohesive policy of oil and gas regulation statewide. Senator Neville asked if the moratorium was still in effect. Mr. Campos stated the moratorium only lasted six months and has been lifted. Mr. Griego wanted to make it clear that Rio Arriba County is not against oil and gas drilling. However, when contractors drill, the county wants to ensure the safety of its water and environment.

Senator Smith gave a brief background on oil and gas in New Mexico, highlighting its importance to the state. He then spoke about the gross receipt tax issue, stating local governments were worried when the tax was taken off of food and prescription. However the state stepped up to hold local government harmless. The cost of compensation to counties has grown to $150 million a year and is projected to be about $400 million to $500 million in 15 years. Sixty percent of that $500 million, if it were available, would go to education between public and higher education. The challenges have been phenomenal after natural gas prices fell and the state doesn't have the ability to sustain on the same course and given the national economy. No one wants to impose tax increases by any means. Senator Smith stated it has nothing to do with ideology; it has more to do with being efficient with taxpayer dollars and doing the best we can with what we have and keeping it affordable for all New Mexicans.

Senator Leavell asked for clarification on the moratorium, stating it was his understanding the moratorium was still in place in Rio Arriba County. He spoke about fracking and how it has not adversely affected the water in his district, which consists of the southern part of Lea and Eddy counties. Mr. Campos stated the moratorium lasted for six months in order to give them time to write an ordinance to govern the east side of the county. He said the county never touched the west side. He reminded the committee the county is two-thirds federal and Jicarilla Nation land. Senator Leavell asked if there have been any drilling permits issued in this part of the county since the moratorium was lifted. Mr. Campos stated there were 15 on the east side of the county, but only one was drilled. It was next to the Chama Canyon and left an open pit that the Bureau of Land Management had to clean up. Mr. Campos said in Rio Arriba County fracking takes place at about 5,000 feet and the water is at 250 feet and above.

Representative Bratton spoke about the fracking process and how it has been around since the 1950s without a documented case in the United States where hydraulic fracturing had caused contamination. If contamination did exist it was result of some kind of discharge on the surface. He said they have been developing the oil and gas industry in Lea County and would be willing to assist the Rio Arriba County commission and staff to facilitate a better understanding of the oil and gas industry. The state does a very good job with regard to provisions to protect the environment and understands the reluctance to embracing something they may not have an understanding of. Representative Bratton said the boom that is happening in the oil and gas sector across the United States is a result of advances in horizontal drilling technology coupled with hydraulic fracturing. He said there has been resurgence in southeast New Mexico and West Texas, resulting in unlocking hydrocarbon resources that have helped to fuel the economy.

Senator Smith asked for clarification on the Jicarilla Nation owning the Land and Cattle Company and whether or not it was taxable land or if they were pursuing sovereign recognition for that land. Mr. Campos said it is are no longer on the tax rolls and is not in trust status. He also wanted to make clear Rio Arriba County and the Jicarilla Nation communicate well. The tribe assists with the economy in Rio Arriba County.

Representative Rodella spoke about concerns and complaints from constituents concerning Northern New Mexico College, such as tuition increases, faculty and financial issues. Michael Branch, Northern New Mexico College Board chairman, said the Legislature expects excellence and efforts to meet that expectation have resulted in issues with faculty tenure and seniority. He said no one is let go at Northern as a result of speaking out. Change is difficult and has been initiated as a result of our requirement to go from what many conceive to be mediocrity to higher performance. Representative Rodella said she is concerned because she speaks to individuals almost on daily who are employed or have some affiliation with Northern New Mexico College who are afraid to discuss situations in fear of retribution. She expressed hope that she, Representative Varela, Senator Cisneros, Senator Martinez and Representative Salazar could meet with the president of Northern New Mexico College to discuss concerns. Representative Varela suggested they schedule a meeting with the Board of Regents and the president of Northern New Mexico College.

Representative Rodella asked Mayor DeYapp if the village was still contracting with the state to provide law enforcement services. Mayor DeYapp said the city has outsourced its law enforcement due to the inability to actively recruit and retain officers in the village. The city council could choose to explore the option of starting its own law enforcement agency but current receives adequate support. Responding to Representative Rodella, Mayor DeYapp said the ongoing contract with the State Police is reviewed annually. Representative Rodella asked where they are currently stationed. Mayor DeYapp said they are currently at the old elementary school in Tierra Amarilla and are in discussions to move the site within the Village of Chama.

Representative Rodella asked Commissioner Griego about a road that has been blocked in the Ensenada area, urging the commission to look into the matter. She also urged the commission to take up the offer Representative Bratton extended with regard to meeting with officials to gain a better understanding of the oil and gas industry. Commissioner Griego stated he would look into the road closure and also thanked Representative Bratton for the offer of educating Rio Arriba County in the area of oil and gas. Mr. Griego said the county is not opposing drilling in Rio Arriba County but has a responsibility to represent its constituents, who are very concerned about water.

Representative Rodella asked about the status of drilling on the Tierra Amarilla Land Grant, which recently sold its mineral rights. Mr. Campos said he was unsure because the president of the Tierra Amarilla Land Grand passed away recently and there are estate issues to contend with but his understanding is the mineral rights are still owned by the Bureau of Land Management.

Representative Hall asked Superintendent Casados why there was a substantial increase in student enrollment from FY12 to FY13. Superintendent Casados stated the spike in enrollment is due to the transferring of special education students into the district as well as a spike in kindergarten enrollment. He also spoke about community growth and the need for afterschool programs in the area because parents are commuting to Los Alamos and Santa Fe for work.

Reforming the Gross Receipts Tax. Richard Anklam, Director of the New Mexico Tax Research Institute described the tax system as "3-legged stool" with the three-legs made up of property, income and consumption taxes. Because taxpayers have different economic profiles, a taxation strategy that uses multiple approaches gets "more feathers with less squawking" and may make it easier to ensure everyone pays a "fair share."

Mr. Anklam said property taxes are ad valorem (according to value) taxes imposed primarily by local governments but are more stable than other taxes because property values (the base) are more stable than other tax bases. Property taxes also lag further behind economic trends, making them somewhat counter-cyclical (that is they keep going up while the economy is declining and they decline as the economy picks up). For example, in 2010, states saw sharp declines in sales and income tax collections, but property tax revenues continued to rise for almost a year before beginning a much more gradual decline. Property tax revenues are still declining even though sales and income tax revenues have recovered.

