LEGISLATIVE FINANCE COMMITTEE
May 11, 12, 13, 2009
MINUTES

May 11, 2009

The following members were present on Monday, May 11: Chairman Luciano "Lucky" Varela, Vice-Chairman John Arthur Smith, Representatives Donald E. Bratton, Rhonda King, Don Tripp, Edward C. Sandoval, Jeanette O. Wallace, Nick L. Salazar, and Henry "Kiki" Saavedra; and Senators Carlos R. Cisneros, Sue Wilson Beffort, Carroll H. Leavell, John M. Sapien, and Mary Kay Papen.

Federal Stimulus Overview – American Recovery and Reinvestment Act (ARRA). Katherine Miller, secretary, Department of Finance and Administration, and Dona Cook, New Mexico Office of Recovery and Reinvestment, provided an overview of the federal stimulus package for New Mexico. More than $2.8 billion has been identified for the state through state and federal agencies, including benefits to businesses and individuals through loans and several new tax-exempt and tax credit bonds, direct expenditures by federal entities, and competitive grants through state, local, or private applications.

The recovery act funds will be distributed to every community in New Mexico, softening expected cuts in school budgets, assisting students' ability to afford higher education and provide direct infusions into local economies. The package will also support investments for long-term growth through infrastructure projects identified through existing state and federal processes.

Additional upcoming funding opportunities exist to assist individuals and businesses by taking advantage of individual tax relief, housing programs, business tax relief, and small business loan programs. Work with the New Mexico Finance Authority and other entities to pursue other bond and loan program opportunities for economic development, education, energy, and other local investments and collaboration on applications for competitive grant funding administered by state or federal entities is also taking place. Over 2,800 entities are eligible for grants; however, only 700 are registered online through the federal grant website.

Through executive order, the governor has established a competitive grants advisory team chaired by Rick Homans, secretary, Taxation and Revenue Department. The team's goal is to maximize the number of federal dollars coming to the state to create jobs and revitalize the economy.

The General Appropriation Act appropriates $166.5 million in additional federal matching funds, or FMAP. Temporary increases tied to the FMAP appropriation include a hold-harmless increase for four quarters, an across-the-board increase for nine quarters, and additional tiers of increased FMAP based on unemployment tiers. A temporary increase in the federal share of the Title IV-E program is based on the additional FMAP as well. Several attestations must be made to be eligible for the increase. Because the state's budget was balanced with a targeted 10 percent reserve on June 30, the FMAP increase was not needed from October 1, 2008, to June

30, 2009. House Bill 920 established a mechanism for funds to be used toward a revenue shortfall. In the event there is not a shortfall, funds will be used for Medicaid in future years. As of May 1, the Centers for Medicare and Medicaid (CMS) has authorized $154 million to New Mexico. CMS has implemented passive attestation by drawing down the funds.

The education stabilization funds for New Mexico total $260.4 million and the General Appropriation Act of 2009 uses $164.7 million in public school support for FY10. To be eligible for stabilization funds, states must make assurances in four areas. New Mexico complies with the requirements for FY09, FY10, and FY11. The level of state support for public schools and higher education institutions must be at least the FY06 level of state support.

On April 1, the U. S. Department of Education made 67 percent of funds available upon application. The application deadline is September 30, 2009; New Mexico's application will be submitted before the end of the fiscal year. Beginning July 1, funding will be distributed monthly to school districts based on the FY10 funding formula distribution

Ms. Cook said the New Mexico Office of Recovery and Reinvestment is focusing on ensuring no dollar is left behind. Most funding received by the state will be used for existing programs or processes available through the federal government. The office has organized grant task forces including for broadband, health information technology, and the smart grid.

The general accounting office put out its audit quote for 16 states; New Mexico will follow the auditing guidelines to comply. The office is working to account for every stimulus dollar separately and is issuing guidance to state agencies. A recovery act strategic planning process has been initiated following the federal model. The amount of funds going into administrative costs will be minimized while the amount going into programs is maximized. A major focus when reviewing what state agencies will do with the federal stimulus funds is the process used, how the public is involved, and how people are informed of decisions. Ongoing prevention of fraud, waste, and abuse is being accomplished by following the Procurement Code. The office is also working with the State Treasurer to ensure cash flow does not become a problem because most funds are distributed on a cost reimbursement basis. The federal government is requiring extensive quarterly reporting; however, requirements are not yet available. The first federal report is due in October and will require an overall quality assurance. The Human Services Department (HSD) has agreed and is preparing a compliance matrix that will consist of two components for every agency. An audit and compliance unit has begun to establish audit instruments for agencies. Agencies may come up with their own instruments and will be asked to conduct self audits; independent audits will then be conducted. Ms. Cook provided an overview of outreach and communications steps taken to date.

Chairman Varela asked if the technology structure has been prepared to start putting out information as well as receiving data. Ms. Cook said it is a challenge nationwide; the federal government is giving thought to putting up information where they show all the money going to each state. Secretary Miller added that staff is working with local governments to find a way to capture what is received directly through the budget adjustment process. Ms. Cook said a report on recovery act projects by county is available and includes what has been received, where it came from, what it is for, and how much it is. Chairman Varela asked if a separate set of books are being kept for the stimulus package. Ms. Cook said auditing of the federal money is required. The purpose is to account for the stimulus dollars separately from the base dollars; however, it will be rolled up into the agency audit. Chairman Varela asked if the state auditor is involved in this process. Secretary Miller said she has met with the state auditor to discuss the role he sees his office taking. Initially his concept was to incorporate the stimulus money into annual financial audits and not individual spot audits. Chairman Varela asked that staff follow up with the State Auditor to see how they are going to incorporate the federal regulations into the regular audits.

