STATE OF ARIZONA

Joint Legislative Budget Committee

STATE SENATE

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF REPRESENTATIVES

JOINT LEGISLATIVE BUDGET COMMITTEE
Tuesday, November 20, 2007
9:30 a.m.
House Hearing Room 4

MEETING NOTICE

- Call to Order

- Approval of Minutes of October 18, 2007.

- DIRECTOR'S REPORT (if necessary).

1. DEPARTMENT OF ECONOMIC SECURITY - Review of Increase to Division of Developmental Disabilities' Therapy Rates.

2. DEPARTMENT OF REVENUE - Review of General Fund Revenue Enforcement Goals for FY 2008.

3. ARIZONA DEPARTMENT OF ADMINISTRATION
   A. Review of Telecommunications Contractor and Carrier Cost Rate Structure.
   B. Review of Emergency Telecommunication Services Revolving Fund Expenditure Plan.

4. STATE TREASURER - Review of Changes to Management Fees.

The Chairman reserves the right to set the order of the agenda.
11/13/07

People with disabilities may request accommodations such as interpreters, alternative formats, or assistance with physical accessibility. Requests for accommodations must be made with 72 hours prior notice. If you require accommodations, please contact the JLBC Office at (602) 926-5491.

STATE OF ARIZONA

Joint Legislative Budget Committee

STATE
SENATE

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF
REPRESENTATIVES

MINUTES OF THE MEETING

JOINT LEGISLATIVE BUDGET COMMITTEE

October 18, 2007

The Chairman called the meeting to order at 10:25 a.m., Thursday, October 18, 2007, in House Hearing Room 4. The following were present:

Members:	Representative Pearce, Chairman	Senator Burns, Vice-Chairman
	Representative Rios	Senator Aboud
	Representative Yarbrough	Senator Flake
		Senator Garcia
		Senator Harper
		Senator Verschoor
		Senator Waring
Absent:	Representative Adams	Senator Aguirre
	Representative Biggs	
	Representative Boone	
	Representative Cajero Bedford	
	Representative Lopez	

APPROVAL OF MINUTES

Hearing no objections from the members of the Committee to the minutes of September 20, 2007, Chairman Pearce stated that the minutes would be adopted.

DIRECTOR'S REPORT

Mr. Richard Stavneak, Director of the Joint Legislative Budget Committee (JLBC), stated that the Committee is only at quorum for the length of the meeting and that the voting will take place before 12:30 p.m.

In addition, Mr. Stavneak stated that the current report on JLBC and JLBC Staff Statutory Responsibilities is now posted online and allows agencies to be sure they have complied with their action items.

ARIZONA STATE UNIVERSITY - Review of Downtown Phoenix Campus Operational and Capital Plans.

Ms. Leah Ruggieri, JLBC Staff, stated that the FY 2007 Higher Education Budget Reconciliation Bill (Laws 2007, Chapter 265) requires that the Joint Legislative Budget Committee review Arizona State University's

(ASU) operational and capital plans for the ASU Downtown Phoenix Campus (DPC). In considering ASU's request, the Committee has 2 options to consider, a favorable or unfavorable review.

Discussion ensued on this item.

Mr. Steve Miller, Deputy Vice President, Office of Public Affairs, ASU, introduced Rich Stanley, Senior Vice President and University Planner.

Mr. Richard Stanley, Senior Vice President, University Planning, ASU, responded to member questions.

Senator Burns moved that the Committee give a favorable review to Arizona State University's operational and capital plans for the ASU Downtown Phoenix Campus. The motion carried.

DEPARTMENT OF PUBLIC SAFETY - Consider Revision of the Gang and Immigration Intelligence Team Enforcement Mission (GIITEM) Expenditure Plan.

Ms. Kim Cordes-Sween, JLBC Staff, stated that the JLBC Chairman requested that the Committee recommend a revision to the Department of Public Safety's (DPS) GIITEM expenditure plan to increase the Maricopa County allocation by $634,700. Pursuant to a General Appropriation Act footnote (Laws 2007, Chapter 255), $10 million is appropriated for non-DPS law enforcement GIITEM efforts. The Committee is to review any new expenditure plans for these monies. The additional funding would be allocated to the Maricopa County Sheriff's Office (MCSO) to add 5 deputies and purchase 2 vans for transportation of individuals detained for violation of immigration laws. To date, DPS has received a favorable review to use $6.9 million of the FY 2008 GIITEM appropriations for local law enforcement efforts as well as a total of 87 local law enforcement personnel. Of the local GIITEM monies, with the recommended revision, the Maricopa County GIITEM allocation would increase from $1.5 million to $2.2 million. The additional $634,700 funds only 85% of the total project cost while Maricopa County would provide the other 15% as required by Laws 2007, Chapter 255.

Discussion ensued on this item.

Mr. Brian L. Sands, Chief of Enforcement, Maricopa County Sheriff's Office, responded to member questions.

Senator Burns moved that the Committee recommend a revision to the GIITEM expenditure plan to increase the Maricopa County allocation by $634,700. Pursuant to a General Appropriation Act footnote, $10 million is appropriated for non-DPS law enforcement GIITEM efforts. The additional funding would be allocated to the Maricopa County Sheriff's Office to add 5 deputies and purchase 2 vans for transportation of individuals detained for violation of immigration laws. The motion carried.

DEPARTMENT OF PUBLIC SAFETY - Quarterly Review of the Arizona Public Safety Communications Advisory Commission.

Ms. Kim Cordes-Sween, JLBC Staff, stated that pursuant to A.R.S. § 41-1830.42C, the Committee is required to review Department of Public Safety's (DPS) FY 2007 fourth quarter expenditures and progress for the Public Safety Communication Advisory Commission statewide interoperability project. The interoperability project allows first responders in various jurisdictions to communication with each other on the same frequency. Total expenditures for the fourth quarter totaled $524,100 in FY 2007. For the entire fiscal year, DPS expended $1.3 million of the $4.3 million in FY 2007 funding. The JLBC Staff recommended a favorable review of the request.

Senator Burns moved that the Committee give a favorable review to the DPS fourth quarter expenditures and progress for the statewide interoperability project. The motion carried.

DEPARTMENT OF ECONOMIC SECURITY - Review of Increase to Division of Developmental Disabilities' Therapy Rates.

Chairman Pearce stated that this item will not be heard at this meeting as the Department of Economic Security has requested it be pulled from the agenda.

AHCCCS - Review of Proposed Acute Care and ALTCS Capitation Rate Changes.

Ms. Jenna Goad, JLBC Staff, stated that pursuant to a footnote in the General Appropriation Act, the Committee is required to review the Arizona Health Care Cost Containment System (AHCCCS) capitation and fee-for-service inflationary rate changes with a budgetary impact prior to implementation. The proposed rates would cost $9 million more from the General Fund than budgeted in FY 2008, assuming budgeted caseload levels. The JLBC Staff provided several options for the Committee to consider.

Discussion ensued on this item.

Mr. Tom Betlach, Deputy Director of AHCCCS, responded to member questions.

Senator Burns moved that the Committee give a favorable review of the proposed changes. The motion carried.

ATTORNEY GENERAL - Review of Allocation of Settlement Monies

Ms. Leah Ruggieri, JLBC Staff, stated that a footnote in the General Appropriation Act requires the Committee to review settlement monies of $100,000 or more that are not deposited directly into the General Fund before the allocation or expenditure of monies. The Office of the Attorney General (AG) has notified the Committee of the allocation of monies received from the Guidant Corporation consent judgment. The AG will receive $815,000 as a result of the settlement for deposit into the Consumer Fraud Revolving Fund. The actual cost of the litigation is estimated to be no greater than $125,300. The JLBC Staff recommended a favorable review of the allocation plan.

Senator Burns moved that the Committee give a favorable review of the allocation plan from the Guidant Corporation consent judgment. The motion carried.

ADMINISTRATIVE OFFICE OF THE COURTS - Review of Expenditures of Judicial Collection Enhancement Fund and Criminal Justice Enhancement Fund.

Mr. Jon McAvoy, JLBC Staff, stated that pursuant to a footnote in the General Appropriation Act (Laws 2007, Chapter 255), the Committee is required to review an expenditure plan for any monies in excess of the FY 2008 appropriation for the Judicial Collection Enhancement Fund (JCEF) and Case Processing Assistance Fund (CPAF). CPAF is a sub-account of Criminal Justice Enhancement Fund (CJEF). The JLBC Staff provided several options for the Committee to consider.

Senator Burns moved that the Committee give a favorable review to the expenditures of: 1) $2.5 million above the Supreme Court JCEF appropriation and $2.5 million above the CJEF appropriation in FY 2008 to fund a new case and cash management system, and 2) $700,000 above the Superior Court JCEF probation surcharge appropriation in FY 2008 for county Adult Probation officer pay raises. The motion carried.

DEPARTMENT OF REVENUE - Review of Business Reengineering/Integrated Tax System Contract Amendment.

Mr. Bob Hull, JLBC Staff, stated that Laws 2007, Chapter 259 requires Committee review of any BRITS contract extensions or modifications that change the dollar value of the contract. DOR is requesting Committee review of a proposed additional $4 million contract amendment which includes $288,000 for 4 enhancements to individual income tax, and $3.7 million for vendor operational support of implemented BRITS systems through June 2008. The Committee has 2 options to consider, a favorable or unfavorable review.

Discussion ensued on this item.

Ms. Kristine Ward, Deputy Director, Department of Revenue, responded to member questions.

Senator Burns moved that the Committee give a favorable review to the proposed $4 million contract amendment. The motion carried.

ARIZONA COMMISSION ON THE ARTS - Review of the Arizona Arts Endowment Fund and Private Contributions.

Ms. Caitlin Acker, JLBC Staff, stated that pursuant to A.R.S. § 41-986F, the Committee is required to review the report on private monies that are donated for use in conjunction with public monies from the Arizona Arts Endowment Fund. Each year the Committee reviews what the commission receives in private donations in conjunction with public monies from the AZ Arts Endowment Fund. In CY 2006 the Commission generated $4.9 million in private donations. The JLBC Staff recommended a favorable review of the request because the commission increased private donations in CY 2006 over CY 2005.

Mr. Richard Stavneak, JLBC Director, stated that the Committee only needs to formally review the contribution level at this time. The Arts Endowment is now fully funded through private contributions, therefore, the statutory change to delete future reviews can be decided upon during session.

Senator Burns moved that the Committee give a favorable review to the report. The motion carried.

ARIZONA DEPARTMENT OF ADMINISTRATION

A) Review of Risk Management Deductible.

Mr. Dan Hunting, JLBC Staff, stated that A.R.S. § 41-621 provides that the Arizona Department of Administration (ADOA) Director may impose deductibles of up to $10,000 per risk management loss on state agencies. These amounts are subject to annual review by the Committee. The JLBC Staff recommends a favorable review because $10,000 is the maximum amount allowed by law.

Discussion ensued on this item.

Ray Di Ciccio, Risk Manager, ADOA, responded to member questions.

Senator Burns moved that the Committee give a favorable review of the $10,000 deductible amount. The motion carried.

B) Rule 14(3)(P) - Report on Loss Prevention Plans.

Mr. Dan Hunting, JLBC Staff, presented revisions to the format of the loss prevention plans required under Rule 14 of the Joint Legislative Budget Committee Rules and Regulations.

This item was for information only and no Committee action was required.

JLBC STAFF - Consider Approval of Index for School Facilities Board Construction Costs.

Ms. Leatta McLaughlin, JLBC Staff, stated that A.R.S. § 15-2041D.3c requires that the cost-per-square-foot factors used in the School Facilities Board (SFB) building renewal and new school construction financing "shall be adjusted annually for construction market considerations based on an index identified or developed by the Joint Legislative Budget Committee (JLBC) as necessary but not less than once each year." The Committee has at least the following 2 options to consider:

1) Approve a 5.53% increase in the cost-per-square-foot factors as requested by School Facilities Board Staff and based on the Committee's 2006 methodology. This is an average of the PinnacleOne and Ryder indices.

2) Approve the PinnacleOne option of 2.2% or Rider Index option of 8.9%. PinnacleOne is a Phoenix project management firm and Rider is an international construction consulting group.

Discussion ensued on this item.

Mr. John Arnold, Executive Director, School Facilities Board, distributed *Attachment A* and responded to member questions.

Attachment B was distributed to the Committee on the School Facilities Coalition by Connie Erikson, Principal in the Vail School District in Tucson.

Several members of the public also spoke.

