Legislative Finance Committee
Meeting Minutes
Room 322 – State Capitol – Santa Fe, New Mexico
January 14, 2013

Monday, January 14, 2013
The following members and designees were present on Monday, January 14, 2013: Chairman John Arthur Smith, Vice Chairman Luciano "Lucky" Varela, Representatives Henry "Kiki" Saavedra, Larry A. Larrañaga, Don Tripp, Edward C. Sandoval, Nick L. Salazar, James P. White, William "Bill" J. Gray; and Senators Carlos R. Cisneros, Sue Wilson Beffort, Mary Kay Papen, John M. Sapien, Carroll H. Leavell, Steven Neville, and Pete Campos. Representatives Patricia Lundstrum and Jimmie Hall attended.

Charter School Facilities Lease Assistance and Capital Outlay Planning. Legislative Finance Committee Program Evaluators Jeff Canney and Jon Courtney briefed the committee. Mr. Canney stated the evaluation was conducted to determine if charter school leases are providing the best value to the state and to assess charter school facility budgeting and planning. The complete evaluation and agency responses are on the LFC website.

Mr. Canney stated that three things were learned about charter school facilities:

1. Charter school facility payments have more than quadrupled over the past nine years.
2. The state is paying high leasing rates caused by third-party profits, additional costs combined with the base rent, and unmanaged tenant improvements.
3. Charter schools are using their operating budgets, intended for instruction, to subsidize the high leasing costs.

KEY FINDINGS.
Charter schools pay excessive lease costs at taxpayer expense.

Charter school facility costs are increasing, with payments quadrupling over the past nine years. Mr. Canney stated charter school facility payments have more than quadrupled over the past nine years, while the number of charter schools has tripled.

Average leasing rates are sometimes higher than market rates. In September 2012 the Public School Capital Outlay Council (PSCOC) began deferring payments to schools with the highest cost leases, requiring justification. Many of the cost per square foot revisions were the result of those deferments.

Charter school foundations and other third parties are driving the cost of charter school leases higher than necessary, costing the state millions of dollars. Many charters lease their facilities as a sublease from a foundation, or another third party, and the sublessor marks up the rent.

Some charter schools use operating funds to pay for expensive leases and high administrative costs.

Additional costs and questionable space utilization are major factors in the high cost of charter school leases.

Expenses beyond base rent drive up lease payments for schools. Additional costs are included in lease payments, including tenant improvements, maintenance, facility and infrastructure repair, janitorial services and utilities.

Poor oversight and mismanagement of tenant improvements in particular have been expensive for taxpayers. For example, Los Puentes Charter School's lease includes $1.1 million of tenant improvements the school cannot account for. Similar examples of tenant improvements unaccounted for were found at La Promesa Charter School and at the Albuquerque School of Excellence.

The New America School in Albuquerque incurred a more than 245 percent in increased rent, primarily attributed to $1.6 million in leasehold improvements to property infrastructure the state will never own.

Some school districts are collecting the maximum allowable lease payments for portables and land that taxpayers have already paid for. For example, Cariños Charter School in Española is paying the Española School district more than $130 thousand to occupy the old Española Middle School building, classified by the Public School Facilities Authority as unfit for students and recommended for demolition.

The space allotted for each school varies greatly with no apparent consequence. La Promesa Charter School is planning a move to a facility larger than the Santa Fe Convention Center and will pay a rent that is 11 times higher, or $360 thousand more per year, than the school's current rent. The explanation provided for additional space is increased enrollment and planned growth, even though the current facility meets the minimum New Mexico Administrative Code (NMAC) space requirements of 32 net square feet per student for grades one through five.

Standardized leases are needed to provide stronger oversight, lower costs, and reduce risks to taxpayers.

Mr. Courtney stated the LFC recommends the Legislature should limit or eliminate lease assistance awards being provided for buildings already owned by either the state or the school. Recommendations for the PSCOC and Public School Facilities Authority (PSFA) include developing and requiring the use of a standardized PSFA approved lease format and not allowing tenant improvements for charter schools that have not been renewed in accordance with state statute.

Lack of oversight and planning cost the state millions of dollars.

Poor accountability and lack of planning results in some charters being housed in temporary, inadequate facilities. In the September 2012 Public School Capital Outlay - Oversight Task Force's Review of Charter School Facilities, the primary policy consideration was to provide charter schools with a dedicated central resource, to provide increased facilities knowledge and

experience. This dedicated resource could reside with the Public Education Department or the PSFA.

Charter schools are being approved before they have facilities, resulting in schools with temporary locations and unplanned leases. The Coral Community School remains in temporary facilities after a last minute lease change would have required them to pay rent daily and clean up the rooms every Friday so that the church could use the space.