Gene Moser, principal analyst, LFC, reported that during the session House Bill 578 was passed and pocket vetoed. The legislation would have established LFC oversight on the expenditure process. Infrastructure, activities, or programs will not be set up so the Legislature would be expected to continue to provide funding at a later point. Staff met recently with Toney Anaya and Secretary Miller, both with the recovery act task force, to discuss the possibility of sharing information. Mr. Anaya indicated that transparency and accountability are critical to the process and he would be willing to share information. Both federal laws and the Workforce Investment Act require that certain types of funding coming to the state must be appropriated by the Legislature. Not all money allocated to the state has been appropriated. The state is looking at other states that are not using their funding. Funding that is not utilized will go back into a pool and will be reallocated.

Renada Peery-Galon, principal analyst, LFC, continued with health and human services and said the federal medical assistance percentage rates are increasing. It is anticipated that increased rates will continue through December 31, 2011, freeing state general fund revenues for other purposes. There is approximately $18 billion available from federal stimulus money for competitive grants for the health information technology improvements; $546 thousand is available in FY10 to expand the Women, Infant, Children (WIC) program providing food, supplements, and nutrition. The state Department of Health will submit a grant to the U.S. Department of Agriculture to update the WIC computer system. There is $17.8 million available in early childhood for the child care development block grant. There is also $5.4 million that will come to the state for Head Start; however, those funds will not go through state agencies and will go directly to Head Start providers statewide.

In regards to education, a majority of funds will be distributed to schools. The distribution can either go directly to schools through the state funding formula, through legislative appropriation, or through existing federal Title I and IDEA-B. Concerns exist about the ability of the school districts to effectively spend the funds and improve student achievement without creating recurring obligations. The federal amendment allows the districts up to five years to expend federal funding. There is also an additional $8 billion reserve for competitive grants.

Department of Public Safety (DPS) has existing grants that stimulus funds will increase by $39 million. DPS reports that presently staff is waiting for a final award and provisions for a majority of the funds. The justice assistance grant totals $11.1 million and is a formula augmentation of the existing programs. It is anticipated that in regards to that grant, there will be a contingency for acceptance of the money and commitment to continue those positions for at least one year after termination of the grant.

Local boards have received $8.3 million of the Workforce Investment Act (WIA) funding to the state. The Workforce Investment Act does require that funds be appropriated by the state Legislature through the budget adjustment process. The transfer of funds was approved through the process and was viewed as necessary for the programs, especially in dealing with the youth summer employment. The Workforce Solutions Department has not sent through a budget adjustment request in regards to the administrative, discretionary or the rapid response funding.

The Housing and Economic Relief Act of 2009 authorizes $19.6 million for the neighborhood stabilization program in New Mexico to acquire and redevelop foreclosed urban and residential properties.

Mr. Moser said a workgroup has been established within the LFC of analysts to focus on the stimulus package. All analysts will be inputting and updating a spreadsheet with information received on a daily basis as it becomes available. The workgroup will conduct its own analysis, and it is expected to work closely with the recovery office to obtain information. That information will be cross referenced and an update will be provided to the committee at monthly meetings. Vice-Chairman Smith asked if there was a short executive bulletin of what the federal government is trying to accomplish with the stimulus package. Ms. Cook responded that there is a bullet list available. Creating jobs is the main goal and the federal government has stressed that the funds are nonrecurring and spending of the funds must be a transparent process free of fraud and waste. Ms. Moser added that states must demonstrate that funds are spent in economically disadvantaged areas and the spending will create jobs. Vice-Chairman Smith asked what is considered an economically deprived area. Ms. Cook responded that information is imbedded into the federal standards; most processes already exist.

Vice-Chairman Smith said he is concerned with the accountability at the educational level and asked for information on federal funds by individual school districts as well as information on what has been accomplished. Catherine Cross Maple, deputy secretary, Public Education Department (PED), said the department was talking to districts about setting up separate accounts to assist with spending and accounting for the federal stimulus funds.

Senator Papen inquired about non-profits and how they are able to schedule appointments with Mr. Anaya and expedite applications. Ms. Cook said groups around the state have been put together and individuals are asked to post information on the website. Information is then sent out to agencies for assistance. If agencies cannot help, the information is reviewed to determine if groups can be assisted by ARRA.

Capital Outlay and Projects Greater than $1 Million Quarterly Report. Linda Kehoe, principal analyst, LFC, presented the March 2009 capital outlay quarterly report listing the fiscal accountability for outstanding capital funding appropriated between 2002 and 2008. The data within the report does not include $139.9 million for 73 projects authorized in the 2009 legislative session. The report does include the general fund and severance tax bond authorizations voided for solvency. Currently, there is $1.4 billion outstanding for 6,454 projects. Since December, there has been $277 million expended or voided and nearly 4,000 pre-2008 projects worth $654.2 million had seen no activity. The majority of funds that have not been expended are from 2005 and older.

LFC staff currently tracks $821 million for 356 projects funded for $1 million or greater, which accounts for 59 percent of all unexpended funds. Staff will continue to work on tracking projects requiring additional funding throughout the interim. Ms. Kehoe reported the activity of several projects during the last quarter and discussed management and other issues. Robert Apodaca, director, Local Government Division, provided an update on capital projects and said because of the last legislative session and having to reduce funds, there is a major impact on local communities; however, a large amount of activity is still being seen.

Ms. Kehoe discussed the new procedures DFA has formulated to address non-profit issues including reimbursements. Mr. Apodaca sent correspondence to local government entities regarding implementation of new procedures for general fund monies. The major change provides that the Local Government Division will no longer require local governments to submit copies of agreements for private organizations prior to a reimbursement being processed. This exception means that the general fund appropriations of more than $25 thousand will no longer require approval by the Board of Finance. The Local Government Division will review the grant files for documentation already required by the grant agreement and will require a letter of certification signed by an authorized representative of the local government's governing body and its legal counsel stating that all current and future agreements between the local government and any private organization complies or will comply with all state laws including the anti-donation clause of New Mexico.