Senator Burns moved that the Committee approve a 2.2% increase in the cost-per-square-foot factors based on the PinnacleOne Index. The motion carried.

EXECUTIVE SESSION - Arizona Department of Administration - Risk Management Annual Report.

Senator Burns moved that the Committee go into Executive Session. The motion carried.

At 12:28 p.m. the Joint Legislative Budget Committee went into Executive Session.

Senator Burns *moved that the Committee reconvene into open session*. The motion carried.

At 12:30 p.m. the Committee reconvened into open session.

This item was for information only and no Committee action was required.

Without objection, the meeting adjourned at 12:30 p.m.

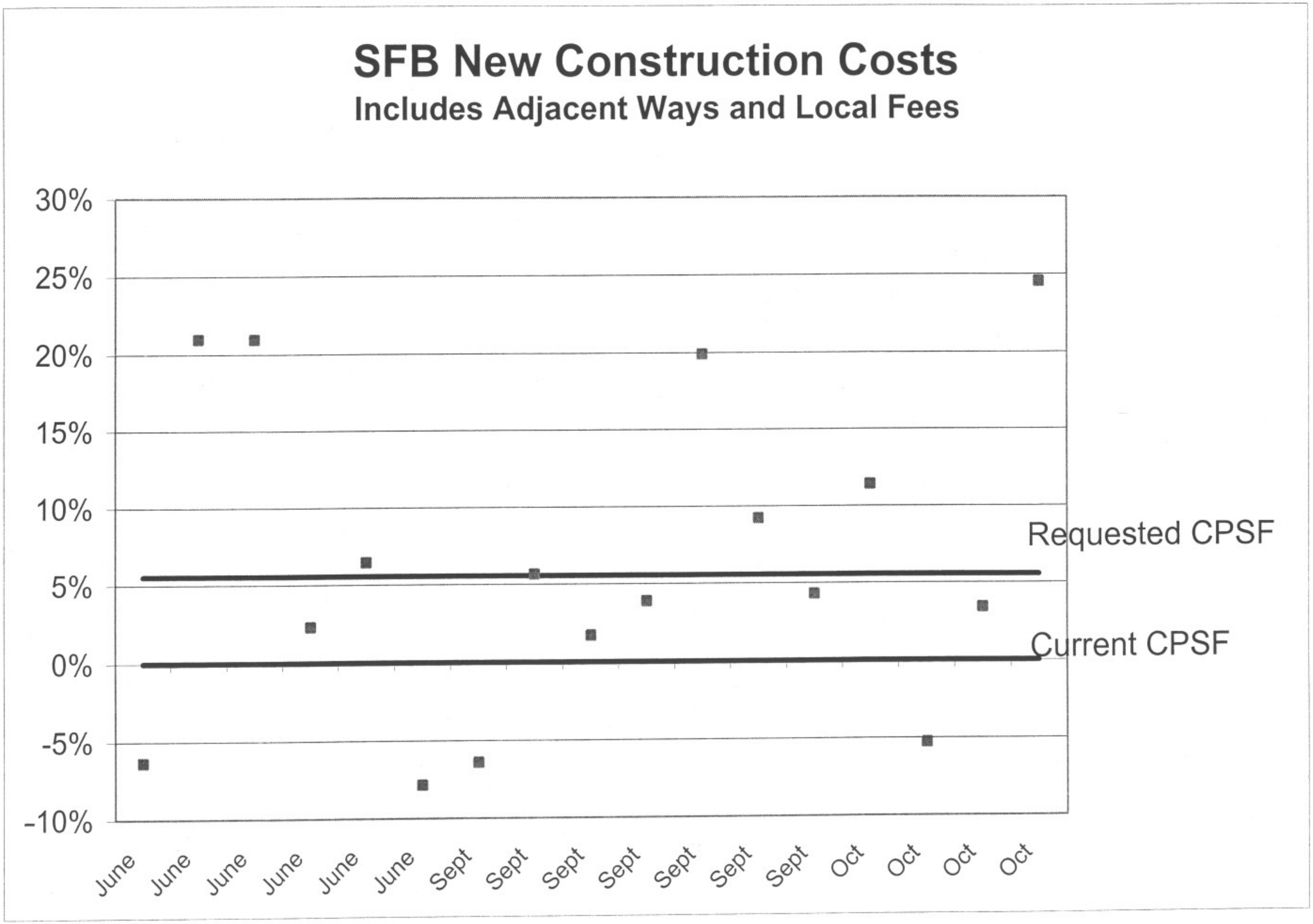
Respectfully submitted:

Sandy Schumacher, Secretary

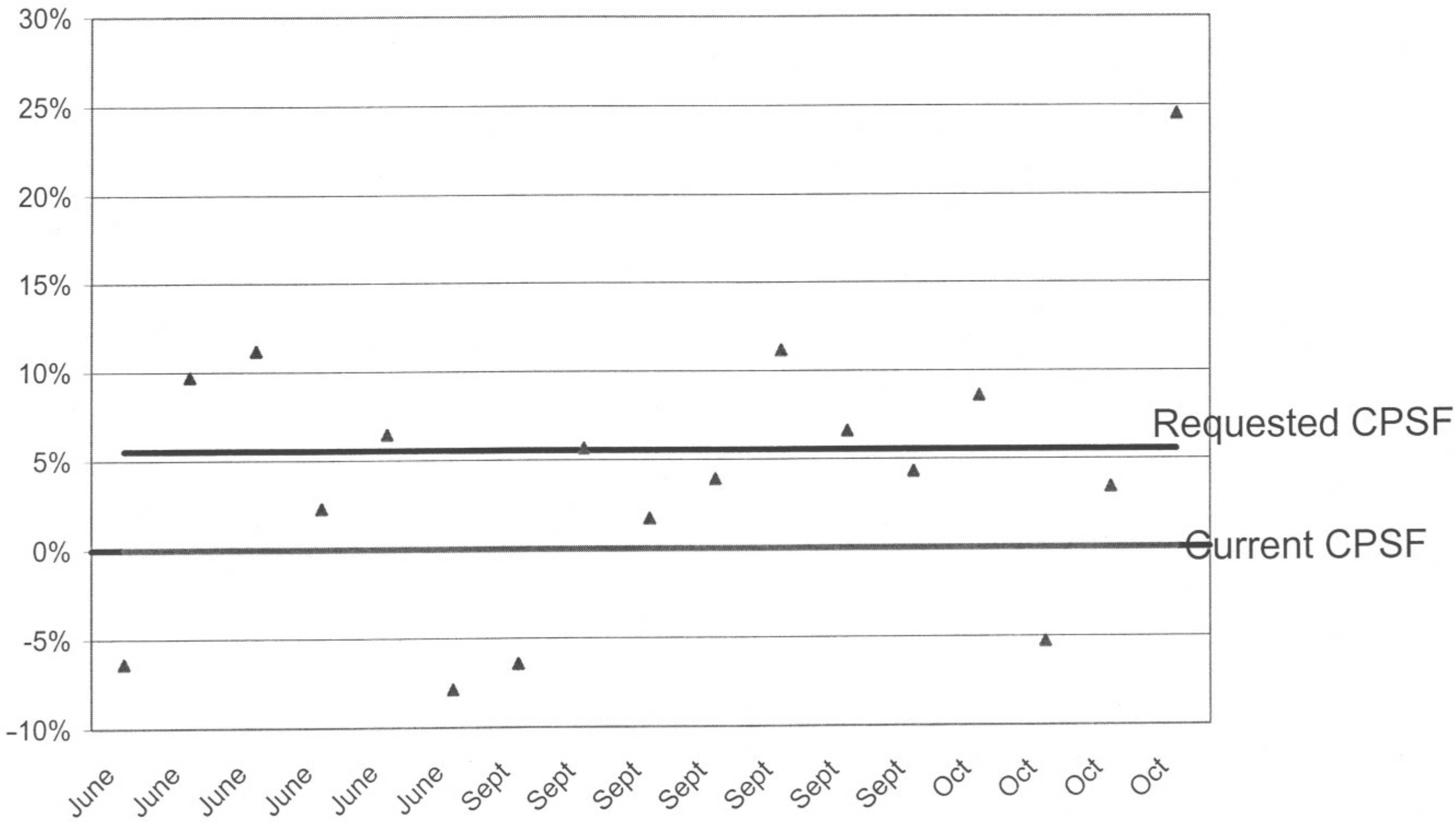
Richard Stavneak, Director

Representative Russell Pearce, Chairman

NOTE: A full audio recording of this meeting is available at the JLBC Staff Office, 1716 W. Adams. A full video recording of this meeting is available at http://www.azleg.gov/jlbc/meeting.htm.


SFB New Construction Costs
Includes Adjacent Ways and Local Fees
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
Requested CPSF
Current CPSF
June
June
June
June
June
June
Sept
Sept
Sept
Sept
Sept
Sept
Sept
Oct
Oct
Oct
Oct

SFB Cost Per Sq. Foot
Minus Adjacent Ways and Local Fees



Arizona Builders' Alliance
"Building Excellence"

CEFPI
The School Building Association

ASA

ACEC

SCHOOL FACILITIES COALITION

As professionals in the industry, we support educational excellence.
The effect of the built environment is critical to student achievement.
Adequately funded schools are essential in meeting the needs of students, instructors and Arizona's demand for quality education.

Who We Are:
The School Facilities Coalition is comprised of the statewide component of the American Institute of Architects, Arizona Builders Alliance, Council of Educational Facility Planners International, Arizona State School Superintendents and the American Council of Engineering Companies of Arizona.

Why We Are Here:
The current funding levels and adjustments for the construction of new schools provided through the Arizona School Facilities Board (SFB) have not kept pace with the construction market.

Specific Concerns:

- Current funding does not follow the formula-based system.
- Current funding is significantly below what is needed to provide educational space with a construction quality necessary for operational maintenance and long-term utilization of the facilities.
- Current funding is not providing the environment proven to support the learning process and the energy efficiency the State of Arizona mandates.

Background Information:
The SFB project budget for a K-8 Elementary School in an urban area is currently $132.85/SF. This is Total Project Budget **NOT** the Construction Cost Budget. To arrive at the Construction Cost Budget the following costs must be subtracted:

- telephone and data design consultant, kitchen design consultant, all furniture, fixtures and equipment, computers, survey, permits, construction testing, plan review fees, construction advertising, architecture and engineering fees plus civil engineering and landscape architecture fees, special inspection/material testing fees, CM@Risk fee, reimbursable expenses, and geotechnical report. These costs amount to approximately $22.59/SF.

The Actual Construction Cost Budget for an Arizona School Facilities Board funded K-8 Elementary School, in an urban area in Arizona is: **$132.85 less $22.59/SF (17%) or $110.26/SF.** (For comparison, a sampling of SFB minimum standard funded K-8 Elementary schools and their Actual Construction Cost per square foot is provided on the back of this document.)

Recommendation:
The current SFB funding formula must be increased to align with the actual cost of construction, of **$128.00/SF or a 16%** increase (does not include 6.5% for construction inflation) to the current funding formula, good until November 2007.

May 3, 2007

A comparison of SFB minimum standard funded K-8 Elementary schools and their Actual Construction Cost per square foot.

District / School Type	Size S.F.	Date Funded	SFB Formula per Sq. Foot	SFB Funded Project Cost per Sq. Foot	SFB Funded Construction Cost per Sq. Foot	Actual Construction Cost per Sq. Foot	Remarks
Littleton Elementary District - K-8	89,813	01/04/07	$104.92	$126.52	**$105.00**	**$ 130.64**	Littleton ESD added funding for sidewalks, landscaping/irrigation, stage curtain and data cabling.
Buckeye Elementary District - K-8	73,920	01/04/07	$118.40	$134.81	**$111.90**	**$ 133.55**	Buckeye ESD added funding for carpet, landscaping, sidewalks, canopies, fencing, athletic equipment, site lighting and bleachers.
Wickenburg Unified District - K-8	73,920	12/07/06	$132.85	$139.95	**$116.15**	**$ 128.07**	Wickenburg USD added $855,000 of District funding.
Dysart Unified District - K-8	101,640	12/07/06	$118.40	$118.40	**$ 98.27**	**$ 124.73**	Dysart USD added funding for stage curtain, operable walls, fencing, cabinets, canopies, built-up roof upgrade, and acoustic wall panels.
Coolidge Unified District - K-8	73,920	10/05/06	$118.40	$132.28	**$109.80**	**$ 123.32**	Coolidge USD added funding for floor coverings, landscaping, additional parking, cabinets, fencing and operable walls.
Higley Unified District - K-8	94,710	10/05/06	$118.40	$127.44	**$105.77**	**$ 126.36**	Higley USD added funding for classroom sinks, canopies at entrances, acoustic panels, tot turf and play equipment, fencing, landscaping and parking lot lighting.
Average					**$107.81**	**$127.78**	

The Actual Construction Cost Budget for an Arizona School Facilities Board funded K-8 Elementary School, in an urban area in Arizona is: $132.85 less $22.59/SF (17%) or $110.26/SF.