Many schools are leasing portable classrooms for permanent facilities, a short-term inefficient solution. After an average of eight years, an estimated $525 thousand per year would be saved if portables were purchased rather than leased. The exception of the four is the Public Academy for Performing Arts (aka PAPA), which pays the Albuquerque Public School district for the portables. These portables and land have already been paid for by taxpayers, but the state continues to provide lease assistance to the Albuquerque Public School district every year at the maximum allowable amount of $251 thousand annually.

Many lease purchase agreements are being executed without appraisals to determine value and some without required PED or PSFA approval.

Charter school applicants are not required to report potential conflicts of interest regarding facilities.

The Charter School Act includes a section defining conflicts of interests. The act did not include potential conflicts regarding the schools' foundations, and these are becoming more common. Mr. Canney stated a few potential conflicts include ACE Leadership Charter, Southwest Learning Centers, the Great Academy, and La Promesa Charter School.

Mr. Canney stated the LFC recommendations, in part, are:

- The Legislature should consider amending statute to address conflicts of interests to include foundation board members, school founders, and contracted employees and make funding contingent on avoiding these conflicts.
- The PSCOC and the PSFA should require state charter schools to submit for approval all leases and amendments, with the PSFA assisting with negotiating lease amounts on request.
- The Public Education Department should enter into an agreement with the PSFA to transfer a portion of the 2 percent revenue the PED withholds from charter schools' state equalization guarantee for administration and oversight. The amount should be no less than the equivalent of 0.5 percent of state-chartered state equalization guarantee.

Finally, he said, the LFC conducted an evaluation of charter schools in 2010 and included two recommendations relevant to this evaluation that were never implemented:

- Charter authorizers should freeze approval of all new applicants until the application and renewal process has increased monitoring and oversight;
- Charter schools should be excluded from small-school funding.

Agency Response. Tim Berry, deputy director, Public School Finance Authority, stated the PSFA's response is included in the evaluation. The Public School Capital Outlay Oversight

Taskforce and the PSCOC reviewed the issues in this report extensively during the interim and have developed a report and recommendations.

Paul Aguilar, deputy director, Public Education Department, provided the committee with the department's draft response, saying he discovered changes the LFC made from the draft to the final, bound copy, and would like to present the final agency response after a thorough review.

Mr. Aguilar stated LFC recommendations in the evaluation conducted in 2010 dealing with the moratorium on the approval of new charter schools and the removal of eligibility for the small school funding are not appropriate for this evaluation, nor do they have the support of the governor or the PED.

Mr. Aguilar clarified the lease assistance program is not just for charter schools.

The department is concerned about the LFC statement that the state is paying lease payments to districts whose facilities are already paid for by the public, he said. The PED will work with the identified charter schools to understand the issues and to assist in developing a plan to ensure full transparency as the process unfolds. Mr. Aguilar said school districts collecting lease payments for portables and land leased to charter schools is in statute. The provision was included, he said, to incentivize districts to make excess capacity available to charter schools, which does not appear to be effective.

The LFC finding that charter school costs are increasing with payment quadrupling over the past nine years is mathematically sound, he said. More charter schools mean more lease assistance payments. The PED is not arguing with the fact that a number of leases appear to be high, but a "straight across" comparison between a commercial lease cost for a building and one with "E" occupancy ratings is difficult, he said. Mr. Aguilar noted a table regarding schools with lease costs of more than $18 per square foot is no longer in the evaluation, as it was in the draft.

Mr. Aguilar stated that, while a conflict of interest between ownership of buildings and charter school foundations may exist, it is legal as long as ownership is disclosed to the charter school's board and made public to auditors. Perception is the issue that will be addressed, he said. The PED stands ready to work with legislators and the PSFA to look at a standard lease agreement document.

A statutory requirement exists for each charter schools to be in a publicly owned building or in a building subject to a lease-purchase by 2015, he said, and helping charter schools understand what is in lease-purchase agreements is critical. Mr. Aguilar added the assessment that portable classrooms should be purchased rather than leased is probably true and urged the committee to not look at portables as a bad thing.

Finally, Mr. Aguilar said there may be unintended consequences with some of the LFC recommendations – transferring 25 percent of the funds generated from the 2 percent money for the administration of schools is problematic because the staff is already committed to that money. Now, the department supports 55 charter schools; Governmental Accounting Standards Board (GASB) 61 may allow districts to shed the charter schools as component units of their

audits, so the PED will oversee all charter school audits. Part of the evaluation, he said, suggests the PSFA become a lease management agency, which would involve a significant expansion of a state agency.