For future general fund appropriations, DFA proposes to promulgate a rule that will establish new procedure requirements in order for local governments to receive general fund reimbursements on a timely basis. DFA proposes to hold public hearings to gather input from non-profits and local entities affected by the proposed procedures before they are implemented. Mr. Apodaca added that local governments are now required to certify they are complying with the statute and anti-donation issues. The procedural changes will not affect any law requiring the local entities lease or operating agreement approval.

Program Evaluation: Investments in Early Childhood Programs. Charles Sallee, program evaluation manager, LFC, provided a summary of the staff evaluation on investments in early childhood.

Mr. Sallee reported that New Mexico faces significant challenges to ensure the health and well-being of children and that 40 years of rigorous evaluation have demonstrated that public investment in early childhood programs can improve long-term child outcomes. In FY08, 18 major state- or federally funded programs provided $300 million in services for pregnant woman and young children. Mr. Sallee indicated that this total significantly underestimates the amount of money available and actually being spent because it does not include Medicaid, which plays a crucial role in the financing of prenatal care and other care for young children, or other programs that fund services directly. Efforts to improve outcomes for young children are worth public investment; however, the evaluation found that a significantly more coordination of public effort is needed to ensure these investments result in desired outcomes. The report identifies savings of over $4.2 million by reallocating funding from duplicative services and reducing excessive administrative spending.

Mr. Sallee reported that additional attention is needed to ensure that the state funds programs with a strong and positive evidence base and that programs' performance is monitored in a regular and comprehensive approach for the entire early childhood system. In addition, better coordination will help ensure that public investments improve outcomes for pregnant woman and young children. Without coordination, meaningful change and outcomes may not be seen for children and their mothers. Because there is no single entity that focuses on this issue, policies, programs, and outcomes do not always rise up as a priority within the larger departments. There are also numerous coordinating and advisory committees. Executive agencies have proposed creating an early childhood collaborative (ECC). Mr. Sallee reported the ECC would need to set clear goals for improving outcomes for pregnant women and young children, identify areas in the state with poor outcomes or a high concentration of risk factors, ensure current resources are sufficiently targeting areas needing improvement, and routinely monitor and report information to the committee.

Mr. Sallee reported that more attention needs to be placed on improving prenatal and birth outcomes in the state. New Mexico trails most states in the delivery of early and adequate prenatal care and subsequent birth outcomes. Along with Medicaid, the Woman, Infants and Children (WIC) program plays a vital role in improving the state's birth outcomes. Early home-visiting services are another proven strategy for not only improving birth outcomes, but a range of other childhood outcomes for at-risk families. However, New Mexico is not well-positioned to obtain the benefits of these investments and services. Currently, CYFD does not require funded programs to implement evidence-based home visiting, which diminishes the potential for positive outcomes for return on the state's investment. Since its inception, the department has been plagued with the lack of agreement about which home-visiting model to choose. Mr. Sallee reported that the Department of Health appears better positioned to implement a nurse-based home-visiting program and to capture Medicaid and other federal funding sources. Implementation of a nurse family partnership program in FY10 is recommended and funding for a pilot program is requested for FY11. CYFD should focus on implementing the comprehensive plan for home visitation and apply it to all contractors.

Mr. Sallee reported that New Mexico faces challenges in developing an efficient and effective publicly funded preschool system. In FY08 there were seven major preschool programs that accounted for $81 million in services for children. Since FY06 the state has invested almost $80 million in the state pre-K program, administration, planning, evaluation, and capital outlay. The state lacks clear authority to extend pre-K program standards and accountability measures. Mr. Sallee recommended that CYFD and PED should identify methods to integrate pre-K, Head Start, and Title I IDEA preschool into a single publicly funded preschool system and submit a report to LFC and LESC by November 1.

Dorian Dodson, secretary, Children, Youth and Families Department, said that some of the findings and recommendations are not agreed upon. It is agreed within CYFD that there needs to be more focus on early childhood services and that should include early childhood development as well as child care. It is not agreed that one medical- based model visiting program is appropriate for the entire state. The state has a unique pre-K program divided into two separate sections that work closely together and have had extraordinary outcomes.

Chairman Varela said some states have attempted to combine federal programs with their pre-K program and asked Julia Maccini of Senator Bingaman's office if the congressional delegation could work on legislation allowing states to manage Head Start and pre-K programs together. Ms. Maccini said she would share information with Senator Bingaman and ask that it be discussed in the future. Information will also be provided to the Congressional Research Services agency in Washington to prepare a report about state and federal efforts to coordinate head start and states' pre-K programs.

In response to an inquiry regarding administrative costs, Mr. Sallee said it is unusual and inefficient to have two separate departments administering the same program; however, the departments seem to be coordinating the program well, ensuring program standards apply across each respective department's contractors. He provided an example where each department contracts with the same contractor for administrative support services, requiring two contracts and payment processes for the same service by the same contractor. Mr. Sallee also reported that administrative costs for pre-K were as high as 20 percent. Lowering administrative and support costs to the statutory requirement of 10 percent would save an estimated $1.6 million. Mr. Sallee, in response to a question, noted that results from the external evaluation on pre-K are promising and benchmark information should be included to put gains into context. He indicated pre-K students demonstrated gains on scores, but their outcomes were at the 25th percentile nationally.

Miscellaneous Committee Business.

Action Items.

Approval of LFC Minutes – January 2009. **Senator Cisneros moved to adopt the January 2009 LFC minutes, seconded by Senator Wilson-Beffort. Motion carried.**

Information Items.

2009 Calendar and Meeting Dates. Representative Saavedra recommended traveling to Hobbs. Director Abbey recommended the committee travel to Clovis in June, Gallup in July, and Angel Fire in August. Chairman Varela recommended that local officials be invited to provide presentations stating concerns so that follow-up can be provided. **Senator Cisneros moved to approve the interim meeting locations, seconded by Representative Salazar. Motion carried.**

The committee tentatively approved meeting dates for 2009.