Summary
The School Facilities Coalition recommends that the current SFB funding formula be increased to align with the actual cost of construction, of **$128.00/SF or a 16%** increase (does not include 6.5% for construction inflation) to the current funding formula, good until November 2007.

May 3, 2007

STATE OF ARIZONA

Joint Legislative Budget Committee

STATE
SENATE

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF
REPRESENTATIVES

DATE: November 13, 2007

TO: Representative Russell Pearce, Chairman
Members, Joint Legislative Budget Committee

THRU: Richard Stavneak, Director

FROM: Jay Chilton, Fiscal Analyst

SUBJECT: Department of Economic Security – Review of Increase to Division of Developmental Disabilities' Therapy Rates

Request

Pursuant to a footnote in the FY 2008 General Appropriation Act (Laws 2007, Chapter 255), the Department of Economic Security (DES) requests that the Committee review an increase to the Division of Developmental Disabilities' (DDD) therapy rates. This request was originally placed on the October meeting agenda but was withdrawn at the agency's request. This memo is unchanged, except for technical updates, from the original October memo.

Recommendation

The Committee has at least the following 2 options:

1. A favorable review as DES has said that it has sufficient funds in its current year budget to fund this increase.
2. An unfavorable review of the request as implementation of the higher rates precludes the use of these funds as an option to reduce the state's budget shortfall.

DES estimates that the increase will have an estimated General Fund impact of $800,000 in FY 2008. The estimated annualized cost of the increased rates is $1.6 million from the General Fund.

Analysis

In a September 2005 performance audit, the Office of the Auditor General reported that therapy services are the greatest unmet service need of individuals with developmental disabilities. This includes occupation, physical, and speech therapy. The report noted that one of the reasons for the lack of therapy service availability is that reimbursement rates are not adequate. In an effort to address this issue, DES

(Continued)

contracted with an independent consultant to evaluate the rates paid to occupational, physical, and speech therapists. The proposed new rates will be effective beginning January 1, 2008.

Reimbursement will vary according to a client's location. Previously, rates paid for services provided in natural settings (such as in the client's home) varied according to the distance traveled by the therapist. Under the new rate structure, the state is divided into 4 reimbursement tiers, with rates increasing as client density decreases. DES expects that the new reimbursement rates will encourage more providers to participate and will increase the availability of service, thus increasing the total number of clients served. DES estimates that in FY 2008 it would otherwise provide 326,000 units of therapy service. DES believes that the adjusted therapy rates will enable an additional 14,000 units of service, for an FY 2008 total of 340,000. A unit of service is 1 therapy or evaluation session. DES does not track the number of individual clients receiving therapy services.

Concerns regarding the new rates have been raised by some providers, as the rates may impact the ability of providers to provide services to clients in rural areas. In-home services rates vary depending on the distance that the provider travels, while the new rates will provide a fixed rate depending on the tier in which the client lives. This may reduce the total reimbursement for therapists traveling from the urban areas of Phoenix and Tucson to outlying urban fringe and rural areas, where there may be no local providers. The reduced reimbursement may discourage therapists from being willing to provide services in such areas. The higher rates in rural areas may encourage therapists in those areas, however, to provide services if they have not previously.

DES acknowledges that therapists who drive significant distances to provide services will see decreases in rates, but states that the new methodology is designed to increase the capacity to provide therapy services locally in the more rural areas of the state. Therapists who provide services in natural environments near their homes or offices in rural areas will see the greatest increase in their rates.

The department estimates that the rate increase will have a $1.6 million General Fund ($2.7 million Total Funds) annual impact, which reflects both the increased rates as well as the anticipated increase in the number of clients served. The new rates will be effective beginning January 1, 2008, resulting in a 6-month FY 2008 cost of approximately $806,500 from the General Fund. The FY 2008 General Fund cost to the state-only program will be about $525,000 and the General Fund cost to the Arizona Long-Term Care System (ALTCS) will be about $281,500. The state-only portion will be funded from a surplus within the existing General Fund appropriation for the state-only Home and Community Based Services Special Line Item. The department anticipates that the increase to the ALTCS program will be covered by the FY 2008 capitation rate.

RS/JC:ss

ARIZONA DEPARTMENT OF ECONOMIC SECURITY
1717 W. Jefferson - P.O. Box 6123 - Phoenix, AZ 85005

Janet Napolitano
Governor

Tracy L. Wareing
Director

SEP 14 2007

RECEIVED
SEP 17 2007
JOINT BUDGET COMMITTEE

Mr. Richard Stavneak
Director, Joint Legislative Budget Committee
1716 West Adams
Phoenix, Arizona 85007

Dear Mr. Stavneak:

Pursuant to a footnote in Laws 2007, Chapter 255, Section 28, the Department of Economic Security requests review of an increase to the Division of Developmental Disabilities' therapy rates.

> Prior to the implementation of any developmentally disabled or long term care statewide provider rate increases not already specifically authorized by the legislature, court mandates or changes to federal law, the department shall submit a report for review by the joint legislative budget committee. The report shall include, at a minimum, the estimated cost of the provider rate increase and the ongoing source of funding for the increase.

In a September 2005 performance audit (Report No. 05-07), the Auditor General noted that therapy services are the greatest unmet need of individuals with developmental disabilities. The audit also noted that reimbursement rates are one of the primary issues causing the lack of service availability. Partly to address this finding, the Department contracted with an independent consultant to evaluate the rates paid to occupational, physical, and speech therapists. These rates were then released for public comment. Many of the comments were incorporated in the revised rates. The table below illustrates the resulting rates, which will be effective beginning November 1, 2007.

	Clinical Setting		Natural Setting	
	Therapy	Evaluation	Therapy	Evaluation
Base	$62.80	$172.56	$77.94	$192.98
Tier 1	$63.27	$172.56	$85.73	$192.98
Tier 2	$71.90	$172.56	$97.43	$192.98
Tier 3	$86.28	$172.56	$116.91	$192.98

Reimbursement will vary according to the client's geographic location. To incentivize the provision of services to clients in more rural areas, the state has been divided into four reimbursement tiers. Rates increase as client density decreases. Previously, rates paid for services provided in natural settings varied according to the distance traveled by the therapist. As a result, the new and old rates are not directly comparable. The $57.52 benchmark rate for clinic-based services in the 'base' areas is less than the current adopted rates for these services. As displayed in the preceding table, the Department will hold these providers harmless and continue paying $62.80 per hour until the benchmark exceeds this amount. Since the clinic-based rate is currently the same regardless of the location in the state, clinic-based providers in each of the three tiers will experience rate increases.

Overall, the Department estimates that this rate increase will have a $2.7 million annual impact, including the projected increase in the number of units of services delivered as more therapists become available to provide services to individuals currently on a waiting list. The new rates will not become effective until November 1, 2007; therefore, the nine-month cost in fiscal year 2008 will be $1.8 million. The cost to the state-only program will be approximately $700,000 and the cost to the Arizona Long Term Care System (ALTCS) will be about $1.1 million. The increases will be funded from the existing appropriations made for home and community-based services (HCBS). In fiscal year 2007, the state-only HCBS appropriation had a General Fund surplus that was transferred to resolve a shortfall in the ALTCS program resulting from an under-funding of the capitation rate. These funds will be adequate to support the cost of this rate increase to the state-only program. The fiscal year 2008 capitation rate for the ALTCS program should be adequate to fund the cost of the increase to that program.

Please contact Stephen Pawlowski, Financial Services Administrator, at (602) 542-3786 if you have any questions.

Sincerely,

Tracy L. Wareing

Tracy L. Wareing
Director

cc: Members of the Joint Legislative Budget Committee
James Apperson, Director, Governor's Office of Strategic Planning and Budgeting

ARIZONA DEPARTMENT OF ECONOMIC SECURITY
1717 W. Jefferson - P.O. Box 6123 - Phoenix, AZ 85005

Janet Napolitano
Governor

Tracy L. Wareing
Director

OCT 17 2007

RECEIVED
OCT 17 2007
JOINT BUDGET COMMITTEE

Mr. Richard Stavneak
Director, Joint Legislative Budget Committee
1716 West Adams
Phoenix, Arizona 85007

Dear Mr. Stavneak:

Pursuant to a footnote in Laws 2007, Chapter 255, Section 28, the Department of Economic Security (DES) requested on September 14, 2007, a review by the Joint Legislative Budget Committee (JLBC) of an increase to the Division of Developmental Disabilities' therapy rates.

A 2005 Auditor General finding noted that therapy services are the greatest unmet need of individuals with developmental disabilities and that reimbursement rates are a primary issue causing the lack of service availability. The Department contracted with an independent consultant to evaluate the rates paid to occupational, physical, and speech therapists. The preliminary rate information resulting from this study was released for public comment; many of the comments received were incorporated into the proposed rates.

Current rates work on a mileage system, with increased rates for the number of miles that providers drive to see clients regardless of where the client lives. This has helped with the availability of therapies in some areas of the state, but has neither assisted with the development of local capacity or resources nor increased the total capacity of therapy services in the state. Many clients and families are still waiting for needed services. The new rate structure seeks to build capacity by establishing a geography, rather than mileage, based reimbursement schedule. Providers delivering services in the rural areas of the state will receive the highest rate under the new model. Additionally, the new model will end disincentives associated with providers actually located in rural areas. Under the current model, rates are based on distance traveled so providers receive higher rates if they drive a long distance and actually see their rates substantially reduced if they are located in those areas. In addition, by reducing the incentive for time spent traveling long distances, therapy providers should be available to deliver more services.

The review of the therapy rates was placed on the Joint Legislative Budget Committee agenda for October 18, 2007. The Department is requesting that this review be removed from the October agenda and placed on the November agenda so that DES may further engage families and providers as to how the new rate structure will address the concerns with the current rate structure, as well as to further assist providers with transition planning as requested and needed. Although approximately 80 percent of all therapy providers will experience a net increase in revenues under the new rate structure, some families and therapists are concerned with potential impacts of the rate changes. The requested delay will allow additional opportunity for outreach and discussion.

Please contact Stephen Pawlowski, Financial Services Administrator, at (602) 542-3786 if you have any questions.

Sincerely,

Tracy L. Wareing

Tracy L. Wareing
Director

cc: Members of the Joint Legislative Budget Committee
James Apperson, Director, Governor's Office of Strategic Planning and Budgeting

Michael Brune
885 W. Northern Avenue
Coolidge, AZ 85228
telephone 520-723-7669
fax 520-723-5580
e-mail brune@cgmailbox.com

November 7, 2007

Barbara Brent, Assistant Director
Arizona Division of Developmental Disabilities
Site code 791A
P.O. Box 6123
Phoenix, AZ 85005

Dear Ms. Brent,

Thank you for your letter of November 1 on therapists' rate changes. My understanding of the rate change, having been informed of the issues earlier and having read your letter, is this: Under the current mileage system, therapists who drive to rural clients are paid more simply for driving, and the remunerated driving time detracts from their time in actually providing professional services. This encourages therapists who reside in the cities to continue to live in the cities and avoid locating in the rural areas they serve. Now everybody's pay, urban and rural alike, would be based more on delivery of services, and much less on travel. Mileage would be eliminated but apparently the higher the "tier" of remoteness of the client and difficulty in reaching the client, the higher the base rate. The new rates would induce therapists to locate in the rural areas by raising the base rate for service in rural areas.

The rates I saw for the new plan would result in more pay for urban therapy, and less pay for rural therapy, compared to the present rate structure. The 80% of therapists who you say will see an increase are likely those who live in the cities and serve clients in the cities. I do not see how this plan will comply with the federal requirements which I cited in my letter of October 11 (20 U.S.C. §§ 1431-1445).

The problem, I believe, runs deeper than mileage pay. As you indicated, therapists are in short supply all over. There is plenty demand for their services in the cities. A therapist can make a good living working in the city at city rates. And most professionals, most people in general, prefer to live in the cities. Cities offer more attractions, opportunities, choices, and convenience in employment, housing, education, health care, shopping, entertainment, social activities, etc. For example, there are 562 M.D. psychiatrists with offices in Maricopa and Pima Counties. In Pinal and Gila Counties there are seven, four of them in Apache Junction at the eastern edge of the Phoenix metro area. (Three counties have none.) The Early Intervention program in Casa Grande has found it very difficult to find professional staff in the area with the proper educational credentials. I could give plenty more examples, but you know the problem.