Mr. Anklam said income taxes are a taxes on wages, earned income, investment returns and profits (not necessarily wealth) and are imposed primarily by federal and state governments. He said they are the least stable of the three legs. In the second quarter of 2009 – state income taxes shrunk by 28 percent on average. In the first quarter of 2013, they grew by 18 percent. Corporate income taxes are the most volatile of all state taxes. Not only do income taxes decline sharply during economic downturns, they decline at the very time that governments may need to provide additional services.

Mr. Anklam said consumption taxes include not only general sales taxes but also excise taxes (vehicles, fuel, insurance premiums, etc.). Consumption taxes are susceptible to pyramiding (a problem discussed in more length later). Consumption taxes are more volatile than property taxes, but less volatile than income taxes, and are the only tax that encompasses the "underground economy."

Mr. Anklam said most states, including New Mexico, piggyback state taxes on federal law, which determines the tax base. This greatly simplifies the state level administration, requiring little effort on the part of the state to ensure a reasonable level of compliance. It also creates a substantial amount of uniformity, although states can and do make adjustments to the federal base. Most of the filing is done by households with relatively simple returns (wages). Withholding on wages guarantees that tax is collected on a substantial amount of that income. Passthrough entities are generally not taxed at the entity level, although a few states have imposed taxes directly on passthroughs (e.g. business activity taxes). Corporations have more complex filing requirements. The big issue generally is tracking the source state of income

Mr. Anklam said consumption taxes require the seller to collect and report the tax. The seller collects the money for the transaction so this works well (just as withholding works for collecting the income tax on wages). Also, the seller maintains records of the transactions, which the purchaser is not required to maintain. Administration is complicated for multistate businesses because every state's general sales tax rules are slightly different and what is taxed or not tax varies. Sourcing (that is deciding what state should tax the sale) can be an issue for some types of sales (e.g. services, digital goods, etc.). Under U.S. Supreme Court holdings, states cannot collect the tax from certain remote sellers so collecting on Internet and mail order sales can be very difficult, if not impossible.

Mr. Anklam said New Mexico ranks 26th in per capita revenue collected at $2,440, while the average U.S. per capita revenue collected is $2,536. In terms of the percentage share of total tax revenues collected in 2011 – with first being the most revenue collected – New Mexico ranks 19th in property tax, 39th in sales tax, 11th in excise tax, 15th in personal tax, 3rd in corporate tax and 13th in other taxes.

Discussing the history of the gross receipts tax, Jim O'Neill, CEO, O'Neill Consulting said by the late 1980s it was obvious that New Mexico taxed a lot of transactions that other states did not. As the national economy continued to integrate, it became equally apparent that many New Mexico businesses suffered tax-wise in interstate competition. Not surprisingly, one business after another, one industry after another, approached the Legislature for tax relief. Many exemptions and deductions were born. Also, tax credits were invented to paper over (without correcting) flaws, but in many instances these rewarded only those able to identify and claim the relevant tax credits. Even for them, the credit process is more costly than not having to pay the tax in the first place.

Mr. O'Neill said the Streamlined Sales Tax movement was kicked off in 1999. Its goal is to create a functioning template for state sales taxes. If every sales tax state conformed to the template, sale tax structures, taxable items and tax administration would be sufficiently similar across the nation that it would a relatively simple matter for a vendor in any state to collect and remit the tax imposed on a buyer in any other state. Because New Mexico's gross receipts tax does not fit the template, New Mexico is one of the very few outliers. Being a small market state with an odd tax system is not a boon to New Mexico's economic development.

Mr. O'Neill said the gross receipts tax is actually a family of taxes with very broad reach. Every state with a general sales or gross receipts tax has a companion tax that applies specifically to imports, called a compensating tax in New Mexico. As is the practice in sales tax states, New Mexico sellers report and remit gross receipts tax and buyers compensating tax. From there, New Mexico diverges. The gross receipts tax rate is determined by the business location of the seller and ranges from 5.125 percent to 8.6875 percent (Taos Ski Valley). In contrast the compensating tax rate is a uniform 5.125 percent regardless of the buyer's location. The compensating tax applies to a much smaller base than the gross receipts tax, not covering imported services or intangibles.

Mr. O'Neill said New Mexico tightly controls the finances of its local governments. They may impose only those taxes and fees authorized by the Legislature, gross receipts taxes being one of them. Because gross receipts tax authority has proven the easiest to obtain, local governments have become heavily invested in the gross receipts tax system. They may impose over two dozen different types of local option gross receipts taxes. Municipalities also receive 1.225 percent of the state's 5.125 percent, an echo of municipal taxes formerly imposed. On average about three-quarters of municipal general funds come from the gross receipts taxes and distributions. Counties are becoming more dependent on gross receipts, especially as resistance to property taxes grows.

Mr. O'Neill said the bases for the state and local option gross receipts taxes are virtually identical. Because of their growing dependence on gross receipts revenues, local governments, especially municipalities, are vulnerable fiscally to revisions to the state gross receipts tax base. Local economies are much smaller than the state's; any given revision of the state tax base will have a much greater range of effects on the local economies. What may seem like a good move at the state level can devastate some local governments.

Tribal governments are sovereign with respect to the state. They have taxing power of their own. They do not have to align their general excise tax with New Mexico's. It is a matter of mutual convenience that they do; currently 15 tribal entities impose a gross receipts tax administered by the state under cooperative agreements. It would be useful for economic development purposes to continue presenting a coordinated system to the outside.

Mr. Anklam said the gross-receipts tax is broken. As a sales tax, GRT is over-broad. There is economic interference and it is inefficient. As a true gross receipts tax, it is too narrow and the rate is too high. It has no single focus and is a hybrid, the worst of both worlds. The rate is high and rising rates and shrinking base. It is increasingly a high rate business inputs tax. There is also an over-reliance on ad hoc measures, like credits, to patch the system.

Mr. Anklam said a true gross receipts tax means the following: eliminating most exemptions and deductions and reducing rates (below 1 percent). Every state that has a gross receipts tax uses it as a general business tax in lieu of corporate income tax. Every state that has a GRT-like tax also imposes a general sales tax.