Post-Session Review. Director Abbey said the review was highlighted in the LFC newsletter.

February Cash Balance Report. Director Abbey highlighted items in the report and said cash balances are up. Representative Bratton said in regards to capital outlay, governmental entities should be given a reasonable amount of time to secure additional funding and, if it cannot be structured within a reasonable period of time, the money should revert. Chairman Varela asked that LFC auditors monitor the cash flow and compare the suspense account and the reserve account against the appropriation account.

April BAR Report. Director Abbey reported 69 budget adjustment requests have been approved and reflect transfer authority, including capital outlay.

April LFC Budget Status Report. Director Abbey said the budget reflects a modest surplus.

May 12, 2009

The following members were present on Monday, May 12: Chairman Luciano "Lucky" Varela, Vice-Chairman John Arthur Smith, Representatives Donald E. Bratton, Rhonda King, Don Tripp, Edward C. Sandoval, Jeanette O. Wallace, Nick L. Salazar, and Brian F. Egolf, Jr. (for Henry "Kiki" Saavedra); and Senators Carlos R. Cisneros, Sue Wilson Beffort, Carroll H. Leavell, John M. Sapien, Mary Kay Papen, Pete Campos, and Steven P. Neville (for Stuart Ingle). Speaker of the House Ben Lujan and Representative Miguel Garcia attended as guests.

LFC Staff Briefings. Michelle Aubel, principal analyst, LFC, gave an overview of third-party marketing and the New York allegations that two former aides to the former state comptroller conducted a fraudulent pay-to-play scheme extracting payments from private equity and hedge fund managers in exchange for investment commitments from the $122 billion New York pension fund. Under the scheme, the aides acted as third-party marketers or placement agents, collecting fees from investment managers. While third-party marketing by itself is not illegal, both the New York state attorney general's office and the federal Securities and Exchange Commission (SEC) allege that in this case these payments were nothing more than "thinly disguised kickbacks." As the New York case illustrates, differentiating between a legitimate third-party marketer and an individual with political ties posing as one selling influence can be difficult. As the *Wall Street Journal* reports, "The main legal issue for the investment firms turns on whether they knew or should have known that fees they paid to certain entities for access to the New York fund were legitimate or improper kick backs and whether they were properly disclosed."

LFC has closely monitored the state's alternative investment programs and in 2006 contracted for a business review of the state's alternative investment policies and procedures. The report highlighted the decreased transparency of fees as well as the documented fraudulent activity that makes due diligence a critical aspect of oversight. In addition to the issues of due diligence, illiquidity, valuation, fees, benchmarking, evaluating performance, transparency and reporting, two LFC hearings highlighted three key issues relevant to the current discussion: expertise, procurement, and monitoring.

The New Mexico ties to the New York case were reviewed. Aldus Equity Partners, the private equity advisor for the SIC and ERB, is being sued by New York, and its founder (Saul Meyer) was recently arrested as part of the New York investigation. Additionally, other key names associated with the New York scandal have shown up as having received third-party payment in

New Mexico. Both Hank Morris and Dan Hevesi received payments of over $250 thousand related to SIC private equity investments. The SIC, Educational Retirement Board (ERB), and the Public Employees Retirement Association (PERA) requested disclosures from funds in which they have made commitments regarding third-party fees. Third-party payments reported by SIC and ERB total almost $35 million while PERA totals $1 million. These totals may be understated to the extent that funds did not respond or refused to divulge information; agencies do not have subpoena power. In reviewing agency disclosure reports, troubling patterns emerged similar to those identified by prosecutors in New York. Fees are concentrated, a few fees appear high and it appears one hedge fund hired a third-party marketer one year after ERB already invested in the fund.

Recent events suggest existing policies and procedures may have failed to meet expectations and point to possible areas where weaknesses might evolve. In addition, agencies may have not been provided the requested resources commensurate with high due diligence required for the alternative investments. There are no current written formal policies regarding third-party disclosures. No agency has required a breakdown of fees being paid to the investment firms including any third-party fees as a condition of investing. Such disclosure will now be required under Laws 2009, Chapter 152 (HB876).

Agencies are currently reviewing their business practices and developing third-party disclosure rules to meet new requirements. SEC may establish new rules covering third-party payments. At its May meeting the Legislative Council passed a motion directing the Legislative Council Service staff to partner with the state Board of Finance to perform an independent forensic audit or business review of all three state investment agencies. The results of such independent reviews could then be directly reported to the Investments Oversight Committee (IOC) and the LFC.

Dan White, LFC economist, reported on the preliminary performance report for all three investment agencies for the quarter ending March 31, 2009, and noted it is improved from previous quarters. Both permanent funds outperformed their policy benchmarks by 540 basis points. It is expected that these returns will be put at the top 5 percent for funds around the country. PERA was the worst performer, missing its performance benchmark by 130 basis points (bps) and losing over $700 million during the quarter. PERA has an actuarial liability level for existing retirees of $7.7 billion; at one point during the quarter, the overall fund value dropped to $7.6 billion. The quarter ended with $8.2 billion. ERB continues to underperform; however, performance was better than last quarter. The pension fund is underperforming quarterly, one- and five-year benchmarks. For the quarter, ERB underperformed by 40 bps and dropped $395 million, a 6 percent drop. PERA is $1 billion below the level it was on December 31, 2003; whereas, ERB has lost $500 million. If trends continue, increased contributions will have to be considered.

Senator Sapien asked if there is anything in the agency investment policies to guide the agencies to look for other advisors after poor performance over a period of time. Ms. Aubel said they do have a watch list and have taken action by firing some managers. PERA, for example, will be looking to rehire international emerging markets managers after firing Alliance Bernstein. Additional funds have also been moved to passive investing. Mr. White added that they have continued on with their general advisors, and if underperformance remains an issue, the overall advisor needs to be re-evaluated.