The current rate structure has its problems. But the incentives in the new plan, such as they are, will not overcome the law of supply and demand and the attractions of city life. Therapists who live in the cities will lose money serving rural clients. So long as there is plenty work in the cities, not many therapists will settle in rural communities; not nearly enough. It won't work. And the clients in rural areas will suffer.

Yours truly,

Michael J. Brune

Michael J. Brune

xc: District V/VIII HRC, JLBC members, Joe Priniski, Peggy Lopez, Al Nieto

STATE OF ARIZONA

Joint Legislative Budget Committee

STATE SENATE

ROBERT L. BURNS, CHAIRMAN 2008
PAULA ABOUD
AMANDA AGUIRRE
JAKE FLAKE
JORGE LUIS GARCIA
JACK W. HARPER
THAYER VERSCHOOR
JIM WARING

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF REPRESENTATIVES

RUSSELL K. PEARCE, CHAIRMAN 2007
KIRK ADAMS
ANDY BIGGS
TOM BOONE
OLIVIA CAJERO BEDFORD
LINDA J. LOPEZ
PETE RIOS
STEVE YARBROUGH

DATE: November 13, 2007

TO: Representative Russell Pearce, Chairman
Members, Joint Legislative Budget Committee

THRU: Richard Stavneak, Director

FROM: Bob Hull, Principal Research/Fiscal Analyst

SUBJECT: Department of Revenue - Review of General Fund Revenue Enforcement Goals for FY 2008

Request

Pursuant to a General Appropriation Act footnote, the Department of Revenue (DOR) requests review of its General Fund revenue enforcement goals for FY 2008. DOR is required to report by July 31, 2007 on their goals, and to provide quarterly progress reports to the Committee as to the effectiveness of the department's overall enforcement and collections program within 30 days after the end of each calendar quarter.

Summary

DOR's overall General Fund revenue enforcement goal for FY 2008 is $369.8 million, which is $36.4 million, or 10.9%, above their FY 2007 goal of $333.4 million. However, the $369.8 million goal for FY 2008 is $(57.2) million, or (13.4)%, below their FY 2007 actual General Fund revenue enforcement collections of $427.0 million. DOR notes that they may adjust their FY 2008 goal, if they receive any mid-year budget reductions.

DOR's revenue enforcement goal consists of audit revenue, collections revenue, and accounts receivable. Compared to actual FY 2007 General Fund enforcement revenue, DOR is projecting:

- A major decrease in <u>audit</u> revenue of $(60.7) million in FY 2008, due primarily to DOR's belief that a substantial amount of its corporate income tax and licensing activity in FY 2007 was one-time.

- A slight increase in <u>collections</u> activity and a small decline in <u>accounts receivables</u>.

(Continued)

Recommendation

The Committee has at least the following 2 options:

1) A favorable review since, as required, the report provides information on DOR's General Fund revenue enforcement goals for FY 2008. DOR's overall General Fund revenue enforcement goal for FY 2008 is $369.8 million, which is $36.4 million, or 10.9%, above their FY 2007 goal of $333.4 million.

2) An unfavorable review, since DOR's overall General Fund revenue enforcement goal of $369.8 million for FY 2008 is $(57.2) million, or (13.4)%, below their FY 2007 actual General Fund revenue enforcement collections of $427 million.

Under either option, JLBC Staff recommends that DOR continue to report license compliance and transaction privilege tax as separate items for FY 2009, since each program produces a significant dollar amount of audit revenue.

Analysis

A footnote in the General Appropriation Act requires DOR to provide the department's General Fund revenue enforcement goals for FY 2008 for Committee review by July 31, 2007. The table below compares DOR's General Fund revenue enforcement goals for FY 2008 to their goals and results for FY 2007. The 3 main categories of enforcement revenue are audit, collections, and accounts receivable. Audit enforcement revenue includes revenue due to DOR's auditing of taxpayer returns, and finding and licensing unlicensed businesses. Accounts receivable revenue includes taxpayer accounts paid before they would have been moved to collections, which allows DOR's collectors to work on other accounts. After certain periods of time, unpaid taxpayer accounts are moved from accounts receivable to DOR's Collections Section. DOR explains the major changes in FY 2008 goals as follows:

Audit:
DOR's FY 2008 goal for audit revenue is $94.9 million, which is $13.2 million, or 16.1%, above their FY 2007 goal. The FY 2008 goal, however, is $(60.7) million, or (39)%, below their FY 2007 actual audit revenue of $155.7 million. DOR attributes the large increase in FY 2007 audit revenue to the one-time discovery of several large non-taxpaying businesses by both corporate audit's nexus program and by license compliance. DOR does not expect to repeat these large one-time findings in FY 2008. The nexus program is the part of corporate income tax audit which locates out-of-state businesses with an Arizona business presence who are not paying Arizona corporate income tax. The License Compliance Program is the part of transaction privilege tax audit which finds unlicensed businesses and brings them into compliance.

DOR currently reports on the nexus program separate from the rest of corporate income tax, and the License Compliance Program separate from the rest of transaction privilege tax, since each program produces a significant dollar amount of audit revenue. DOR has requested that next year license compliance and transaction privilege tax be combined into one revenue line for their FY 2009 goal. JLBC Staff believes that DOR should continue to report license compliance and transaction privilege tax as separate items for FY 2009, since each program produces a significant dollar amount of audit revenue.

On the negative side, DOR projects decreases in FY 2008 audit revenue for transaction privilege tax and individual income tax. DOR projects a decrease in transaction privilege tax audit revenue due to a hiring freeze in the Audit Division which began in FY 2007 to pay for $1.7 million for annual software licensing fees for their new BRITS computer system. DOR estimates a decrease in individual income tax audit

(Continued)

revenue due to anticipated disruptions from implementing BRITS individual income tax system in December 2007 and BRITS audit case management system in April 2008.

Collections:
DOR's FY 2008 goal for collections revenue is $212.1 million, which is $13.9 million, or 7%, above their FY 2007 goal and $8.9 million, or 4.4%, above their FY 2007 actual collections revenue.

Accounts Receivable:
DOR's FY 2008 goal for accounts receivable revenue is $62.7 million, which is $9.2 million, or 17.3%, above their FY 2007 goal, but $(5.4) million, or (8)%, below their FY 2007 actual accounts receivable revenue. DOR is uncertain as to the reason for the large increase in accounts receivable in FY 2007, and does not expect such a large increase in FY 2008.

DOR's General Fund Enforcement Revenue Goals in FY 2008 Compared to FY 2007 (Net of Duplications)

	FY 2007 Goals	FY 2007 Actual	FY 2008 Goals
Audit Division			
Corporate Tax	$39,129,100	$69,113,800	$26,681,400
Nexus [1/]	--	--	16,038,000
Individual Tax	12,855,600	11,246,700	6,737,200
Transaction Privilege Tax	15,392,400	17,068,300	12,835,200
Luxury Tax	594,000	195,600	594,000
Discovery [2/]	1,782,000	2,865,200	1,900,800
License Compliance	12,015,000	55,171,400	30,149,900
Subtotal Audit	$81,768,100	$155,661,000	$94,936,500
Collections	198,206,200	203,188,700	212,127,500
Accounts Receivable [3/]	53,469,600	68,144,500	62,699,300
Total	**$333,443,900**	**$426,994,200**	**$369,763,300**

1/ DOR did not report separately on this item in FY 2007. The nexus program is the part of corporate audit which locates out-of-state businesses with an Arizona business presence who are not paying Arizona corporate income taxes.
2/ Discovery revenue is DOR's term for additional revenue attributed to BRITS, which can be traced to specific taxpayers.
3/ Taxpayer accounts paid before they would have been moved to collections, which allows collectors to work on other accounts.

DOR states that mid-year budget reductions may impact these goals, "if implementing any budget reduction exceeds the capacity of the Department's non-revenue generating areas."

RS/BH:ym

STATE OF ARIZONA
Department of Revenue
Office of the Director
(602) 716-6090

Janet Napolitano
Governor

Gale Garriott
Director

October 12, 2007

RECEIVED
OCT 12 2007
JOINT BUDGET COMMITTEE

The Honorable Russell Pearce
Chairman - Joint Legislative Budget Committee
1700 West Washington
Phoenix, Arizona 85007

Dear Representative Pearce:

Re: Department of Revenue FY 2008 Enforcement Revenue Goal

The Department of Revenue's FY 2007 Enforcement Program was projected to generate \$461,036,318. After a very successful but somewhat surprising year, the Enforcement Program brought in \$583,700,957, or 126.6% of (\$122.6 million above) the annual objective. This success can be primarily attributed to:

- The License Compliance unit brought in over \$79 million – far exceeding any previous year's total. Prior to FY 2007, the License Compliance unit never brought in more than \$33 million. In fact, the five year average for License Compliance is just short of \$27 million (\$32.1 million for FY 2006, \$31.5 million for FY 2005, \$28.7 million for FY 2004, \$20.8 million for FY 2003, and \$21.6 million for FY 2002).

  To understand this discrepancy better, some background information may be helpful. Through a variety of methods, the License Compliance unit discovers unlicensed businesses that are engaged in taxable activities. The unit then brings these businesses into compliance and receives credit for the Transaction Privilege Taxes (TPT) that otherwise would have gone uncollected. Unlike prior years, in FY 2007 these efforts resulted in the licensing of many large taxpayers whose monthly sales were generating taxes due of \$500,000 or more.

  Discovering this level of unreported TPT activity was totally unexpected, and the Department does not believe it is realistic to expect that the same volume of such large accounts will be discovered on an annual basis.

- The Nexus unit collected over \$30.0 million above its target – another unexpected occurrence. The Nexus unit is part of the Corporate Audit Section and its purpose is to locate out of state businesses that have an Arizona business presence but are not paying Arizona corporate income taxes. As with License Compliance, Nexus benefited from the discovery of several large businesses which were enjoying solid corporate earnings. Identifying so many large accounts was entirely unexpected and, therefore, we cannot assume that what happened in FY 2007 will repeat itself in FY 2008.

- For the first three quarters of FY 2007 Accounts Receivable was tracking very close to target, but in the final months of FY 2007 an extra \$21.1 million was generated. While it is difficult to attribute this increase to any single event, it is believed that the majority of the additional revenue was generated from an increase in the number of taxpayers who owed taxes and filed their income tax returns prior to April 17th, but did not pay their owed taxes until April 17th, or shortly after April 17th. Although prior fiscal years typically produced an increase in 4th quarter collections, the magnitude of the increase in FY 2007 was substantially above the norm and was impossible to predict.

Based on a three year average, the Department is increasing the Accounts Receivable target, but with a slowing of the economy it is difficult to envision the 4th quarter spike that occurred in FY 2007 repeating in FY 2008.

The Department believes it can continue to increase revenue objectives in the following areas:

- Increase the Collection's effort by $20 million to over $300 million;
- Increase the combined Corporate Audit and Nexus estimate by $14.5 million to $53.6 million;
- Increase License Compliance by $26 million to over $43 million;
- Increase Accounts Receivable by $13 million to $90 million.

The Department needs to lower expectations for two areas:

- The Department is reducing Individual Income Audit section's FY 2008 objective by $6 million. It is estimated that Individual Income Audit production will be at 50% for a period of 6 months or so due to the different implementation timeframes for BRITS and ESKORT (Audit's case management software). This lower estimate is because 14 auditors will be required to dedicate 50% of their time to transition individual income tax to BRITS in December of 2007 and then to implement ESKORT in April of 2008.

- For FY 2007, TPT had a goal of $25.9 million. This goal is being adjusted to $21.6 million for FY 2008. This adjustment is directly related to the number of vacancies in the section. As a result of not receiving funding for the BRITS software licenses, in FY 2007 the Audit division was forced to undertake a hiring freeze to generate sufficient vacancy savings to pay those license fees. In addition, because the cities are able to offer superior financial packages, it is difficult to hire and retain TPT auditors. At the beginning of FY 2007, the TPT section had only 15 vacancies, but even with attempting to hire more TPT auditors this fiscal year, there are currently 28 vacancies.