Mr. Anklam said most comparisons do not take into consideration the impacts of pyramiding when comparing sales tax burdens. Pyramiding is when a consumption or transaction tax (including the NM GRT) is charged on business inputs (business-to-business sales) and becomes embedded in the cost of the ultimate goods or services sold to the consumer. Rising rates makes the pyramiding problem worse.

GRT is also regressive. It hits poorer households harder relative to income. Carving out food and medical services did not help. Because, to make up for lost revenue, the rates were raised on everything else. Food stamp recipients were especially hurt because they did not pay tax on food purchased with food stamps in the first place. State, municipalities', counties and others are in competition for tax base. Counties are increasingly dependent on GRT; some now receiving more revenue from GRT than property tax.

Helen Hecht, Tax Counsel, Federation of Tax Administrators said other states are attempting to expand the tax base by, one, taxing services and digital goods. Progress by other states has been slow. States do not want to increase taxes on business inputs. Policymakers consider New Mexico "lucky" that its base has always been broad. But as discussed, this creates many other problems. States are also expanding their tax base by, two, replacing other taxes with an expanded sales tax.

Mr. Anklam said the basic problem is the fundamental design flaw in the gross receipts tax — it tries to do too much. This should be cured. That requires first examining the tax system as a whole, assigning roles to each of the major elements and then designing a general excise tax that fits within the overall system. It also means recognizing that sizeable chunks of the existing GRT base may have to be jettisoned.

Senator Smith commented that the Legislature and executive need to come to a consensus.
Senator Cisneros commented that this is the best report he has ever heard about tax reform. He asked if there was time to prepare a package before the session. Mr. O'Neill answered that the Share and Taylor proposal is more radical than it appears and that coming up with an estimate is difficult and there is not enough time. Secretary Clifford said there are always winners and losers. Tax analysts need to identify who benefits and who gets hurt. He said they need more time for a proper analysis.

Representative Larrañaga asked if the state can tax non-profits. Mr. Anklam responded that the non-profit healthcare industry should be taxed. Ms. Hecht responded that there are property tax exemptions and income taxes follow the federal rules. Organizations that receive donations would be difficult to tax. Representative Larrañaga asked for a report from the Taxation and Revenue Department on how many solar taxes are collected. He asked if a valued-added tax would be fairer and easier to administer. to collect Clifford responded he is a fan of the value-added tax.

Senator Sharer said a 2 percent tax as he has proposed is simple and creates economic development.

Senator Sanchez commented that meaningful tax reform probably needs to be a little radical.
Mr. O'Neill said the one main problem with tax reform is pyramiding in the GRT. Addressing this problem will increase our competitiveness with other states. But there is an overall problem with the system that needs to be addressed. Senator Sanchez asked what type of group can get this done. Mr. O'Neill said it would take a small group of individuals doing research and analyzing the system in private. There should be no open meetings until the final options are presented. Sanchez commented that this needs to be "fair" to everyone.

Representative Taylor said the state cannot incrementally fix the system and needs to get back to its original intent. Taking the tax off food destroyed the GRT. The GRT needs to be completely reformed.

Miscellaneous Business
Action Items
Approval of July 2013 Meeting Minutes – **Senator Cisneros moved to approve the July 2013 meeting minutes, seconded by Representative Larrañaga. The motion carried.**
Approval of Contracts – Director Abbey recommended a contract for information technology project assistance. **Senator Cisneros moved to approve the contract, seconded by Representative Saavedra. The motion carried.**
Approval of LFC FY15 Budget Guidelines – **Senator Cisneros moved to approve the LFC FY15 Budget Guidelines, seconded by Representative Saavedra. The motion carried.**
LFC FY15 Budget Request – **Senator Leavell moved to approve the LFC FY15 Budget Request, seconded by Representative Bratton. The motion carried.**

Miscellaneous Items
Director Abbey briefed the committee on contents of miscellaneous items stating he did not believe there are any he needed to bring attention to and advised the committee to review the contents.

New Mexico Tax Gap. Christine Boerner, senior analyst, LFC, opened with the following comments: The "tax gap" is defined as the total amount of taxes owed but not paid; the gross tax gap is the amount of true tax liability faced by taxpayers that is not paid on time; and the net tax gap is the amount of true tax liability not paid on time and not collected later, either paid late voluntarily or following enforcement activities.

The most recent federal tax gap study was published in 2006 and it estimated the gross tax gap at $450 billion. An estimated $65 billion was collected following enforcement efforts and late payments, resulting in a $385 billion net tax gap. Underreporting was found to be the largest contributor to the tax gap, at an estimated $376 billion. Tax non-filing accounted for $28 billion and underpayment of tax was $46 billion. The Government Accounting Office determined that much misreporting could be attributed to sole proprietors underreporting receipts or over-reporting expenses. (Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is reported to the IRS by third parties.) Another important finding was that compliance is generally much higher when reported amounts are subject to information reporting and higher still when subject to withholding.

State methods to conduct tax gap analyses vary, including studies based on the federal model, studies that compare state tax information with income and tax data reported in U.S. Census data, and sophisticated econometric models. California based its tax gap analysis on the federal model. In 2006 California's Franchise Tax Board implemented a multi-year plan that balances "soft" approaches, such as education and outreach, with enforcement. According to a March 2011 report outlining the proposed initiatives, the state was on track to meet revenue estimates of an additional $114 million in FY11.

Additionally, various states have taken action against some types of fraud that are likely impacting New Mexico. For example, in 2007, Texas passed legislation to require electronic reporting of most wholesale alcohol and tobacco sales, making it easier for the state comptroller to identify retailers that fail to remit sales taxes to the state. Connecticut, Florida, Georgia, and Illinois have passed anti-tax zapper laws. Tax-zapping technology consists of devices, software or both, that allow businesses to create a second set of books to hide transactions and avoid paying taxes. Nevertheless, states often lack forensic resources to conduct effective tax zapper audits; however, having laws on the books can be a deterrent and allow quick action if someone is caught—perhaps as a result of a federal investigation.

In October 2012 the TRD met with the LFC and described its efforts to reduce the tax gap and address fraud. Such efforts include tape matches, managed audits and the upgrade of GenTax, the state's tax information system funded with a $6 million general fund appropriation in 2012. In July 2013 the department reported $5.8 million in increased revenue since it began upgrading the system. Nevertheless, LFC staff recommends the department conduct a tax gap analysis and develop a comprehensive audit plan to ensure limited resources are focused on audit and compliance initiatives with the greatest return on investment.