Final FY09 Second-Quarter and Preliminary Third-Quarter Investment Performance. Gary Bland, state investment officer, reviewed the State Investment Council (SIC) performance summary for aggregate accounts and managed pools. The small mid cap pools continue to have difficulty; therefore, changes will have to be made. Performance for private equity has been impacted significantly by the dollar gaining strength against other currencies. The allocation and investment manager impacts for performance attribution have been positive. Real estate numbers are in line with industry averages. The average daily fluctuation for portfolios for the year is $100 million. The performance relative to SIC's internal benchmark is acceptable, but not outstanding.

Bob Gish, chief investment officer for PERA, reported that, for the December quarter, PERA performed 549 basis points (bps) under its own benchmark. Both three- and five-year results are driven primarily by performance during calendar year 2008 and, to a lesser degree, the last six months of 2007. Mr. Gish explained the individual returns per year and said the 2008 calendar year performance is responsible for pulling down the numbers. Mr. Gish also explained the attribution report and said the manager added value was the primary driver; 90 percent of the underperformance -- and the worst year for PERA -- was due to manager effect. Almost half of the manager effect was in the fixed income category. Independently, PERA's attribution performance was very good before 2008. Current assets are almost $9 billion through May 2009. During the first quarter, PERA terminated almost $400 million in international equity accounts. PERA's percentile ranking was 97th as of the March quarter. PERA is slightly ahead with current allocation to equities.

Bob Jacksha, chief investment officer for ERB, reported on performance for the first calendar quarter 2009 and the general market environment overview. For all periods of five years or less, all equity indices are negative with the exception of emerging markets, which grew 5.9 percent. The portfolio is down 5.5 percent for the quarter, is down 28.2 percent for the year ending March 2009, and ranks below the median for the year; however, it was slightly above the median for the quarter. ERB is a mature pension fund and is paying out more than what is received in contributions. Assets as of March 31, 2009, were $6.2 billion. ERB's policy states that 45 percent will be put into equities, 10 percent in emerging markets, etc. If the policy had been followed and indexes were invested in, it would have given slightly more value than the median fund. ERB was allocated slightly differently due to market-value changes and anticipation of market movements. For one year, 2.6 percent was added by a variance in allocation from the policy; managers took away 5 percent for the one year. Changes in managers have been made. Two managers have been terminated and one has withdrawn.

Chairman Varela asked for comments on passed legislation for third-party marketers. Mr. Bland said legislation was supported and language was corrected and tightened. Support was also provided for legislation to limit contributions by investment managers. Mr. Gish responded that PERA has no problem with obtaining statements from firms in the selection process. Managers have been surveyed and full cooperation has been received in obtaining information regarding third-party marketers. PERA's five-year performance and third-party marketing fees were low because implementation of an alternative program began in December 2007. Anything in excess of $100 million was not funded until June 2007. PERA currently has 2 percent of its target in private equity funding. Mr. Jacksha said the bill gives agencies a new tool in obtaining proper disclosure. ERB is in favor of the bill and is communicating with its attorneys on how to incorporate language in future contracts.

The Role of Third-Party Marketers in the Public Investment Process. Allan Martin, partner, New England Pension Consultants (NEPC), reported that NEPC advises on $250 billion worth of assets and is the fifth largest pension advisor. NEPC's role is to work with funds in developing appropriate strategy in terms of asset allocation, assist in selecting managers to execute the strategy, and to report the performance objectively on both an absolute and relative basis.

Money managers, especially emerging managers and those that have products that are not continuously available in the market place (including private equity and real estate), find it necessary to forego full-time marketing staff. Third-party marketers have a duty to help understand the potential clients and assist the money manager determine how to most effectively raise new assets. Placement agents apply to companies that specialize in finding institutional investors able to invest in private placement funds and are generally regulated by the SEC and the Financial Industry Regulatory Authority (FINRA). Placement agents work with managers to understand the product, write up marketing material, and prepare a private placement memorandum. The placement agent also relieves the money manager of the duty to understand marketing and is a sales marketing activity. Average fees for performing these functions range from 1 percent to 2 percent.

The use of third-party sales agents is higher among firms that offer alternative products. These types of asset classes have been dramatically embraced by public funds in particular, but all funds in general. The client in an alternative firm has a limited partnership interest in the fund and pays a fee to the general partner. The general partner determines whether a placement agent is needed and the general partner pays the placement agent. The primary value of a third-party placement is it relieves the money manager of the obligation to spend resources looking for new business and gives them better access to appropriate clients. Legitimate third-party marketing agents spend time understanding the needs of the market place and look for managers that have the skills to do that. Emerging managers are able to exchange a fixed fee of having internal staff for a variable fee associated with having a third party. Disadvantages to using third-party marketers include the expense, association with a disreputable third-party marketing firm, and the liability that the third-party marketer may misrepresent a firm.

Jan Goodwin, director of ERB, read a letter from Bruce F. Malott, ERB chairman, regarding third-party marketing fees that highlighted the need for transparency. To this end, the letter noted the following recommendations that the board will be taking action on: perform an independent review of ERB's investment process; perform an independent review of all Aldus recommendations; determine whether unfunded Aldus investments move forward; require robust legal documentation of all investments, including full disclosure of third-party marketing; and incorporate significant penalties in all contracts for failure to fully disclose placement fees associated with investments.

Vice-Chairman Smith noted LFC flagged irregularities relating to the Treasurer's Office as early as 2005 and questioned the investment officers regarding their knowledge of any irregularities associated with third-party marketing and how to implement polices and procedures to mitigate against possible misuse. LFC had noted that the governmental staff discussed the down side of third-party marketers but that the information registering concerns was not forwarded to the boards. Mr. Bland said he recalled participating in discussions and said it was presented as an agenda item for the SIC; however, there was not a quorum at that meeting. Because no action was taken, only certain procedural aspects were implemented. Mr. Jacksha added that implementation began in late 2006. ERB contracts with private equity consultants had a specific clause requiring them to disclose placement agent usage. In addition, language indicating ERB would not pay for placement fees was incorporated into contracts.