Director and chief financial officer for Southwest Learning Centers (SLC) Leslie Lujan stated the small-school factor is a funding formula issue. With regard to the conflict of interest issue, Ms. Lujan said the founders of the SLC had to use their personal credit for the lease to start the school a decade ago, as is probably the case with new charters starting back then. Moving forward, she said, the SLC have maintained the lease, which is not excessive, she said.

Bruce Hegwer, executive director, New Mexico Coalition for Charter Schools, said the coalition was at a disadvantage because they received the report that morning. Mr. Hegwer stated there are inaccuracies and misreports that the coalition will respond to in writing. The issue, he said, is charter schools do not have access to capital funds. The coalition has great ideas for developing a revolving funding mechanism for charter schools to borrow against to provide facilities at a lower cost. The coalition is close to providing the Legislature with a structure. The coalition is also concerned about the conflict of interest issue, so they are providing training.

Chairman Smith stated he would like to know how many people creating their own foundations are also administrators of their own schools, for transparency.

Charles Sallee, deputy director, LFC, stated evaluators followed protocol and worked with agencies to review drafts and incorporate comments and changes and then issue the final report with final responses. The LFC reached out to various charter schools visited to give them an opportunity to respond, he said, and noted a response from Southwest Charter Schools is included in the final report.

Mr. Sallee stated one of the key issues brought up by the charter schools was their inability to have enough access to capital funds, forcing use of operating budgets to subsidize lease costs, which is why small-school funding is needed. The LFC looked at the effect of pulling lease costs out and shifting them to the PSCOC lease assistance and wanted to ensure the lease costs were reasonable before recommending doing so.

Vice Chairman Varela stated this report troubles him. General standards for charter schools have yet to be created, and the executive is not supportive. Mr. Aguilar stated the administration is supportive of the idea of having the standardized leases, but in this study, it does not support the moratorium on charter schools and the small-school funding factor. Vice Chairman Varela said whether it is done through a report or direct legislation, these issues need to be addressed.

Senator Sapien asked how many charters are leasing buildings from foundations that benefit the schools. Mr. Canney stated leases from private individuals exceed 50 percent, but the number of foundations that lease to these schools is not known. Mr. Canney stated he will provide the committee with this information. Senator Sapien asked if charter schools are signing leases without going through the approval process is a training challenge. Mr. Aguilar stated there is lack of knowledge regarding the approval process for lease/purchase agreements, and the PED is going through the process of reviewing all charter lease agreement documentation. Mr. Hegwer

said the coalition provides training to governing council members during conferences and at will. The coalition also makes referrals to the PSCOC.

Representative Larrañaga stated he, too, was troubled about the report, specifically referring to the Public Academy for Performing Arts in Albuquerque (PAPA) where APS received $251 thousand in revenue from PAPA in FY12 that went into APS's operating budget. Taxpayers are paying twice, he said.

Mr. Berry stated the PSCOC has participated in about six or seven projects for charter schools through the standards-based capital outlay process, additionally the council has also awarded a few charter schools some "boot money" for facilities that were owned. Representative Larrañaga asked if any charter schools were ranked in the top 50 to be improved. Mr. Berry stated Cariños in Española is number three and listed four others in the top 50.

Representative Larrañaga asked what the recommendations were for standardizing leases. Mr. Canney stated one of the LFC recommendations is to have centralized, standardized leases administered by either the PSFA or the PED.

Chairman Smith stated transparency is necessary, as is appropriate use of funds.

LFC Proposed 2013 Legislation. All were approved with no objections.
Representative Larrañaga will sponsor the motor vehicle excise tax revenue legislation.
Representative Larrañaga will also sponsor the legislation to move supplemental severance tax bond proceeds to the road fund and higher education.
Representative White will sponsor the Legislative Lottery Scholarship Program solvency proposal.
Senator Papen will sponsor Spaceport Authority liability legislation.
LFC Director David Abbey stated this is the recommendation to increase the at-risk factor from about 0.09 to about 0.2 to prioritize more funding for at-risk students. Representative Lundstrum agreed to sponsor legislation.
Chairman Smith stated Senator Rue and Vice Chairman Varela will co-sponsor the procurement reform for emergency and sole source contract legislation.

Miscellaneous Business.
Action Items
Approval of November 2012 and December 2012 Meeting Minutes – **Senator Cisneros moved to approve the November 2012 and December 2012 meeting minutes, seconded by Representative Larrañaga. The motion carried.**

Information Items
Status Report of DFA and STO Cash Reconciliation Issues and General Fund Adjustment – LFC evaluator Maria Griego stated unreconciled balances between SHARE and the state's bank accounts of the state treasury persist to this day, a chronic problem dating back to the inception of SHARE in FY07. It is possible unreconciled balances were introduced into the new SHARE system from LEGACY accounting systems. In May 2012, the staff identified key areas that contributed to the cash reconciliation issue including outdated business practices, manual process

for agencies using systems outside of SHARE, such as Medicaid; and insufficient training for agencies on the share system. The Financial Control Act requires the Department of Finance and Administration (DFA) to complete monthly account reconciliations to ensure the general ledger in SHARE accurately reflects bank balances at the State Treasurer's Office. The DFA has not been performing this reconciliation, she said.