Secretary Padilla introduced herself and commented on the department's overall audit strategy, which includes educating taxpayers on correct reporting requirements (New Mexico is a self-reporting state), providing taxpayers with the resources they need, and allocating resources to areas that can reduce the tax gap. She explained that large cash transactions are reported to the TRD, but only if the taxpayer is in the banking system. They have also had good progress with focusing on training tax preparers—in this way all of the preparer's clients become trained in reporting requirements too.

Jeff Bjarke continued the discussion by describing the department's preliminary effort to estimate New Mexico's tax gap. In the income tax area, the TRD based its estimates on the federal IRS model (with exceptions such as FICA, estate and self-employment taxes which New Mexico does not collect). Based on the IRS model, the TRD estimated the total tax liability in New Mexico at $1.7 million; the gross tax gap at $236 million (estimated 86 percent compliance); $65.5 million in late payments following enforcement activities; and a final net tax gap of $170.5 million (estimated 89.9 percent compliance). Similar to the federal model, New Mexico's tax gap is primarily comprised of underreporting (83.6 percent), underpayments (10.2 percent) and non-filing (6.2 percent).

With respect to gross receipts taxes, the department used the Minnesota sales and use tax gap study as a model; Mr. Bjarke stated the department would like to construct a similar study for New Mexico using the same methodology. Using the Minnesota model, the department estimated the net tax gap at $228 million. In summary, the department estimated the total gross tax gap at $573 million; based on this, the department estimates they are currently collecting about 30.15 percent of estimated gross tax gap in gross receipts, corporate income, and personal income taxes.

Secretary Padilla noted additional areas where they have good tools or have been able to improve:

- Last year the department was able to reclassify auditor positions into three tiers so that workers will have the opportunity to move up and will want to stay.
- The department has have become more efficient with respect to how it select returns to audit and has even begun to audit themselves to be sure they are selecting the best audits to review.
- The department offers "managed audits" to certain industries (such as trucking) that allows the entities to conduct their own audits with the benefit of no penalties or interest—the entity is just required to remain current with their filing. The secretary noted the managed audit approach is much better than offering amnesty because businesses may opt to stay noncompliant while waiting for the next anticipated amnesty period.
- The secretary noted that they currently rotate auditors from program to program so that all areas are eventually audited over a period of time.
- Regarding tax fraud, the secretary noted that the department does not prosecute many cases because auditors do not pursue cases unless they are nearly 100 percent sure they

can win. This is so they do not "water down" the impact tax fraud audits.. They have a 98 percent conviction rate.

- The department also plans to start using the tool of civil fraud penalties; although it has this tool, it has never used it, she explained.

The secretary noted one mistake the department made that cost the state money. When the department updated the GenTax IT system, staff failed to set certain filters in the system that would allow them to intercept fraudulent tax returns; consequently, staff intercepted fewer bad returns this year than the year before ($4.82 million in bad refunds were stopped in 2012 compared with only $1.45 million in bad returns stopped in 2013).

Representative Trip asked about gross receipt taxes and how the department makes sure the taxes go to the correct county with respect to large construction projects. The secretary responded that she asks counties to report large construction projects to her department and that she could possibly look into the expansion of 1099 reporting for this purpose. Representative Trip also asked about tax zappers. The secretary responded it is difficult to prove because you have to know that a business has hidden a transaction and then you have to be able to prove it. Finally, the representative also asked if there are required credentials to be a tax preparer. The secretary responded that if you are a CPA there is a certain amount of continuing education that a person must maintain. Also, a person must apply every year to be a tax preparer.

Senator Leavell asked if the department ever audits out-of-state truckers. He stated that locals are telling him that certain truckers are not paying as they should and that the motor transportation police will do blitzes but is not consistent. The secretary responded that they do.

Update on Health Insurance Exchange Implementation. Interim Executive Director Mike Nunez presented an overview of activities relating to the implementation of the New Mexico Health Insurance Exchange (NMHIX). He covered the agency Plan of Operations and noted the board has four standing committees: finance, operations, and benefits; information technology; marketing, public relations, and outreach; and Native Americans. Mr. Nunez noted that NMHIX is developing a hybrid exchange model, with individual enrollment and eligibility performed by the federal government and small business (SHOP) enrollment and eligibility performed by the NMHIX. The NMHIX will be fully operated by the state starting in 2015. Consumer assistance, including outreach, education, and enrollment will be performed by the NMHIX and its contractors.

Mr. Nunez said enrollment will start on October 1, 2014, and will end on March 31, 2014, for the 2014 insurance plan year. Projected enrollment could be up to 82,557 in 2014, increasing to 211 thousand in 2020. In terms of funding, initial establishment federal Level I grant funding of $34.2 million is available for implementation and operational costs and another $18.6 million grant was received in July 2013 for outreach, education, enrollment, and marketing activities. An additional $8.5 million supplemental federal grant is pending. In presenting the NMHIX budget for 2013 through 2015, Mr. Nunez noted that the NMHIX board is projecting budget deficits for 2014 and 2015, but is planning to request additional federal implementation funds to cover any deficits. By 2016 the exchange must be fully self-sufficient and has legislative authority to assess the insurance carriers (or exchange clients) fees to cover the reasonable operational costs of the NMHIX.

Mr. Nunez noted some of the key implementation activities, including the award of a contract for the exchange information technology infrastructure with Get Insured for up to $39.4 million. A project management contract was awarded to the Public Consulting Group for $4.7 million and BVK received a contract for marketing and public relations for up to $7.7 million. A call center request for proposals was issued with responses due the last week of August. Mr. Nunez noted that outreach is a key priority as the exchange is established. An outreach director was hired on August 7, and NMHIX has held numerous "listening sessions" with stakeholder groups. Tribal consultation is important, with a Native American liaison to be hired and a Native American Advisory Committee to be named. Marketing and media activities will be a call to enrollment
The NMHIX will enter into two contracts with organizations to oversee outreach and enrollment activities. The New Mexico Primary Care Association provides a comprehensive enrollment system in all counties in partnership with clinics, hospitals, nonprofits for up to $4.3 million from August 2013-June 2014. The Native American Professional Parent Resources will receive a $1.4 million contract for a comprehensive outreach and enrollment system in Native American communities from August 2013-June 2014

Outreach and education activities will provide information and drive people to enroll sites that will be located throughout state to reach all populations and geographic areas. Outreach will include targeted efforts in rural and remote communities using community-based resources such as counties, public health offices, churches and other resources. Partnerships will be established with numerous business organizations to maximize small business SHOP enrollment in all areas of the state through a cover New Mexico employees campaign.