Representative Egolf asked what advice was given to SIC and ERB as it related to third-party placement agents. Mr. Martin said there were no questions in searches regarding the use of third-party marketing. There was no knowledge in advance or even after the fact if third-party marketers were employed by money manager. Representative Egolf asked who signs the final agreement using the state's money and how is it ensured that the state's money is not used for to pay placement fees. Mr. Jacksha responded that alternative investments are taken directly to the board or investment committee for voting. The contract is ultimately signed by the executive director or himself. The placement agent is not a party to those contracts. The only control over the investment manager's fee is negotiation making sure it is a commercially reasonable fee. Mr. Bland added that industry fees are generally standard. Representative Egolf urged the agencies to suggest to the Legislature ways to tighten oversight. Mr. Bland said SIC fully supports independent audits of agencies and campaign contribution issues were addressed in legislation. Performance and private equity areas have been exceptional. Mr. Bland suggested that third-party marketers be registered and regulated as lobbyists. Chairman Varela said the structure and confirmation of all boards, committees, councils, etc., needs to be reviewed to make sure independence is provided in terms of appointing authority.

Senator Beffort asked if the public perception or campaign contributions associated with awards of contracts were discussed. Mr. Bland responded that contributions were not reviewed; the results and quality of investments were of concern.

Senator Beffort asked if the membership of PERA is fully aware that the overall fund has fallen over $1 billion. PERA is in a situation where future increases in membership contributions may be needed. Mr. Gish responded that PERA has never dropped below $7.2 billion prior to the 9/11 attacks and is currently at $9 billion. Performance in 2008 was attributable to active manager's underperformance. Senator Beffort asked if there is any plan to recover losses from any of the funds. Mr. Bland responded that other states and other funds are being reviewed to possibly join in a class action lawsuit. Mr. Jacksha added that Austin recently disclosed they used Barring Capital; the signed contract indicated they did not use a placement agent. Representative Bratton asked how Vanderbilt became involved. Mr. Bland said an introduction was made through a third-party marketer on using the process of collateralized debt obligations and collateralized loan obligations.

The committee presented Norton Francis with a letter of recognition for his service as chief economist for LFC.

Ensuring Independence and Expertise on State Investment Committees. Senator Smith said legislation for improving the make up of boards was introduced; however, there was opposition. The executive branch needs to take additional steps to make sure individuals placed on boards have the financial expertise to carry forward. James Lewis, state treasurer, said in looking at alternatives it is very important to not only look at boards, but look at directors, staffing, and financial experience. Chairman Varela said the Board of Finance sets the investment criteria and suggested looking at the board to determine what appointing authority the governor has. Chairman Varela also suggested developing a sustainable deferred plan to supplement another retirement in the future. LFC will work on structuring boards and councils to develop consensus for legislation.

Review of the Supercomputer and the New Mexico Computer Application Center. Aurora Sánchez, information technology program evaluation manager, LFC, provided an update of the supercomputer and the establishment of the New Mexico Computing Application Center (NMCAC). The $16.8 million appropriation has purchased an $11 million supercomputer and paid for contract staff for operations, technical support, an attorney, and maintenance and support. To date, there has been $13.8 million expended or encumbered and $2.5 million set aside for gateways. The $3 million appropriated this year is only for maintenance and support. The supercomputer costs $2.1 million to maintain and support, leaving $800 thousand for other operational costs. Senator Papen asked what would happen in five years when the supercomputer was obsolete. According to Mr. Bowles, NMCAC will seek federal and foundation funding to replace or upgrade it.

The purchase of the supercomputer was pre-selected. Funding was requested during the 2007 legislative session totaling $42 million over five years with first-year funding of $20 million. NMCAC informed LFC staff Silicon Graphics Inc. (SGI) would provide the supercomputer and Intel would provide space to house the supercomputer at no cost. SB827 was signed with an appropriation of $14 million for the first year. The request for proposal (RFP) process was followed from this point forward and committee recommendations were issued, giving SGI the highest rating. The evaluation committee did not evaluate the financial stability of the company even though it was an RFP requirement because, according to the General Services Department, State Purchasing Division, the state does not have the expertise to evaluate financial stability. At the time of the RFP, SGI was emerging from bankruptcy. In April 2009, SGI again filed for bankruptcy, the bankruptcy court has approved Rackable Inc's purchase of SGI. The Attorney General's Office and Department of Information Technology general counsel are following proceedings closely.

The documents supporting the appropriation indicated that in five years NMCAC would be self-sufficient and funding would come from sources other than the general fund. The model was based on federal, foundation, private, and state funding. To date, NMCAC is totally reliant on state general fund revenue. Private sources have brought in $300 thousand. There have been in-kind contributions; however, those could not be validated. Federal and foundation funding has been zero. Use of the supercomputer is free and is being used to 90 percent of its capacity;

65,000 jobs have been run since June 2008. Services appear to be duplicated, contract upper limits have been exceeded, and the attorney has been paid for non-billable services. Currently there is an RFP out for gateways (video conferencing) that supports the Innovative Digital Education and Learning initiative (IDEAL) for 44 sites; however, there are no funds in the current operating budget to support them. Representative Tripp asked if it was cost-efficient to put full gateways at all 44 sites or if videoconferencing equipment would suffice in some locations and who would pay for the required bandwidth. Mr. Bowles said that each site cost $50 thousand to $60 thousand and that bandwidth would be paid using stimulus funds.

NMCAC was incorporated under the University Research Park and Economic Development Act but is not affiliated with any single university as is the practice in research parks throughout the country. It is a nonprofit outside of the university structure. Currently the accounting of revenue and expenditures is complex. The state tracks part of the appropriation and expenditures, the University of New Mexico acts as the flow-through agent for state funding, and NMCAC has a private bank account. NMCAC's 501.3 (c) tax exempt status application was filed in late April with IRS.