For FY 2008 the Department's Enforcement Objectives are (please see Attachment A for a General Fund breakdown of these numbers):

Audit Division		
Transaction Privilege Tax -	$ 21,608,100	
License Compliance -	$ 43,350,012	
Individual Income Tax -	$ 6,737,160	
Corporate Income -	$ 26,681,400	
Nexus -	$ 27,000,000	
Discovery -	$ 3,200,000	
Luxury Tax -	$ 1,000,000	
Audit Division Total		$ 129,576,672
Collections Division		$ 305,000,000
Accounts Receivable		$ 90,150,000
FY 2008 Revenue Enforcement Goal		**$ 524,726,672**

FY 2008's Revenue Enforcement Goals are $63.7 million or 13.8% above FY 2007's Goals. For the first time ever, the Department is anticipating collecting over $500 million in a single fiscal year.

These targets were developed prior to any consideration of mid-year budget reductions. The Department is committed to making every effort to minimize the negative impact of budget cuts on revenue generation. However, if implementing any budget reduction exceeds the capacity of the Department's non-revenue generating areas, the FY 2008 targets will need to be revised accordingly.

For FY 2008, the Department will continue to report TPT and License Compliance revenues separately, but the Department would request that starting in FY 2009 these two items be combined into one revenue line. The reason for this is that when the Department first began reporting revenues as part of the revenue generating program in FY 2003 the License Compliance unit was located in the Taxpayer Services Division, not the Audit Division. The License Compliance unit, however, performs an audit function by collecting unreported TPT dollars, and the unit was subsequently relocated to the Audit Division. Therefore, it is appropriate to include those dollars with the Audit Division's TPT revenue.

I hope this information has been helpful and if you have any questions regarding this response, please contact Reed Spangler at 716-6883.

Sincerely,

Gale Garriott

Gale Garriott
Director

GG:rs
Attachment

cc: Senator Robert Burns
Richard Stavneak – Director JLBC
Jim Apperson – Director OSPB
Bob Hull – JLBC
Marcel Benberou – OSPB

Attachment A

FY 08 Revenue Enforcement Goals – General Fund

Audit Division		
Transaction Privilege Tax -	$ 12,835,211	
License Compliance -	$ 30,149,933	
Individual Income Tax -	$ 6,737,160	
Corporate Income -	$ 26,681,400	
Nexus -	$ 16,038,000	
Discovery -	$ 1,900,800	
Luxury Tax -	$ 594,000	
Audit Division Total		$ 94,936,504
Collections Division		$ 212,127,500
Accounts Receivable		$ 62,699,325
FY 2008 Revenue Enforcement Goals		**$ 369,763,329**

Arizona Department of Revenue
Enforcement Revenue Net of Duplication
For FY07
Month of June 2007

General Fund

SOURCE OF REVENUE	Month of June, 2007 Actual	Month of June, 2007 Actual GF	Month of June, 2007 Objective	Month of June, 2007 Objective GF	YTD Actual	YTD Actual GF	YTD Objective	YTD Objective GF
GROSS REVENUE								
Collections	26,507,268	18,435,805	23,748,648	16,517,185	292,147,672	203,188,706	284,983,784	198,206,222
Individual Income Tax Audit	1,432,285	1,432,285	1,766,952	1,766,952	17,878,074	17,878,074	21,203,424	21,203,424
Corporate Audit	13,822,576	13,822,576	3,302,035	3,302,035	69,276,024	69,276,024	39,624,420	39,624,420
Transaction Privilege Tax Audit	7,237,031	4,298,796	2,703,668	1,605,979	35,531,457	21,105,685	32,444,016	19,271,746
License Compliance	7,755,202	5,393,743	1,660,453	1,154,845	91,495,140	63,634,870	19,925,436	13,858,141
Accounts Receivable	4,851,188	3,374,001	6,406,615	4,455,801	97,979,181	68,144,520	76,879,379	53,469,608
Discovery	242,372	143,969	250,000	148,500	4,823,570	2,865,201	3,000,000	1,782,000
Luxury Tax	200,949	119,364	83,333	49,500	329,331	195,623	1,000,000	594,000
SUBTOTAL	**62,048,871**	**47,020,539**	**39,921,704**	**29,000,796**	**609,460,449**	**446,288,703**	**479,060,452**	**348,009,560**
Less: Duplications:								
Collections	-	-	-	-	-	-	-	-
Individual	482,262	482,262	695,649	695,649	6,631,436	6,631,436	8,347,788	8,347,788
Corporate	550	550	41,275	41,275	162,230	162,230	495,300	495,300
TPT	973,825	578,452	544,248	323,283	6,796,975	4,037,403	6,530,976	3,879,400
License Compliance	1,031,442	717,368	220,840	153,594	12,168,851	8,463,436	2,650,080	1,843,131
Accounts Receivable	-	-	-	-	-	-	-	-
Discovery	-	-	-	-	-	-	-	-
Luxury Tax	-	-	-	-	-	-	-	-
SUBTOTAL	**2,488,079**	**1,778,632**	**1,602,012**	**1,213,802**	**25,759,492**	**19,294,505**	**18,024,144**	**14,565,618**
REVENUE NET OF DUPLICATIONS								
Collections	26,507,268	18,435,805	23,748,648	16,517,185	292,147,672	203,188,706	284,983,784	198,206,222
Individual Income Tax Audit	950,023	950,023	1,071,303	1,071,303	11,246,638	11,246,638	12,855,631	12,855,631
Corporate Audit	13,822,026	13,822,026	3,260,760	3,260,760	69,113,794	69,113,794	39,129,122	39,129,122
Transaction Privilege Tax Audit	6,263,206	3,720,344	2,159,420	1,282,695	28,734,482	17,068,282	25,913,042	15,392,347
License Compliance	6,723,760	4,676,375	1,439,613	1,001,251	79,326,289	55,171,434	17,275,360	12,015,013
Accounts Receivable	4,851,188	3,374,001	6,406,615	4,455,801	97,979,181	68,144,520	76,879,379	53,469,607
Discovery	242,372	143,969	250,000	148,500	4,823,570	2,865,201	3,000,000	1,782,000
Luxury Tax	200,949	119,364	83,333	49,500	329,331	195,623	1,000,000	594,000
TOTAL COLLECTION REVENUE	**59,560,792**	**45,241,907**	**38,419,692**	**27,786,995**	**583,700,957**	**426,994,198**	**461,036,318**	**333,443,942**

STATE OF ARIZONA

Joint Legislative Budget Committee

STATE
SENATE

ROBERT L. BURNS
CHAIRMAN 2008
PAULA ABOUD
AMANDA AGUIRRE
JAKE FLAKE
JORGE LUIS GARCIA
JACK W. HARPER
THAYER VERSCHOOR
JIM WARING

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF
REPRESENTATIVES

RUSSELL K. PEARCE
CHAIRMAN 2007
KIRK ADAMS
ANDY BIGGS
TOM BOONE
OLIVIA CAJERO BEDFORD
LINDA J. LOPEZ
PETE RIOS
STEVE YARBROUGH

DATE: November 13, 2007

TO: Representative Russell Pearce, Chairman
Members, Joint Legislative Budget Committee

THRU: Richard Stavneak, Director

FROM: Dan Hunting, Fiscal Analyst

SUBJECT: Arizona Department of Administration – Review of Telecommunications Contractor and Carrier Cost Rate Structure

Request

The Arizona Department of Administration (ADOA) requests Committee review of the revised contractor and carrier cost rate structure of the Statewide Telecommunications Management Contract, as required by A.R.S. § 41-712.

For FY 2009, ADOA is recommending a rate structure that would increase the state's overall telecommunications budget by $671,100. This amount includes a General Fund decrease of $(36,300), an Other Funds increase of $355,600, and a Non-Appropriated Funds increase of $351,800. The report from ADOA also addresses 2 other issues of concern to the telecommunications system of the state, replacement of end-of-life equipment and Local Area Network (LAN) upgrades at state agencies.

Recommendation

The JLBC Staff recommends that the Committee give a favorable review with the provision that a favorable review does not constitute an endorsement of any FY 2009 General Fund appropriations to cover higher AZNet costs or additional funding requests, nor does it constitute an endorsement of the ADOA expenditure plan.

Analysis

Laws 2003, Chapter 263 required ADOA to contract for the privatization of the state's telecommunication services. ADOA signed the Statewide Telecommunications Management Contract in January 2005. A.R.S. § 41-712 requires all Executive agencies to participate in the new Arizona Network (AZNet).

(Continued)

AZNet FY 2009 Expenditure Plan

ADOA estimates the FY 2009 costs to be approximately $46.2 million. In comparison to FY 2008, the AZNet budget is projected to increase by $671,100. The increase comes largely from infrastructure replacement projects. *Table 1* summarizes the ADOA proposal for FY 2009 using FY 2008 as a baseline.

Table 1

AZNet Rate Structure Summary
FY 2008 to FY 2009 Comparison ($ in thousands)

	FY 2008	FY 2009	Difference
Carrier Charges / Savings	$15,036.1	$14,638.2	$ (397.9)
Seat (Phone Service) Costs	20,894.7	19,608.3	(1,286.4)
Infrastructure Investment	4,713.7	6,656.0	1,942.3
ADOA Administration	3,327.6	3,384.7	57.1
Other Expenses	1,527.1	1,883.1	356.1
Total Expenses	**$45,499.2**	**$46,170.3** 1/	**$ 671.1**
Fund Sources			
General Fund	$17,961.2	$17,924.9	$ (36.3)
Other Appropriated Funds	18,240.5	18,596.1	355.6
Non-Appropriated Funds	9,297.5	9,649.3	351.8
Total	**$47,499.2**	**$46,170.3**	**$ 671.1**

1/ Numbers do not add due to rounding

The infrastructure investment charge (IIC) is funded by retaining the difference between the seat rate charged by the contractor ($38.07 in FY 2009) to the state, and the seat rate charged by AZNet to the state agencies ($50.76). The $12.69 per seat difference is remitted from the contractor into the Telecommunications Fund – Infrastructure Improvements Account for expenditure by the ADOA Telecommunications Program Office (TPO). *Table 2* illustrates the per seat deposit into the infrastructure investment account through FY 2014.

Table 2

	State Seat Rate	Contractor Seat Rate	IIC Deposit (Difference)
FY 2007	$50.76	$44.49	$6.27
FY 2008	50.76	42.20	8.56
FY 2009	50.76	38.07	12.69
FY 2010	50.76	35.23	15.53
FY 2011 - 14	50.76	36.29	14.47

Money from the IIC is to be used to build a statewide voice, video, and data network. The estimated expenditure from the IIC is $4.7 million in FY 2008 and $6.7 million in FY 2009. IIC expenditures include costs for the state's Wide Area Networks (WANs), but do not include costs for the state's Local Area Networks (LANs). LANs generally consist of wiring inside buildings, while WANs generally consist of wiring outside buildings. The LAN expenses are expected to come from existing agency budgets or new budget requests.

Of the $6.7 million estimated IIC expenditure in FY 2009, $5.0 million will be used for three major projects.

- End-of-life data equipment will be replaced at a cost of $2.0 million.
- Telephone systems will continue to be converted to Internet Protocol Telephony systems at a cost of $1.5 million.

(Continued)

- Phoenix and Tucson office buildings will have both voice and data communications moved on to the core AZNet system for $1.5 million.

AZNet Administrative Costs

As noted in *Table 1*, the ADOA TPO administrative budget is approximately $3.4 million in FY 2009. TPO operations are funded by applying an administrative charge of 8.07% to agencies' AZNet expenditures. This charge is unchanged from FY 2008. This rate includes 0.48% to create an error reserve which will be applied to the FY 2009 budget to avoid the need for a further increase in the administrative charge. Last year, the error reserve was funded by a 0.17% rate. There was also an additional 0.60% charge to raise $250,000 for cash balances.

RS/DH:ss

IANET NAPOLITANO
Governor

WILLIAM BELL
Director

ARIZONA DEPARTMENT OF ADMINISTRATION
OFFICE OF THE DIRECTOR
100 North Fifteenth Avenue, Suite 401
Phoenix, Arizona 85007
(602) 542-1500

RECEIVED
OCT 2 9 2007
JOINT BUDGET COMMITTEE

October 26, 2007

The Honorable Russell Pearce, Chairman
Joint Legislative Budget Committee
1700 West Washington Street
Phoenix, Arizona 85007

Dear Chairman Pearce:

Pursuant to Laws 2005, Chapter 301, the Arizona Department of Administration is submitting its contractor and carrier costs rate structure by agency and fund type for review by the Joint Legislative Budget Committee (JLBC). We also are submitting the rate schedule for telephones (seats) and other per occurrence charges from the management contractor.