A NMHIX-based call center will be established to screen individuals and make referrals to Medicaid, a healthcare guide for exchange enrollment, or an insurance broker for small businesses seeking coverage for employees. Extensive outreach and education is planned to help guide individuals to the right place for coverage. Most healthcare guides will have capability of also doing Medicaid enrollment but all final Medicaid determinations will be made by the Human Services Department (HSD) as required by the federal government

A marketing, public relations, and educational materials contract has been awarded to BVK from Milwaukee, Wisconsin, for $7.7 million from August 2013-June 2014 to implement a major media campaign with TV, radio, billboards, print materials, public relations, social media, and toolkits of educational materials to be distributed widely throughout state. The initial launch is planned for September 2013. Additional outreach contracts will be issued, including a $375 thousand contract with UNM to partner with NMSU and other higher education institutions, $150 thousand for the Association of Counties to establish outreach activities in every county, and additional contracts for outreach to hard-to-reach populations. In the area of small business outreach, ACI will receive a $168 thousand contract to hold events and coordinate and implement outreach activities with chambers throughout the state. The Albuquerque Hispano Chamber of Commerce will receive a contract for $125 thousand to hold events and outreach activities in Albuquerque and with the Hispano chambers in Santa Fe, Taos, and Los Lunas. Finally, the Las Cruces Hispano Chamber of Commerce will receive a $75 thousand contract to hold events and outreach activities in Las Cruces region and with the Hispano chambers in Roswell and Hobbs area.

Next, Human Services Department Deputy Secretary Brent Earnest and CIO Sean Pearson provided an update on HSD's integrated case management and eligibility determination system (ASPEN) information technology, which is a full replacement of HSD's current legacy eligibility systems. The ASPEN project will include the YES-NM online portal, which will allow clients to apply for Medicaid and other state benefit programs on-line. ASPEN pilot implementation is underway at the Rio Arriba County Income Support Office through September 20, 2013, and is currently going well. ASPEN will next be implemented in Southern New Mexico starting in September, Northern New Mexico in November, and Bernalillo County in January. Mr. Pearson walked the committee through graphs showing the interfaces between ASPEN, the NMHIX, and the federal data hub, which provides information needed for benefit determination such as citizenship and income. For 2014, an additional interface is needed to connect New Mexico to the federally facilitated marketplace which will be handling the individual insurance market for the NMHIX for calendar year 2014 before the NMHIX takes it over in 2015.

Next Mr. Earnest provided an update on Centennial Care, New Mexico's new Medicaid program of integrated care that will be implemented January 1, 2014. All Medicaid recipients will have from October 1 to December 2, 2013, to select their Centennial Care managed care organization (MCO) and will receive a notice encouraging them to do so. Recipients required to be in Centennial Care who do not select an MCO on time will be auto-assigned to an MCO. Recipients already in a current MCO that is also a Centennial Care MCO will be auto-assigned to their current MCO. Native American recipients enrollment in Centennial Care are not required to be in Centennial Care unless they want to, except for those who meet nursing home level of care or have both Medicare and Medicaid. HSD has planned over 200 Centennial Care educational events throughout the state beginning in the second week of August and the curriculum will also include information about the adult Medicaid expansion including eligibility requirements and enrollment information.

After the two presentations the panel answered committee questions. A number of members asked Mr. Nunez about the NMHIX budget deficit shown in 2014 and 2015 and if he felt confident that federal funding would be available in the future to cover the deficits. Mr. Nunez replied that additional grant opportunities were scheduled and he had no reason to believe the NMHIX would have any problems getting federal funding for 2014-2015 NMHIX operations. Mr. Earnest addressed a question from Senator Beffort about Centennial Care auto-enrollment, noting that the department had learned from prior transitions and planned to give clients ample opportunities to change their managed care provider as Centennial Care is implemented. Clients currently with a managed care company will be kept with that company unless they exercise the option to change.

Juliana Koob, representing the New Mexico Center on Law and Poverty and the Southwest Women's Law Center, briefly spoke with the committee and noted that for health care reform to be successful, it is critical for enrollment to happen in both health care exchanges and with Medicaid. He said healthcare guides are needed to help with enrollment in the field and additional outreach is needed from HSD for Medicaid expansion.

Friday, August 23, 2013
The following members and designees were present on Friday, August 23, 2013: Chairman Luciano "Lucky" Varela; Vice Chairman John Arthur Smith; Representatives Larry A. Larrañaga, Don L. Tripp, Edward C. Sandoval, Nick L. Salazar, James P. White, and Donald E. Bratton; Senators Carlos R. Cisneros, Sue Wilson Beffort, Mary Kay Papen, Howie C. Morales, Steven Neville, Carroll H. Leavell, and Clemente Sanchez. Guest Legislators: Representative Jimmie C. Hall and Senator William F. Burt.

Local Capital Outlay Appropriations. Linda Kehoe, principal analyst; Ryan Gleason, director of the Local Government Division (LGD), Jim Chiasson, Construction Programs Bureau chief of the NM Environment Department (NMED), and Duncan Sill, financial and strategic development manager for the North Central New Mexico Economic Development District (NMNCEDD) presented the history of local capital appropriations between 2002 and 2008 and the status of local funds today.

Ms. Kehoe reported between 2002 and 2008, the Legislature authorized more than $3 billion for 14.5 thousand local projects, but when the economy deteriorated and oil and gas revenues fell in December 2008, policymakers had to move quickly to address a $454 million revenue shortfall. With $670 million unexpended for nearly 3,000 projects, capital dollars were targeted to help address the solvency issue. Five bills passed in 2009 and 2010 to "deauthorize" or "reauthorize" more than $280 million to curb the general fund gap. The loss of so much local funding characterized the importance of establishing criteria and guidelines to assure projects are adequately planned, supported by local entities, and can be completed in a timely manner.