Recommendations include revisiting the sustainability model; entering into formal agreements with the research universities, labs, and any other entities providing in-kind services; determining when Intel will stop providing free space; re-evaluating the gateways; establishing a written rate structure; using one accounting system to track all revenue and expenditures; reviewing invoices for the attorney; conducting a full security assessment; and dismantling the program if more revenue is not received.

Tom Bowles, governor's science advisor, reported the center provides a remarkable opportunity and will bring in $14 million external funding to the state this year. The purpose of the center is to grow New Mexico economically. Every public institution of higher education is connected into the supercomputing center. Gateways provide local computer capability along with scientific 3D simulation. External income is ahead of projections, and it is anticipated it will exceed the original funding. NMCAC does not provide 60 percent of the supercomputer to non-paying entities; they only provide what is available.

Marlin Mackey, secretary, Department of Information Technology, provided an explanation for the agency's role. On October 10, 2007, the supercomputer was purchased and is a DoIT asset. From then until June 2008, testing was conducted to make sure the required specifications were met. The equipment is under a maintenance contracts through SGI. On April 10, 2009, the master agreement was established between DoIT and NMCAC. Secretary Mackey and Edmundo Gonzales, NMCAC chief operations officer, acknowledged that the six sub-agreements are being negotiated to address security, maintenance, network connectivity, software licenses, etc.

Mr. Gonzalez reported NMCAC is a separate corporation with a board of directors. The board is the fiduciary agent, and all activities are run by the board. To date, more than 40 agreements, contracts, or memoranda of understanding have been negotiated with 35 are pending. Senator Sapien asked if the board had members with business knowledge. According to Mr. Gonzalez, the subcommittees have members with those skills.

Chairman Varela requested organizational and financial records for the board and its subcommittees. Chairman Varela also requested the state auditor comment on post and non-profit audits. LFC staff will follow-up on his request.

Strategic Plans and Policy Objectives for Higher Education: Update on the Funding Formula and Next Steps. Dan Lopez, chairman, Instruction and General ("I and G") Steering Committee, addressed the funding formula. Recovery of funding for higher education will be requested during the next legislative session. Fundamental issues for funding quality programs have to be addressed and possibly other ways of funding higher education. A cost study is needed to illustrate and demonstrate what it costs to offer a quality program and how New Mexico compares with similar institutions around the country. Work will be done with groups to work on new methodologies for the building renewal and replacement (BR&R) study to obtain cost for particular space. As community colleges move toward workforce development, adequate support is needed. Flexibility to move funds will continue to be requested. Technology also needs to be addressed to further gain efficiencies and eliminate duplication. The mix of courses is not designed for the 21st century and core curriculums may need to be reconsidered.

Peter L. White, secretary designee, Higher Education Department, said he would like to focus on student success. The general education requirements throughout the state constitute 35 hours of old-fashioned educational curriculums, are seen by students as a continuation of high school, delay the time it takes a student to graduate, and costs a tremendous amount of money to implement, while not preparing students for the 21st century. Mr. White said he would like to develop a general education curriculum that resembles the most advanced universities in America to meet the challenges of the future. The curriculum would require four separate courses to be taken at anytime during the four-year academic matriculation: Critical or innovative problem-solving, computation or statistical data analysis, communication, and information analysis or research methodology. Funding for higher education has to be considered to make missions specific; formula funding, based on student credit hours taken, encourages acquisition of students. Mr. White said he would like to work with the governor's office and the taskforce to regain the momentum for the College of Santa Fe, particularly using the higher learning center act approach. Mr. White said he would also like to work with the offices of institutional research in every college and university to form new lists of peer institutions and the Public Education Department to focus on the overall statewide condition of higher education.

Arley Williams, principal analyst, LFC, reported attempts have been made to implement performance funding in New Mexico, and numerous states are advancing efforts to use levers such as performance funding to address policy needs. The "I and G" steering committee was formed to provide high level guidance to the formula task force and to discuss, analyze, and set priorities regarding issues facing the funding of higher education institutions in the state. Four items were identified for a policy agenda in 2009: aligning funding with strategic goals, funding by mission, high-risk students or those students traditionally under-represented in higher education, and workforce development, including nurse education, teacher education, and other occupations.

Chairman Varela said there is concern with the amount of time professors devote to research compared with time spent in the classroom. Mr. Lopez said there cannot be a research university without a major emphasis on research and, without research, there will not be a good teaching university.

May 13, 2009

<u>The following members were present on Monday, May 13:</u> Chairman Luciano "Lucky" Varela, Vice-Chairman John Arthur Smith, Representatives Donald E. Bratton, Rhonda King, Don Tripp, Edward C. Sandoval, Jeanette O. Wallace, Nick L. Salazar, and Brian F. Egolf, Jr. (for Henry "Kiki" Saavedra); and Senators Carlos R. Cisneros, Sue Wilson Beffort, Carroll H. Leavell, John M. Sapien, Mary Kay Papen, Pete Campos, and Steven P. Neville (for Stuart Ingle).

<u>Medicaid Update.</u>

<u>Enrollment and Budget Projections.</u> Pamela Hyde, secretary, Human Services Department, reported on projected Medicaid enrollment, costs, and expenditures. In FY09, Medicaid projections show a $120.1 million general fund reversion to the HB920 fund due to the increased federal medical assistance percentage (FMAP) in the federal stimulus bill. Current projections for FY10 show total expenditures of $3.8 billion, including $620.5 million in general fund revenue. With $591.6 million in general fund revenue available, the Medicaid shortfall in FY10 is about $28.8 million, due in large part to higher enrollment that may continue to increase beyond projected levels. In addition, costs in the Coordination of Long Term Services (CoLTS) program have been increasing. Possible higher FMAP rates could significantly offset the projected shortfall, and cost containment measures are not yet necessary. The secretary provided three years of average per-member per-month cost data for the state's managed care programs.