This report differs from prior year reports that focused on the on-going funding necessary for operational costs. The report shows those on-going operational costs as Component 1 where no change in existing rate structure is proposed. Our FY 2009 request shows a Total Fund increase of $671,128, including $355,572 from Other Appropriated Funds and $351,816 from Non-Appropriated sources. With regard to General Fund, the FY 2009 request shows a reduction of $36,260 from FY 2008.

Two other funding components are contained in this report. Component 2 addresses the serious concern I have regarding "end-of-life" equipment. I first mentioned this concern to you in my letter last year regarding the FY 2008 funding request. This concern originated from the outsourcing contractor reporting that 46 percent of data equipment and 16 percent of voice equipment (6,320 seats) are already at "end-of-life." My staff's analysis of funding needs reveals that current levels of funding will not provide enough cash to replace "end-of-life" equipment in a timely manner. Without timely replacement, some potential carrier savings will be lost. I am submitting two policy options, which have been developed by ADOA staff, for your consideration in addressing this issue. One option is a cash loan that could be paid back using existing rates. A second option is a lease purchase agreement that would result in the need for a rate increase to cover the cost of paying back the agreement costs. As you move forward in working out solutions to the current economic and budgetary situation, either option will provide the program the necessary resources to meet the state's mandate to create a statewide consolidated video, voice, and data network.

Component 3 is a funding request to address the impact that this telecommunications contract has on Local Area Networks (LAN). There are costs associated with LAN upgrades to support the Internet Protocol Telephony equipment expected under the contract. The LAN costs of agencies are not a part of the base budget for the telecommunication costs covered in this contract. Availability of funding for the LAN upgrades will impact the rollout of the planned Internet Protocol Telephony projects. Therefore, $3.0 million to cover the upgrade cost is captured in this document as a request for a back-of-the-bill adjustment in one-time funding for these anticipated FY 2009 off-contract costs. The monies would remain unallocated until a request is generated to specifically allocate the monies when the actual project is initiated. In the past, state agencies have been left to seek the funding themselves and this has had a push back effect since many agencies do not have the existing funding needed for these off-contract costs.

Please call me at 602-542-1500 or call Pat Mah, Telecommunications Program Office Director, at 602-364-0558 if you have any questions or need additional information. We appreciate your support and consideration in appropriating the FY 2009 requested funding.

Sincerely,

William Bell
Director

c: The Honorable Robert Burns, Vice-Chairman
Jim Apperson, Director, OSPB
Marcel Benberou, Assistant Director, OSPB
Matt Gottheiner, Budget Analyst, OSPB
Scott Smith, Deputy Director, ADOA
Pat Mah, TPO Director, ADOA LAN
Paul Shannon, Assistant Director, ADOA

Summary All AZNet Agencies - Total Costs *

Component 1: Operations

All AZNet State Agencies	FY 2005 Est. Actual	FY 2007 Est. Actual	FY 2008 Approp.	FY 2009 Request	Difference FY09/FY08
Expenditure Category:					
Personnel Expenses	$2,588,112	$0	$0	$0	$0
Carrier Charges	19,923,647	17,931,629	19,945,445	19,947,086	1,641
WAN/Voice Maintenance Contracts	1,645,952	0	0	0	0
Operations - ATS or Before Transition to AZNet **	8,004,235	0	0	0	0
Capital/Non-Capital Expenditures	1,634,407	0	0	0	0
Seats	0	25,728,651	25,608,389	26,264,283	655,895
Moves/Adds/Changes Costs	0	891,926	630,895	874,364	243,469
FY 2006 Budget Impact Offset	0	894,000	851,800	851,800	0
Carrier Savings - Projection	0	0	(4,909,303)	(5,308,881)	(399,578)
FAX/Other Per Occurrence Charges	0	103,645	44,410	156,991	112,580
Credits/Adjustments	0	(409,208)	0	0	0
TPO/Admin costs	0	3,093,282	3,327,579	3,384,700	57,121
Total	$33,796,353	$48,233,927	$45,499,216	$46,170,344	$671,128
Funding Breakout:					
General Fund	$10,709,657	$18,761,868	$17,961,195	$17,924,935	($36,260)
Other Appropriated Funds	15,998,139	17,155,547	18,240,538	18,596,109	355,572
Non-Appropriated Funds	7,088,558	12,316,512	9,297,484	9,649,300	351,816
Total	$33,796,353	$48,233,927	$45,499,216	$46,170,344	$671,128

* Due to rounding from numerous formulas used in creating this table, whole dollar amounts in the table may vary slightly from the totals shown. The FY 2007 Legislature approved the AZNet FY 2008 funding request in its entirely. Agencies that have left AZNet since that time are not reflected in the above number.

** The $8.5 million in FY 2005 for Operations - ATS or Before Transition to AZNet is distributed, starting in FY 2006, to the actual components for which they were spent. ATS was eliminated in March 2005, but transition occurred throughout FY 2006, ending in May 2006.

Component 2: End-of-Life Equipment Needs

Option 1 - Loan at $6.2 Million over 3 years.

Option 2 - Lease starting at $8.1 Million over 3 years (requires rate adjustment to cover payback costs).

Component 3: Off-Contract Local Area Network Costs as a result of AZNet

The following table shows the funding source as designated by agencies for $3.0 million in off-contract expense to meet contract obligations.

FY 2009 Funding Breakout:

General Fund	$1,673,603
Other Appropriated Funds	1,167,743
Non-Appropriated Funds	167,230
Total	$3,008,575

Assumptions and Caveats

Below are the assumptions made and the caveats used in putting together the FY 2009 cost projections for the telecommunications outsourcing contract. This report excludes agencies that left the *AZNet* contract in FY 2007. Those agencies include Division I of the Court of Appeals, Judicial Conduct Commission, and the Supreme Court. The Arizona Commission for Post Secondary Education also chose to leave the *AZNet* contract so they could continue services with the Board of Regents, which is out-of-scope at this point. In addition, the State Library pulled off the *AZNet* contract in early September 2007.

The result is that this report shows a corresponding drop in the FY 2005 base funding that incorporated these agencies telecommunications expenditures. The same holds true for the other fiscal years shown in this report.

Background:

This report continues to show FY 2005 base funding for comparison purposes. The FY 2005 figures were put together in two ways. There was self-reporting for 14 of the larger state agencies (Arizona Department of Transportation (ADOT), Attorney General, Arizona Health Care Cost Containment System (AHCCCS), Department of Environmental Quality, Department of Economic Security (DES), Department of Health Services, Department of Administration (DOA), Department of Corrections, Department of Revenue, Department of Public Safety (DPS), Game and Fish, Juvenile Corrections, Lottery, and State Retirement). For other agencies, the information was gathered from records of monthly costs for the Arizona Telecommunications System (ATS). Information also was gathered from telecommunication expenditure costs reported in the State's Arizona Financial Information System (AFIS) except for personnel costs that are not captured in sufficient detail to isolate those costs specifically to telecommunications. For this reason, agencies self reported their personnel costs data.

An AFIS data pull was used to validate the data and to fund source the expenditures for FY 2005. The data pull was done using a search for major telecommunication vendors to help overcome the problem of inaccurate data. Significant inaccuracies were noted when the data were pulled using comptroller object code detail.

The percentages for fund sourcing from FY 2005 are what were applied to all state agencies except for DOA, DPS, and DES. These latter two agencies pool their funding sources. Thus, AFIS data cannot be used. The fund sourcing in this report for DPS is from documentation provided by its staff, including FY 2007 when legislative action changed the funding mix for this agency. For DES, the *JLBC Appropriations Report* detail for the agency is used.

The FY 2005 percentages are used for DOA except for payback of a five-year $3.5 million lease agreement reached in FY 2006. This funding, shown as "One-Time Offset" in the agency detail tables, is included, starting in FY 2007, from General Fund. The amount of the payback request in FY 2009 is $851,800 for the third year of the five year payback agreement. Also, emergency phones were added to the Capital Police budget starting in FY 2007 and the fund source for these phones is the General Fund.

A single data pull from AFIS was used to gather actual expenditures for FY 2007. Data were pulled using a search for major telecommunication vendors. The data were pulled at 13th month, but administrative adjustments will continue throughout the current fiscal year.

In prior years, this report has consisted of a request to cover the operational costs of the contract. Besides the operations piece, labeled as Component 1 in this document, the FY 2009 request also includes funding options to address the replacement of high levels of end-of-life equipment, labeled as Component 2. Further, this document includes a third component. Component 3 is a funding alternative to address the upgrade costs of local area networks as a result of the rollout of Internal Protocol Telephony required under this contract for a converged data and voice network. Finally, this report includes details regarding projects specifically funded by agencies in FY 2007 and projects funded from revenues collected under the *AZNet* contract for infrastructure investment.

Component 1 – Operations Cost by Expenditure Category:

The model for reporting telecommunication costs continues to capture expenditure costs in expenditure categories prior to full transition to *AZNet* and then in expenditure categories after full transition. The expenditure categories prior to full transition to *AZNet* include: personnel expenses, carrier costs, Wide Area Network (WAN) and voice maintenance contracts, operations costs from payment to ATS or other phone service contractors, and capital/non-capital expenses. The expenditure categories following transition to *AZNet* include: carrier costs, "seat" or phone service costs, and other costs associated with outsourcing of telecommunications. Reports produced by the State's contractor for the various components of expenditures are the primary source for the cost details in this document for after transition costs. These after transition costs are described below:

Seats:
Seats are the contractor's bundled costs for managing the State's telecommunication services. Seat charge estimates for FY 2009 are made using August 2007 data for seat counts. There is no significant variance between the August 2007 data when compared to the July 2007 data.

There is a separate report in this document for the seat count by type as requested by JLBC. One table shows the seat count per month estimate for FY 2009 and a separate table shows the seat count per month approved for FY 2008.

The seat rate charge in FY 2009 is held at the rate that was used for FY 2008, which is the FY 2006 rate. The seat rates, including Infrastructure Investment Charge rates, are detailed in a separate document in this report.

Moves, Adds, and Changes Costs (MAC): This item includes moves, adds, changes and their associated time and materials charges. When the FY 2007 and FY 2008 estimates for MAC charges were prepared no or little actual cost data were available. For both of those years estimates were made using a statewide estimated cost per seat. For FY 2007, the annualized rate was approved at $8.80 per seat. For FY 2008, the rate was $13.80 per seat. We now have actual cost data for FY 2006 and FY 2007. Evaluation of these data indicates continued use of a statewide single cost per seat methodology would not yield an estimate for MAC charges by agency that would fall within acceptable tolerance limits. Data analysis indicates that a more acceptable methodology for estimating MAC charges by agency is to proportion the total estimate based on actual cumulative charges for FY 2006 and FY 2007. As was done for FY 2008, a $100 minimum per agency is imposed. The FY 2009 request for MAC charges is $874,364.

FY 2006 Budget Impact Offset: The 2006 Legislature approved $894,000 from the General Fund in FY 2007 for the first year of a five year agreement for payback. The monies are in a Special Line Item called Statewide Telecommunications Management Contract Lease Payment. The FY 2009 budget request includes the third year of funding for the lease at $851,800 from the General Fund to further eliminate the lease debt.

This lease debt is from DOA entering into a $3.5 million lease agreement that was used as a credit to other agencies. This credit was used for the purpose of offsetting the FY 2006 fiscal impact for transition to *AZNet*. A total of 43 agencies received the $3.5 million credit on their May 2006 invoice for telecommunications costs from *AZNet*. The goal was to distribute the funding to those agencies where FY 2006 costs exceeded FY 2005 spending.

Carrier Savings: Under contract, Accenture is obligated to achieve carrier savings. The savings is achieved through four initiatives that include:

- Telecommunications expense management (i.e. ensuring that carrier bills and rates are correct, and continuously changing to the lowest rate);
- Trunk optimization (i.e. matching the quantity of calls allowed by the circuits at each site with the quantity actually made from the site);
- WAN (wide area network) consolidation (i.e. consolidating the separate WAN data networks and voice networks of the many agencies into a single consolidated network); and
- Toll charge avoidance (i.e. sending many of today's toll calls paid for by the minute over the WAN at no incremental cost to the State.