In 2009, 2010, and 2011 legislators deferred funds for local projects. It provided LFC staff and state and local entities a period to manage a reasonable number of projects, thus providing more accountability for outstanding funds. With an improved economic outlook in 2012 and 2013, legislators resumed funding for local projects.

Over 2012 and 2013, the Legislature authorized $168.8 million for nearly 1,200 local projects. The governor vetoed $25 million for 264 projects, indicating the funding created hundreds of earmarks for projects with little or no vetting and that many of the projects were funded for less than 10 percent to 20 percent of the total project cost. In May, the governor issued an executive order directing the DFA to develop criteria requiring grantees to have a current FY12 audit and an adopted budget for the current fiscal year and to be compliant with reporting requirements. Following certification by the State Board of Finance, bonds were not issued for 166 projects totaling $38 million.

Executive agencies and LFC staff collaborated to scrutinize fund balances and assist local governments in removing barriers wherever possible, but many of the projects cannot move forward because they were not adequately planned and are underfunded. An analysis of 2012 local projects identified 175 projects totaling $31.7 million with no activity; state agencies reported grant agreements had not been signed for 25 projects totaling $3.1 million in 16 counties, yet the local entities had certified project readiness and the bonds were issued in June 2012.

Ms. Kehoe referred members to a sampling of 2012 and 2013 local projects that were significantly underfunded. Ms. Kehoe stated unless local, federal, or other funds to match state appropriations are available, the funds will remain unexpended or grantees may anticipate legislators will appropriate additional funds for these in addition to other projects in 2014.

Ms. Kehoe reiterated the revenue estimates, presented at the hearing on Wednesday, are approximately $196.1 million for STB, $26.3 million less than last year's capacity, and general obligation bond (GOB) capacity is estimated at $165 million with a flat mil levy. She said the preliminary capital requests in 2014 from state agencies and colleges already exceed $700 million.

Mr. Chiasson discussed the state agency perspective as it relates to the planning, design, and construction of water, wastewater and solid waste systems throughout the state. He said over 23 years the bureau has administered more than $353 million in capital outlay funds and, in doing so, has learned many lessons regarding how best to ensure that projects are completed in a cost-effective and timely manner, free of waste, fraud, and abuse.

Mr. Chiasson provided an example of the water project in Bloomfield. With a shortfall of funds, the project remained incomplete, funds sat idle or they were reverted. Based on past experience and lessons learned by the bureau, he offered the following suggestions for state funding of water, wastewater and solid waste systems:

1.) Consider not using capital outlay funds for planning purposes but more cost-effective sources, such as the New Mexico Finance Authority planning grant fund.
2.) Fund design and construction projects in their entirety or a singular phase (design or construction) and complete a phase in conjunction with other funding acquired by the entity. This will facilitate the expeditious spending of grant funding and will limit reversions.
3.) Limit state capital to capital projects and purchases, and not for operations and maintenance to encourage entities to have more sustainable systems and take responsibility for funding day to day operations.
4.) Consider using a "readiness to proceed" checklist in conjunction with other current state funding sources as a minimum criteria before funds are appropriated.
5.) Continue to use groups like the Construction Programs Bureau to provide professional technical and financial oversight of capital outlay projects through completion to insure cost effectiveness and expedient expenditure of funds.
6.) Use community assistance groups to provide ongoing technical and financial assistance, and training to communities to insure entities have adequate rate structures in place and assist in long-term planning for system sustainability.

Mr. Chiasson provided a handout listing 16 of the most urgent water projects totaling more than $18 million throughout the state that require additional funds for completion.

Mr. Sill presented from the Council of Governments (COG) perspective. He agreed there is extensive confusion regarding the process involving multiple state agencies, each with different eligibility criteria, procedures, and timelines. The confusion often leaves entities uncertain as to what pool of funding to pursue. He cited the town of Springer as an example of how the capital outlay appropriation process is simultaneously a benefit and a challenge. The focus should be on capital planning and efficient asset management of the infrastructure funded by state appropriations. He agreed the state should undertake the consolidation of requirements, timelines, and processes among the various agencies to achieve a unified and predictable process. He said the state should take advantage of the existing expertise and capacity in the various COGs throughout the state to fill the gap in the ability of local public bodies to develop, manage, and complete sound, critical capital outlay projects.

Mr. Gleason suggested a pilot project to address the problem, focusing specifically on water and wastewater projects. The proposed project would demonstrate how the myriad of existing resources can be put together and used in a productive way. He stated the fractured nature of funding local government capital outlay projects leaves millions of dollars sitting idle – often for many years – and puts an unreasonable strain on local government administrative resources. For instance, out of a $21 million federal Department of Agriculture subsidy to New Mexico, $19 million was turned away.

He stated as long as there are more problems than resources, the state should focus on using all available resources, minimizing the administrative burden on local governments, and constructing the most critical properly designed and vetted projects as quickly as possible. He gave the example of a regional water system in Silver City that started in 1998. If it had been fully funded in 1998, it would have cost $2.5 million, but due to lack of coordination between the local, state, and federal entities, the project was not completed until 2008 and cost $12.5 million. Mr. Gleason stated it makes sense to restructure how the state uses all the water- and wastewater-related resources; the pilot he suggested would place the authority for these projects under the jurisdiction of one decision-making body.

In the following ways, restructuring would allow the decision-making bodies to ensure no resources are left unobligated: determine the proper combination of grants and loans to be offered to the local government for a project; reduce the number of applications the local government has to fill out, reduce the number of grant/loan agreements the local government has to enter into, reduce the number of grant agreements the local government has to comply with, unify the application/award/funding cycle so that local governments are not having to repeatedly travel to Santa Fe for application and award hearings, and take away the current perverse incentive for one program to undercut another in an effort to "get their money out the door".

In closing, Mr. Gleason said such a restructuring would require legislative changes because many of these funding sources are statutorily assigned to specific decision-making bodies. It would also require everyone to give up some individual control for the greater benefit of all New Mexicans.