<u>Federal Medicaid Assistance Percentage (FMAP) Outlook.</u> FY09, FY10, and part of FY11 stimulus funds will replace general fund revenue due to higher FMAP rates from October 1, 2008, through December 31, 2010. If the state's unemployment rate reaches an average of 6 percent for three months before the fourth quarter of FY10, the state will see an increase in its FMAP rate.

<u>Federal Children's Health Insurance Program Reauthorization Act (CHIPRA) Changes and the State Coverage Insurance (SCI) Program.</u> Carolyn Ingram, director, Medical Assistance Division, reported on the Children's Health Insurance Program Reauthorization Act (CHIPRA) and said allotments have gone up; however, if the federal allocations are not used, they will be reduced. New CHIPRA changes in law allows services for children in families with incomes above 133 percent of the poverty level. There are new tools and incentives to enroll more children, new citizen verification options, options to cover legal immigrant children and pregnant women without a waiting period, premium assistance subsidies, and purchasing pools for certain employers.

Because of the changes in CHIPRA law, there is only a short amount of time to make changes to the State Coverage Insurance (SCI) Program to comply with requirements. Childless adults must be moved from the CHIPRA funding stream to regular Medicaid. The department is working on applying for a new waiver to modify the program as well as making adjustments to the benefit packages. Co-pays and premium amount adjustments will be considered to assist with cost-effectiveness. The department is also working with the Health Insurance Alliance (HIA) and the New Mexico Medical Insurance Pool (NMMIP) to coordinate benefits and offer an SCI look-alike program for employees not eligible for SCI.

Reporting Medicaid Cost and Enrollment Data. Director Ingram briefly spoke about healthcare reform and said the most recent proposal standardizes enrollment for all individuals up to 115 percent poverty through an exchange model. One hundred percent federal funding would be used for the financing of the programs phasing out over time requiring states to contribute. Preventive care is also included in the proposal. If the proposal moves forward, changes would occur in the state's SCI program.

The Hilltop Institute at the University of Maryland, Baltimore County (UMBC), provided a study on the Salud program and focused on the quality of and access to care for members with chronic disease as well as adults with diabetes and children with asthma. Claims and encounters were reviewed for the time period between 2005 and 2007 to look at health outcomes. Overall, asthma-related emergency room visits and hospital admissions were reduced. Hospital admissions related to diabetes were also reduced. There was high utilization of primary care and preventive care with a lot of access to primary care services throughout the populations. The department has concerns with health outcomes in overall health care screening for children.

Chairman Varela inquired about issues with the operating budget for FY10. Director Abbey said HB2 makes appropriations for Medicaid to behavioral health, physical managed care, and medical assistance. LFC recommended separating programs; however, the operating budget submitted to DFA consolidated all programs. A meeting has been scheduled to discuss this issue and find a resolution. Secretary Hyde added that splitting the Medicaid program in an appropriation is difficult and the Legislature does not have the authority to separate programs without agreement by DFA. Chairman Varela said he would like a resolution before the beginning of the fiscal year.

Director Abbey reported that staff has discussed the operating budget issue and lack of access to data with Mr. Al Llama, Deputy Attorney General. Mr. Llama suggested voluntarily presenting a confidentiality agreement and offered to review the department's justification for not following the appropriation. In the event agreements can't be reached, Mr. Llama suggested he would be willing to work with LFC staff regarding next steps.

Vice-Chairman Smith moved to have LFC staff pursue ensuring compliance with the operating budget as laid out in HB2 and pursue obtaining data by cohort on Medicaid expenditures and to direct the chairman, the director and staff to pursue legal recourse if compliance can not be reached through cooperative approaches, seconded by Senator Papen. Motion carried.

Survey of Economic Development Initiatives. Susan Fleishmann, program performance analyst, LFC, reported on economic development initiatives and said New Mexico does not have a statewide economic plan or high-level performance measures. Economic development programs and practices appear fragmented, duplicative, or overlapping. Most incentives are not linked to performance, formal incentive agreements and incentive recapture for partial or non-performance are not required, and uniform minimum wage standards for job creation and retention have not been established. A statewide economic development plan would include a variety of high-level performance measures, provide a potential structure for identifying cross-cutting activities, and provide additional information about existing program coordination and effectiveness. Representative Salazar suggested the need for a state planning office. Ms. Fleishmann concurred and said a central agency would be able to coordinate all entities' economic development plans.

2009 Interim Work Plans. Manu Patel, deputy director, LFC, and staff presented the program evaluation work plan for 2009. Vice-Chairman Smith requested that information regarding PED litigation and risk management decisions be provided to the committee as it becomes available.

Representative Tripp said students from rural communities are less suitable to graduate from college due to the preparation they received in school and asked that outcomes be incorporated into the audit report.

Representative King requested school districts be reviewed to determine how resources are allocated, how they are being prioritized, and how professional development is built. Representative King also asked that school bus transportation be addressed.

Cathy Fernandez, deputy director, LFC, presented analysts' work plans for 2009. Staff will continue to monitor and track stimulus funding and state plans and identify inefficient programs recommending cost saving measures or elimination of programs. Staff will also track projects that are a million or greater and explore cost drivers and alternatives as well as investments. Accountability for education remains a high priority for both K-12 and higher education. Cost drivers for health and human services will be also be explored to propose cost cutting efforts.

Economists' work plans include tax policy and tax expenditures. Staff will work on providing a case study highlighting the value of tax expenditures. Staff intends to continue the use of report cards and will present them frequently throughout the summer. Staff also intends to review budget adjustment requests and work with other permanent committees. Vice-Chairman Smith requested staff be aware of the stimulus package authorizing the executive to disperse funds and notify the Chairman if there is an issue so that a letter stating concerns could be submitted. Chairman Varela added that if immediate attention is needed, the department be contacted to address the issue.

With no further business, the Committee adjourned at approximately 11:30 a.m.

L. "Lucky" Varela
Chairman

6/22/09
Date