The FY 2009 request for carrier spend is $14.6 million, down $5.3 million from the FY 2005 adjusted base. The request is based on an agency's FY 2007 actual spending for carrier costs, the relationship of FY 2007 spending to the base year of FY 2005, and assumptions made as to the potential for additional savings to be achieved by each agency. Specifically these assumptions are:

1. If FY 2007 actual spending is greater than 75 percent of FY 2005, then an additional five percent savings can be achieved. The estimate for FY 2009 is equal to 95 percent of FY 2007 actual spend for carrier. Obviously, there is some limit to the amount of savings that can be achieved by each agency—carrier spend cannot be driven to zero. Given currently available data, the chosen assumptions of less than 25 percent currently achieved savings with an additional five percent to be achieved seem reasonable.
2. If FY 2007 actual spending is between 50 percent and 75 percent of FY 2005 spending, then no additional savings will be achieved. The estimate for FY 2009 is equal to FY 2007 actual spend for carrier. Here again, currently available data do not allow a more refined estimate to be made. While it is possible that additional savings may be achieved for agencies falling into this group, the amount is uncertain and, if generated, is likely to be very small.
3. If FY 2007 actual spending is less than 50 percent of FY 2005, then the FY 2009 estimate is FY 2007 actual spending plus 50 percent of the difference between actual spending and the FY 2008 appropriation. The implied assumption here is that such a dramatic reduction in carrier spend from FY 2005 to FY 2007 likely comes from some extraordinary circumstance, i.e. shifting of cost due to shared carrier adjustments. It is assumed that some carrier costs will be reallocated back to the agencies falling into this group.
4. If FY 2007 actual spending is greater than the FY 2008 appropriation, the estimate for FY 2009 is equal to the FY 2008 appropriation. The implied assumption is that the previous year's estimated savings can be achieved, just not as quickly as estimated in the previous year.

The assumptions made for generating estimates of carrier spend in future years will evolve as more data become available.

FAX/Other Per Occurrence Charges: In addition to seat costs, there are other line and circuit costs associated with telecommunication services. Those costs previously were captured in the Operations - ATS or Before Transition to *AZNet* category on the report. With transition completed in FY 2006, these costs now are reported here. The costs of these charges are detailed in the rate schedule tab of this report. Specifically excluded from this FY 2009 request, however, are charges for Local Area Network (LAN) support. The LAN charges are an optional service separate from the base budget that is captured here for telecommunication services.

Credits/Adjustments: Captured in these costs are corrections made in FY 2007 for any over or under billing errors for telecommunication services provided under the contract.

TPO/Admin Costs: The Telecommunications Program Office estimate applies a rate of 8.07 percent across FY 2009 projected expenditures (excluding ADOA lease payment costs and expected carrier savings). This rate is the same rate as was approved for FY 2008.

The FY 2009 rate includes 7.59 percent to collect an estimated $3.2 million in requested expenditures detailed in a separate tab in this report called TPO FY 2009 Budget Request. The 8.07 percent rate also includes 0.48 percent for an error reserve. There continues to be uncertainty on the impact of carrier savings to agency budgets. The reserve is requested to avoid any need for a rate increase in FY 2009. If the 8.07 percent rate creates any excess in cash balances, this would be handled through a reduction in the rate charge during FY 2009.

A $5.00 minimum per month charge was initiated in FY 2007 for recouping costs from local and university agencies that have no seats but use data and/or long distance services. However, revenues from these agencies are insignificant.

Component 2 - Options for End-Of-Life Equipment Replacement:
The contractor has completed an inventory of all state communications equipment. The result of this inventory is not encouraging for meeting the mandate of a modern, converged telecommunications system. There is approximately $32.0 million of equipment at or beyond its useful life expectancy. Most of this equipment must be replaced for the State to achieve its legislated goal. The current rate structure will not provide funding to replace this equipment. There must be an infusion of cash. As a result, this report provides two different policy options for covering the costs. One option is a cash loan that could be paid back using existing rates. A second option is a lease purchase agreement that would result in the need for a rate increase to cover the cost of paying back the agreement costs.

The contract calls for the rollout of 22,000 Internet Protocol (IP) Telephony seats by January 2009. The shortfall by the required period is expected to be at least 15,000 seats. As end-of-life equipment is replaced, any refresh of that equipment falls to the contractor. Thus, the benefit of the refresh under the contract is not captured by the State when equipment remains end-of-life.

Component 3 – LAN Cost Impacts:
There are costs associated with LAN upgrades to support the IP Telephony equipment expected under the *AZNet* contract. The LAN costs of agencies are not a part of the base budget for telecommunication costs under this contract though the contract offers them as an optional service. The current "best guess" in LAN upgrade cost for FY 2009 is $3.0 million for agencies where the IP equipment is to be installed. Availability of funding for the LAN upgrades will impact the rollout of the planned IP Telephony projects. Therefore, the $3.0 million upgrade cost is captured in this document as a request for a back-of-the-bill adjustment in one-time funding for these off-contract costs. The monies would remain unallocated until a request is generated to specifically allocate the monies when the actual project is initiated. In the past, state agencies have been left to seek the funding themselves and this has had a push back effect since many agencies do not have the existing funding needed for these off-contract costs.

The funding mix for these costs is put together based on the self reported needs of agencies except for the Department of Health Services. The Department of Health Services did not identify their desired funding mix so the funding percentages used for the *AZNet* operational costs where used in this component. Any answers to questions on the mix of funding are best provided by the individual agencies for these off-contract costs.

Projects Details:

This section of the report details agency specific funded projects and projects funded from the Infrastructure Investment Charges collected under the *AZNet* contract.

Agency - Demand Management Team Projects (DMT) and Other Projects:

Under a separate tab in this document is a table of the invoiced DMT projects and other smaller in scope projects for FY 2007. There are no invoiced projects currently for FY 2008. The status of DMT projects is reported quarterly to the Joint Committee on Capital Review. Only a summary of the information is included here.

Monies for these projects are not included in the base funding captured in the FY 2008 Appropriation. Agencies directly contract for these projects with the state's contractor for telecommunications services. The money is from federal grants or other resources that are available to the agency often on a one-time basis.

Infrastructure Investment Charges (IIC) Projects:

Under a separate tab in this document is a table showing projects funded from the Infrastructure Investment Charges collected under the *AZNet* contract. The contractor's seat rates were scheduled for a reduction in spring 2006. A policy change that resulted in the infrastructure investment charges was incorporated into the contract seat rates in December 2005 since capturing originally proposed carrier savings for these investments proved to be an unviable option. The first revenues from the Infrastructure Investment Charges begin in April 2006.

The State's telecommunications outsourcing contractor collects the revenues for the infrastructure investments as required under A.R.S. 41-712. The revenues are then turned over to the TPO for deposit into the State's account. The estimated revenue from this charge is $4.8 million in FY 2008 and $6.6 million in FY 2009.

These revenues were initially placed in an escrow account approved by the State Treasurer. Since the monies are collected for capital investments, the holding account allowed TPO the opportunity to ensure the projects are completed and/or the equipment is received prior to the contractor receiving payment. The 2007 Legislature chose to have the monies deposited in the Telecommunication Program Office Fund created by A.R.S. 41-713 for the administrative costs of TPO.

The State's contractor put together annually an operating plan for expending these monies fully. The plans include deployment of IP Telephony equipment as required under the current contract.

STATE OF ARIZONA

Joint Legislative Budget Committee

STATE SENATE

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF REPRESENTATIVES

DATE: November 13, 2007

TO: Representative Russell Pearce, Chairman
Members, Joint Legislative Budget Committee

THRU: Richard Stavneak, Director

FROM: Dan Hunting, Fiscal Analyst

SUBJECT: Arizona Department of Administration – Review of Emergency Telecommunication Services Revolving Fund Expenditure Plan

Request

Laws 1998, Chapter 6, 4th Special Session requires the Arizona Department of Administration (ADOA) to submit the wireless services portion of its Emergency Telecommunications Services Revolving Fund (ETSF) expenditure plan to the Committee for review. ADOA oversees and provides support to the communities of the state as they enhance their 911 emergency telecommunications systems. In practice, the department submits its complete expenditure plan annually, although expenditures on wire services are not subject to Committee review.

Recommendation

The JLBC Staff recommends that the Committee give a favorable review to the $8.5 million wireless portion of the ETSF expenditure plan.

In FY 2008, ADOA expects to distribute $25.9 million from the ETSF. However, based on past expenditure patterns this estimate could be high, as over the past 4 years average expenditures were $18.1 million. Of the $25.9 million, $16.8 million is for wire services, $8.5 million is for wireless services, and $0.6 million is for administrative and management costs.

Analysis

ADOA works with county/city 911 administrators to distribute monies from ETSF for FCC-compliant telecommunications equipment, software, carrier services, and maintenance. The counties and cities are responsible for implementing the improvements to their 911 system. ADOA is responsible for providing centralized oversight in developing project schedules to consider the greatest needs, especially in rural areas, and for maximizing regional efficiencies and local readiness. While ADOA prefers that each county complete implementation phases as a whole, the department does make allowances for cities or areas that are behind or

(Continued)

ahead of the county schedule. Localities must provide and fully fund their own personnel, utilities, and facilities. ADOA also requires communities to submit Wireless 911 Service Plans to the agency for its approval.

Emergency 911 Wireless Service Status

Federal Communications Commission (FCC) Report and Order 96-204, issued in 1996, ordered the development and implementation of 911 services for wireless telecommunications systems in 2 phases. Phase I requires local public safety answering facilities to be able to identify the phone number of, and nearest cellular tower to the caller, as well as to relay calls to the nearest emergency response center. Phase II necessitates answering facilities to be able to identify the location of the caller. Mobile service carriers were required to upgrade their systems for Phase II capability by December 2005. *Table 1* highlights the status of Arizona's wireless 911 availability as of July 1, 2007.

Table 1

Arizona Counties Emergency 911 Wireless Capability as of July 1, 2007

Phase I	**Phase II**
Page-Lake Powell	Maricopa County
Pinal County	Northern Yavapai County
Winslow	Pima County
	Graham County
	Santa Cruz County

* Counties not shown have no wireless Phase I or II capabilities.

Wireless Phase II was completed in Graham and Santa Cruz Counties in FY 2007, with Pinal, Cochise and Southern Yavapai Counties scheduled for completion in FY 2008. Areas that have not yet completed Phase I are being encouraged to move directly to Phase II. 0Currently, 80% of the state's population lives in areas where the location of a 911 caller can be identified. By 2011, the entire state will be covered. For a more comprehensive description of emergency 911 deployments see the *9-1-1 Phase II Implementation Plan* attachment.

Funding Mechanism

A.R.S. § 42-5252 authorizes a tax on wire and wireless telecommunication service accounts. On July 1, 2007, the rate dropped to $0.20 per month for each wired and wireless phone account. The rate had been $0.28 in FY 2007. ADOA estimates that revenues will decline from $23.1 million in FY 2007 to $18.9 million in FY 2011, primarily due to the decrease in the tax rate. ADOA also foresees expenditures increasing from $19.5 million to $32.6 million during the same timeframe. Despite the decline in revenues and the increase in expenditures, ADOA projects that the fund will maintain a positive balance until FY 2012, due to the $45.0 million balance currently in the fund.

FY 2008 ETSF Expenditure Plan

ADOA distributes funds to the localities upon receiving copies of their invoices for emergency telecommunications services and equipment. In FY 2008, ADOA expects to distribute $25.9 million from ETSF. Of the $25.9 million, $8.5 million is for Phase I and Phase II wireless services. Of the $16.8 million in proposed wire services expenditures, $2.0 million is for a proposed transition to an IP enabled network. The current 911 system is based on technology not intended to support modern communications devices. The plan to build an Internet Protocol-enabled network is in line with recommendations from the National Emergency Number Association (NENA), on the future of emergency telecommunications standards. ADOA originally budgeted $10.0 million in FY 2008 for this program, but industry standards for this next-generation 911 system are still in development, so designs cannot be finalized.

(Continued)

Table 2 summarizes the actual ETSF distribution during the past 2 fiscal years and projected distribution during the current fiscal year.

Table 2

ADOA Emergency Telecommunications Services Revolving Fund FY 2006 – 2008 Expenditure Plan[1/]

	Actual FY 2006	Actual FY 2007 [1/]	Projected FY 2008
Wireless Services			
Phase I Wireless	$ 1,392,800	$ 557,700	$ 324,300
Phase II Wireless	5,985,500	4,738,700	8,189,700
Wireless Services Subtotal	**$ 7,378,400**	**$ 5,296,400**	**$ 8,514,000**
Wire Services	$10,163,000	$13,462,000	$16,814,800
Administration	$ 770,500	$ 743,200	$ 573,700
ETSF Expenditure Plan Total	**$18,311,900**	**$19,501,700** [1/]	**$25,902,500**

1/ Numbers do not add due to rounding

In September 2006, ADOA estimated that FY 2007 expenditures would be $28.1 million; however, actual expenditures over the course of the year were only $19.5 million. Some of this discrepancy may be attributed to lower levels of participation by rural counties than expected.