Representative Varela agreed there is obviously a fractured process and the state should have a statutory process for capital outlay, similar to the current budget process. Senator Cisneros said there have been several attempts to achieve this and have failed. Senator Cisneros suggested the panel present this to the Revenue, Stabilization and Tax Policy Committee with more specifics on legislation and try to get the committee to agree on something reasonable to bring forward in the next session. Bureaucracy causes bottlenecks and if a process is placed in statute there is no argument. Members discussed the Ute Lake project, the drought, wells going dry (i.e. Magdalena), and the time it takes to respond and provide emergency assistance.

Senator Cisneros also asked about the $1.5 million for river restoration sought by the governor – if the funds had been received and if projects were vetted by LFC staff. Ms. Kehoe clarified that the $1.5 million is being sought in the 2014 session. She also stated that those types of appropriations are difficult to administer and account for because there are no parameters, criteria, or process regarding how to distribute the funds. It is difficult to define what "success" looks like with respect to river restoration projects. Mr. Chiasson agreed the process is difficult because the outcomes are difficult to measure, and the scope of work and parameters differ depending on the work to be done.

Senator Smith stated he has pushed for audit compliance for years, including efforts to make it easier to disincorporate, and gave examples of why it is important (i.e. Columbus and Espanola). He questioned the cash balances in the water revolving fund administered by NMED and stressed there needs to be a better way to get funds out quicker. Senator Smith said the delays are not always the fault of the local entity, and the agency needs to make the process more efficient. He also had a concern about not being able to leverage federal funds. Lastly, he said it is ridiculous the governor refers to allocations for projects such as the Cumbres Toltec Scenic Railroad as "pork barrel."

Representative Larrañaga agreed water is the most critical. He stated there does not seem to be urgency for planning and the need to take care of water issues at the local level (i.e. Chama water system tour). He asked Mr. Sill what the COGs are doing to assist local entities with water issues. Mr. Sill responded the COGs are being more diligent, but the planning process is the most difficult. The cycle of engagement (different deadlines for different types of funding) and time and staff availability are issues. They are taking a strategic/work plan approach, and agree water is critical and the COGs are taking the issues seriously. Senator Larrañaga also asked if the idea of a one-stop-shop for water and wastewater could be done without statutory change. Mr. Gleason responded that the Water Trust Board has a statutory requirement so coordination cannot be done without a statutory change.

Senator Morales and other members discussed the governor's executive order requiring audits and alluded to the impact on small entities that do not have funds or the ability to be in compliance, and the poor timing of its issuance. He asked why the Legislature was excluded from the process, and why local entities were not notified ahead of time. Mr. Gleason responded that a statute has always been in place requiring local entities to complete audits and the ability to conduct an audit is a requirement of being a local public body. He agreed it is a challenge for small communities but some improvements have been made. Chairman Varela said there has been collaboration with the State Auditor to provide assistance and direction. He welcomes further discussion and stressed that local governments need to understand that an audit is a requirement and they need to budget funds for audits.

Senator Papen stated she resents the way the executive order was done, but agreed legislators need to take responsibility for their appropriations. She suggested more detailed questions be included in the Legislative Council Service form for capital outlay legislation so legislators are required to gather and provide more information.

Referencing the timing of the audit, Mr. Gleason stated any date would have been difficult and there was an urgency to stop funds from going to an entity that was not financially compliant. He stated the order allows for flexibility and a local entity can comply by working with state agencies and the State Auditor. Mr. Gleason mentioned some delays occur due to problems identifying the fiscal agent. An entity may certify readiness, but later find out the project was assigned incorrectly due to language in the bill.

Update on State Personnel Policy Issues. Mr. Randall Soderquist, principal analyst, LFC, provided an overview of the three issues on the hearing agenda. On the issue of recruitment, reward, and retention, he emphasized that, according to the *2012 Classified Service Compensation Report* received from the State Personnel Office (SPO), the state continues to fall behind salaries in the region and the nation on critical "benchmark" positions. The LFC provided funding to the Hay Group in 2012 for advice on how to adjust the state salary and classification structure. The results of the study were provided to the SPO in February 2012 and revisions are currently being made to the study by the SPO. After the revisions have been completed, the SPO will forward the study to the governor for analysis. Mr. Soderquist emphasized that, other than a briefing by SPO in May 2013, the LFC has not received any details on the study, including any information on the potential costs of the reclassification effort or the timeline for implementation.

Mr. Soderquist also stated that, although the study has not been completed, reclassifications continue to occur in state government. In the LFC brief were documents that described the current approval process involved in reclassifications. According to anecdotal evidence received by the LFC from state agencies, approximately 1,700 reclassifications had either occurred or are planned to occur in FY14. The concern of LFC staff is these reclassifications are occurring on an ad hoc basis without reference to the strategic employment needs of the state. Mr. Soderquist mentioned the importance of the committee receiving timely documents from the SPO on reclassifications.

Mr. Soderquist then turned the committee's attention to the issue of state employment levels and agency personal services and employee benefits (PS&EB) budget adjustments. Mr. Soderquist discussed the SPO *Baseline Report* included in the LFC brief, with specific reference to the decline in public employees by roughly 3 million from July 2008 to July 2013. However, he emphasized that in spite of this decline, the Legislature continued to authorize full-time equivalent (FTE) employees at July 2008 levels in the General Appropriation Act. Further, he provided data on PS&EB appropriations that were reduced, transferred or reverted in FY12 or projected to be reduced, transferred, or reverted in FY13 and FY14. The point of the discussion was the Legislature was consistently overfunding PS&EB, and the committee could "capture" the vacancy savings for other policy initiatives, including reclassification or merit-based salary increases, dedicating the funding to changes in a revised salary and reclassification structure, or an across-the-board salary increase for public employees.

Finally, Mr. Soderquist discussed the potential fiscal liabilities deriving from the American Federation of State, County, and Municipal Employees (AFSCME) Supreme Court case ruling. LFC staff projected the total costs to the state for FY09 through FY13 to be approximately $50.3 million and the general fund costs to the state to be approximately $22.3 million. Recurring costs would decline as individuals covered under the collective bargaining agreement retire or otherwise leave government service. The data used for this projection were obtained from AFCSME and the Communication Workers of America CWA) and contained a number of assumptions that potentially affected the accuracy of the estimate. This concluded his presentation.

Given concerns over different data on the overfunding of PS&EB appropriations, Chairman Varela directed a question to Michael Marcelli of the Department of Finance and Administration (DFA) concerning the role of DFA in this area. Mr. Marcelli replied that DFA works with agencies to ascertain their budgetary requirements for PS&EB appropriations, with specific reference to examining current vacancies and bringing them in line with future needs.