Ms. Griego stated the DFA received a special appropriation of $200 thousand in the 2012 General Appropriation Act requested by Representative Varela, as well as a $400 thousand loan from the Board of Finance, to address the cash reconciliation issue and contracted Deloitte Consulting to assist them in the process. The DFA's independent auditor, REDW, requested the DFA identify a potential write-off amount for historical variances outstanding in SHARE related to cash. Based on its preliminary analysis, the DFA created a contingent liability against the general fund of $70 million, which was also noted in their FY12 audit.

Ms. Griego stated the LFC has concerns over the methodology used to calculate the liability, which yielded a potential write-off of between $70 million and $460 million and the decision to book the most conservative amount of this range. The LFC does not agree with booking the entire liability against the general fund, as opposed to allocating the charge against various accounts at the state treasury.

The previous auditor for the DFA, Moss Adams, never issued a finding against the agency for not complying with statutory obligations for cash reconciliation under the Financial Control Act, nor was the LFC able to ascertain that the State Auditor had addressed the issue of non-compliance issue with the DFA. The DFA is working to reconcile cash balances on a monthly basis going forward to comply with the Financial Control Act.

The DFA now appears to be on track to turn on capabilities in SHARE and release updated business processes to prevent further variances from occurring when accounting for cash (February 1, 2013), but cash cannot be fully reconciled going forward until historical cash variances in SHARE are resolved. Ms. Griego stated the State Treasurer is working with their fiscal agent, Wells Fargo, to create a bank account structure that increases visibility to agency fund levels to facilitate cash reconciliation (April 1, 2013).

LFC analyst Christine Boerner stated that the Department of Information Technology (DoIT) is working to upgrade SHARE software by the end of 2013. A successful hardware upgrade requires transferring all SHARE data to the new equipment. Initial transferring tests failed, pushing the DoIT further behind, she said, and once the process is completed, upgrade to SHARE version 9.2 can proceed. Ms. Boerner stated upgrading is essential because the current version of SHARE is seven versions behind and no longer supported by the vendor.

The state is looking to complete all planned changes, comprehensive enough to be considered a reimplementation, in SHARE within less than 12 months. Ms. Boerner stated a rushed timeline in the 2006 implementation of SHARE contributed to many of the issues now requiring correction, and the state risks repeating this with the current plan to upgrade SHARE and redesign associated business practices.

Ms. Boerner stated the LFC staff is concerned that while the DFA, STO, and the DoIT all have individual plans related to SHARE, the agencies are not coordinating their efforts long-term, which prevents an analysis of overall impact of all anticipated process and technical changes within SHARE under the current aggressive timelines. The rapid sequence could further exacerbate issues such as cash reconciliation, she said.

The LFC staff offers the following recommendations:

- The DFA, DoIT, and STO bring an appropriation strategy before the Legislature during the 2013 session to address outstanding cash reconciliation issues not yet resolved;
- The DFA move forward on contracting experts to address the historical entries that created cash variances between SHARE and the state's bank accounts before any write-off is taken; and
- The DoIT, DFA, and STO evaluate all projects related to SHARE (unreconciled cash balances, hardware transition, database archiving, software upgrade) and create a unified strategy for moving forward. This plan should allow adequate time for technical testing, business process design and user training, and should also detail required resources.

Vice Chairman Varela stated he did not see any recommendation to restore control back to the DFA, required in statute. To support a minimum of $70 million, Vice Chairman Varela said control must go back to the DFA where it belongs.

Senator Beffort asked how the discrepancy was not uncovered by Moss/Adams. Ms. Griego stated the massive oversight on the part of the independent auditor was a major concern for the LFC. It appears that the DFA's audits made no reference to measurements for achieving statutory obligation under the Financial Control Act. The focus was mainly on generating the financial statements and not many findings changed within a five-year period in the audits, prompting concerns with the level of detail auditors used in auditing the agency, she said. Also, she stated, there is disconnect between the independent auditors contracted for both the STO and the DFA and understanding what role under each agency plays under the Financial Control Act.

Chairman Smith thanked the committee and staff for their hard work throughout the year.

With no further business, the meeting adjourned at 10:33 a.m.

Chairman Luciano "Lucky" Varela

Vice Chairman John Arthur Smith