Chairman Varela directed SPO Director Eugene Moser's attention to the April 8, 2013, memorandum contained in the LFC brief related to approval processes in personnel transactions, and asked the role of the governor in creating the memo. Director Moser did not reply specifically to the question of the role of the governor, but stated that when he took over his duties as director there was little rationale behind the changes in salary and classification. His goal is to ensure there is some stability and consistency in the state classification system and coordination occurring across agencies.

Chairman Varela asked Mr. Marcelli which items in the April 8, 2013, memorandum had to be forwarded to the Governor's Office for approval. Mr. Marcelli provided clarification on how his agency was involved in the process, then stated that the memorandum was accurate in terms of the eight personnel transactions that were to be forwarded to the Governor's Office. Director Moser emphasized the role of the Governor's Office was to provide consistency in the process and the SPO, the DFA and the Governor's Office are all involved to ensure sufficient funding is available for specific personnel transactions.

Chairman Varela asked Mr. Marcelli how the 1 percent salary increase appropriated by the Legislature was distributed. Mr. Marcelli directed the chairman to the May 8, 2013, memorandum contained in the LFC brief. Mr. Marcelli said the pay increases had been processed by the DFA, Director Moser emphasized the importance of the completion of a probationary period and a satisfactory evaluation rating.

Chairman Varela raised the issue of the letter he wrote the governor concerning an additional salary increase for public employees and the proactive effort on the part of some state agencies to pursue this effort using available vacancy savings. He specifically referenced the judiciary branch. He asked Director Moser if he had discussed the issue with the governor consistent with the request in the letter. Director Moser responded he has not discussed the specific issue with the governor, but he has been working with DFA to use vacancy savings to address salary inequities in "critical" positions in state government. The Department of Corrections was used as an example. Chairman Varela stated he understood the problems of "critical" positions, but felt the governor needed to look at the potential for salary increases for all public employees. He requested a response from the governor to his letter.

Chairman Varela asked Director Moser for clarification on the AFCSME Supreme Court ruling. Director Moser provided clarification, with some emphasis on the differences in the calculation of costs between AFCSME and CWA and the key issues -- analysis of appropriate retirement benefits as an example – that would determine the total costs to the state. Director Moser stated it was a complicated process and the SPO was examining the issue thoroughly and correctly so the state would not have to revisit the issue in the future. Chairman Varela stated his understanding was that AFCSME was attempting to negotiate a settlement with the state. Director Moser responded that no discussions had occurred between him and AFCSME leadership since initial discussions in early 2013. Chairman Varela asked Director Moser what the timeline was for the settlement. Director Moser responded that his expectation was the Court of Appeals would remand the case back to an arbitrator and decisions on specifics would be made when that action occurs.

Director Moser stated the LFC analysis related to vacancy savings might not be accurate and more work needs to occur to ensure the data is accurate. He also expressed his gratitude to the committee for using salary classification mid-points as reference for budget formation, as this allowed the SPO to make more progress in recruitment.

Director Moser then began his presentation, using the *State Personnel Office FY13 4th Quarter Workforce Report* as his reference point. He stated his concerns related to the current compensation structure in the state, specifically the amount of benefits provided to public employees in New Mexico and the need to re-distribute funding so more would be provided to public employees in the form of salary. He emphasized that the current distribution is hindering efforts at recruitment.

Director Moser stated that any effort at reforming reclassification structure would be costly and would likely have to occur over a number of years. He emphasized problems with the aging of the workforce in the state and the fact that many individuals who should now be stepping into mid-management positions are retiring, leaving significant experience gaps in state agencies. He reviewed actions by the SPO to address multiple components of pay and average employee compa-ratio. He stated some of the delays related to the reclassification study related to changes that occurred at Hay Group and the importance of examining what other states have done to ensure the New Mexico approach is accurate. He referenced the measure for new employees who successfully completed their probationary period and stressed the importance of the implementation of minimum qualifications to improve outcomes. He discussed problems related to overtime costs. He directed the committee's attention to the number of applications received and processed through the NEOGOV personnel system and the capacity of NEOGOV to address problems related to applicant documentation. He acknowledged problems related to the average number of days to fill a position and the need for more staff to process applications, as well as efforts on the part of the SPO to train agency human resources staff to evaluate personnel. He discussed hires and separations and stated that many of the separations were related to retirement associated with changes in the retirement plan.

Director Moser discussed problems related to new-hire compa-ratio and emphasized the potential for resolution through revised classification program. He discussed the statewide turnover rate and stated that the decline indicates a slow stabilization of the workforce.

Representative Larrañaga asked Director Moser how many applicants are qualified for the positions they applied for. Director Moser stated that many individuals do not satisfy the minimum qualifications and emphasized the difficulties in sorting through the large number of applications He stated this was the rationale for distribution the responsibility for analyzing the applications to state agencies. The SPO has difficulties sorting through the application by itself.

Representative Larrañaga asked Director Moser if the number of separations would decrease once the changes in the retirement plan were fully implemented. Director Moser stated this was his hope, but he again emphasized the importance of adjusting the balance between salary and benefits in the state compensation system. He provided examples of a "tiered" compensation system used in other states. Representative Larrañaga expressed doubt such changes would occur in New Mexico

Representative Larrañaga referenced the projected costs for the AFSCME Supreme Court ruling for the state and the potential timeframe for effective analysis by the SPO. Director Moser stated his hope that SPO estimates will be available by the next legislative session. He also stated the LFC projections included in the LFC brief might be high, but they are not sure.

Chairman Varela referenced the comment by Director Moser that there was confusion in the data related to PS&EB funding levels. He asked for cooperation among LFC, DFA and SPO in this effort to ensure appropriate funding from the Legislature. He stated he wanted to ensure that agencies did not request levels of funding beyond what was needed to provide public services. He asked what an appropriate vacancy rate was. Director Moser stated 9 percent to 10 percent.

Chairman Varela stated 70 percent to 80 percent of the budget was PS&EB and further work is needed to ensure the Legislature appropriated reasonable amounts of funding.

With no further business, the meeting adjourned at 11:55 a.m.

Chairman Luciano "Lucky" Varela

Vice Chairman John Arthur Smith