Table 3 includes the wireless expenditure plans for FY 2008. Of the $8.4 million projected to be spent on wireless services in FY 2008, $6.8 million is for wireless carrier charges. Carrier charges are monthly per customer fees provided to phone companies for providing emergency 911 services to their customers. The remaining $1.7 million of the wireless expenditure plan is for equipment and other expenses.

Table 3

FY 2008 Wireless Expenditure Plan

	Wireless Carrier	Equipment & Other	Total
Cochise County	$ 239,000	$ 525,500	$ 764,500
Graham County	54,700	3,800	58,500
Maricopa County	3,048,700	10,800	3,059,500
Mohave County	819,700	266,500	1,086,200
Navajo Co/Apache County	1,800	-	1,800
Page	91,300	107,200	198,500
Pima County	1,443,000	88,700	1,531,700
Pinal County	382,300	14,600	396,900
Santa Cruz County	76,500	4,900	81,400
Winslow	27,800	2,700	30,500
Yavapai North	239,400	260,700	500,100
Yavapai South	164,600	140,500	305,100
Yuma County	188,100	236,500	424,600
TOTAL	**$6,776,900**	**$1,662,400**	**$8,439,400**

Future Outlook

Arizona statute only requires wire and wireless telecommunication service accounts to pay a tax. Statute is unclear whether more recent technologies such as prepaid wireless accounts, internet based phones, and OnStar pay the 911 taxes. Future fund revenues could decline if phone usage shifts to Voice over Internet Protocol (VoIP) based phones. VoIP phones may be differentiated into 2 divisions, the broadband providers such as Comcast and Qwest and the nomadic providers such as Vonage. The broadband

(Continued)

providers may already be collecting a tax because they view the service as similar to a wire line account, but the nomadic providers are not currently collecting any taxes for emergency 911 services. Of the nomadic VoIP providers, Vonage has approached the ADOA 911 office regarding developing an agreement to collect the tax as long as it is used specifically for emergency 911 purposes.

RS/DH:ss
Attachment

JANET NAPOLITANO
Governor

WILLIAM BELL
Director

ARIZONA DEPARTMENT OF ADMINISTRATION

OFFICE OF THE DIRECTOR
100 North Fifteenth Avenue, Suite 401
Phoenix, Arizona 85007
(602) 542-1500

RECEIVED
NOV 01 2007
JOINT BUDGET COMMITTEE

November 1, 2007

The Honorable Russell Pearce, Chairman
Joint Legislative Budget Committee
House of Representatives
1700 W. Washington Street
Phoenix, AZ 85007

Dear Representative Pearce:

As stipulated in the Laws of 1998, 4th Special Session, Chapter 6, Section 5 – Emergency telecommunications fund: report of expenditure plans, the Department of Administration shall report its expenditure plans to the Joint Legislative Budget Committee for review. In fulfillment of this requirement, I am enclosing:

- The Wireless Program Report for fiscal year 2007.
- The 9-1-1 financial forecast for fiscal years 2008 through 2012 incorporating the Fund Balance transfers to the General Fund during FY2003 and FY2004.
- The Status of Arizona 9-1-1 and the Estimated Costs and Deployment Schedule to Implement Wireless Phase II.
- The 9-1-1 Phase II Wireless Implementation Plan.
- State of Arizona 9-1-1 GIS Standards.
- State Fee Comparison and Organization Structure.

Please note that the financial forecast shows a program deficit in fiscal year 2012. With additional Wireless Phase II deployments and transitioning to an IP Enabled Network, costs will continue to increase. This anticipated deficit will prevent the full implementation of the critical wireless program and may require a revenue enhancement or increase.

Should you have any questions, please contact me at 602-542-1500 or Barbara Jaeger, the State 9-1-1 Administrator at 602-542-0911.

Sincerely,

William Bell
Director

c: The Honorable Robert Burns, Chairman, Joint Committee on Capital Review
The Honorable Timothy S. Bee, Senate President
The Honorable James P. Weiers, Speaker of the House of Representatives
Richard Stavneak, Staff Director, JLBC
James Apperson, Director, OSPB

Enclosures

Arizona Department of Administration
State 9-1-1 Office
Wireless Program Report
2007

The State 9-1-1 program was established, through legislation in 1985, to provide a funding mechanism for the deployment and on-going costs of providing 9-1-1 services in Arizona.

Under A.R.S.§ Title 43, Article 6, Telecommunications Services Excise Tax, a tax is levied for each activated wire line access and wireless service account for the purpose of financing emergency telecommunications services. Current law reduced the tax from thirty-seven cents per month to twenty-eight cents per month in July 1, 2006. The tax reduced to twenty cents per month as of July 1, 2007.

The funds collected are administered by the Arizona Department of Administration under A.R.S. § 41-704 and rules have been established that govern the allowable expenditures and funding eligibility requirements by communities and political sub-divisions in the State.

Components eligible for funding include necessary and/or appropriate network, equipment and maintenance to handle the processing of 9-1-1 emergency calls. Of the revenue generated, the program distributes 98% of the fund for 9-1-1 call service delivery of wire line and wireless services. One percent of the revenue is allocated for local network management of contracts through the 9-1-1 system coordinators.

An amount not to exceed 2% of the annual revenue is used by the Arizona Department of Administration for program oversight expenditures.

Accounting methodology is in place to track all expenditures by community and/or 9-1-1 system. The revenue is also collected and reported separately between the wire line and wireless services. Effective July 1, 2007, the Department of Revenue will transition to collecting the tax as one entity and identify this collection code as 9-1-1.

All Public Safety Answering Point (PSAP) equipment used to answer and handle 9-1-1 calls are budgeted under wire line expenditures, although it should be understood that the equipment is used to answer both wire line and wireless 9-1-1 calls.

The Arizona 9-1-1 Wireless Phase II Implementation Plan has been updated during FY07 to expand the program moving specified sites toward deployment of Phase II Wireless. Costs associated with legislative cost recovery and a copy of the plan is enclosed. The Statewide System Project plan covering each 9-1-1 System for FY08 has been updated and is also attached.

The wireless program criteria established for rollouts, stipulate that Enhanced 9-1-1 (voice, telephone number and address) has been completed for either an entire county or significant portions of a county. Each county or system must complete a Wireless 9-1-1 Service Plan, utilizing the format specified in the State guidelines and appoint a single point of contact for each county or area. The Geographic Information System (GIS) data must be completed and meet the same 95% accuracy rate as established for Enhanced Wire Line 9-1-1. Equipment mapping components will be installed prior to implementation of Wireless Phase II.

Wireless Deployment

Significant progress continues to be made in the deployment of Wireless Phase II. The two major regions in the state, Maricopa and Pima have completed their Phase II deployments constituting approximately 80% of the state's population. The Northern Yavapai County area, which encompasses the City of Cottonwood, City of Sedona, Town of Camp Verde and surrounding Yavapai County has also completed Phase II deployment.

During FY07, funds were expended from the $1 million dollar Public Safety Answering Point (PSAP) Readiness Fund grant to complete the Geographic Information Systems (GIS) work necessary to move three counties from Wireless Phase I to Wireless Phase II. GIS work for Graham and Santa Cruz Counties completed in the fall of 2006. Subsequently, mapping equipment was installed and the Request for Phase II service letters sent to the carriers. Both Graham and Santa Cruz Counties completed their Phase II deployment in spring 2007. GIS work for Pinal County completed fourth quarter FY2007 and the request for Phase II service letter was sent on April 10, 2007. Deployment is scheduled for first quarter FY2008

The completion of these projects will provide wireless Phase II service from Nogales all the way to Phoenix. Recently, Pinal County was identified as the third fastest growing county in the nation and with this deployment, the citizens will have an added level of public safety protection.

The GIS work for Graham, Pinal and Santa Cruz counties were completed for significantly less then what was originally estimated under the Scope of Work. The PSAP Readiness Fund Board is pleased that their grant dollars have been used specifically for what it was intended. With the funds remaining, the PSAP Readiness Board has authorized an expansion to the original Scope of Work. Preliminary planning has identified the next areas for deployment include the southern portion of

Yavapai County, Cochise County and Mohave County with GIS work will be scheduled during FY08.

During FY06, the southern portion of Yavapai County completed their Enhanced 9-1-1 project and with the northern portion of the county already Wireless Phase II, it is logical to implement the remainder of the county. Cochise County completed their Enhanced 9-1-1 project during FY07, developing accurate GIS in conjunction with the addressing project making this area a logical choice. These projects are both scheduled to be deployed with wireless Phase II service during FY08.

In FY07, the Gila River Tribal Community completed their Enhanced 9-1-1 project and since they are adjacent to both Maricopa and Pinal counties, they will move toward Wireless PII in FY08. Request for Phase II service letters have been sent to the carriers and they will begin their deployment within the six month time frame.

Wireless Expenditures

During FY07, the majority of one time charges were expended for completed Wireless Phase II projects. Both the Graham County and Santa Cruz County Wireless Phase II projects were completed in FY07 and all one time charges have been invoiced.

The FY07 expenditures for Wireless Phase I & II are outlined in the table below.

System	FY07 Expenditures		PI/PII
Maricopa Region	$	3,098,230	PII
Pima County	$	1,321,026	PII
No. Yavapai County	$	239,531	PII
Graham County	$	90,464	PI/PII
Santa Cruz County	$	110,392	PI/PII
Pinal County	$	378,294	PI
City of Page	$	62,050	PI
City of Winslow	$	22,907	PI
	$	**5,322,894**	

It should be emphasized that the 9-1-1 answering equipment is fiscally allocated to wire line equipment although this equipment handles calls for both wire line and wireless 9-1-1 calls. In future years, with the reduction of wire line services, an equitable division of equipment costs and maintenance may have to be explored.

The FY08 budget includes the following expenditures for systems currently Wireless Phase I and/or Phase II, those adding in new systems, and those that are close to or have completed their GIS requirements.

Expenditures include network components, both wireless carrier costs and selective router costs.

System	FY08 Budget	PI/PII
Cochise County	$ 764,531	to PII
Gila County	$ 2	to E911
Gila River Indian Community	$ 74,585	to PII
Graham County	$ 58,480	PII
Maricopa Region	$ 3,059,468	PII
Mohave County	$ 1,086,285	to PII
Navajo Co/Apache Co	$ 1,800	E911
Page	$ 198,547	PI to PII
Pima County	$ 1,531,653	PII
Pinal County	$ 396,925	to PII
Santa Cruz County	$ 81,360	PII
Winslow	$ 30,500	PI
Yavapai No.	$ 497,979	PII
Yavapai So.	$ 305,130	to PII
Yuma County	$ 424,607	to PII
	$ 8,511,852	

Additional expenditures budgeted for fiscal year 2008 includes the implementation of a frame relay network for deployment of an Enterprise Mapping System. With significant county boundary issues recognized, this system will allow GIS data to be distributed to the 9-1-1 centers within their county or share the data with other counties. These costs are already being expended in the Maricopa Region and Pima County because of the number of 9-1-1 centers located within that system. When a new map data is available, information can be sent via the network and updated information can be published more efficiently.

FY07 brought significant changes within the wireless industry and thus has positively affected the future of the Arizona 9-1-1 program. Several mergers and acquisitions have reduced the number of wireless network providers. This and with a change of carrier philosophy some of the carriers have opted to not seek cost recovery from the State 9-1-1 program. They have instead opted to seek self recovery from their customers. This does not affect the costs associated with the selective routers, but does effect the amount billed by the individual carriers.

Also, with an emphasis on Homeland Security and network restoration, the Telecommunications Service Priority (TSP) provisioning was added in FY07. This federal program is designed to ensure elevated network restoration to anyone who registers and pays for the service. In the event of a national disaster and federal intervention is required for network continuity, the service will ensure that Arizona's 9-1-1 systems will be restored in a timely manner.

All network components including 9-1-1 circuits, Automatic Location Identification circuits, emergency back circuits and circuits that run to all selective routers have been included in the service package.

The State 9-1-1 Office strives to reduce costs for network and equipment components. During FY07, negotiations with Qwest changed the billing structure for the wireless selective router charges, reducing costs significantly.

Revenue – FY08 Projections

Effective July 1, 2007, the Wireless Tax and Wire line Excise Tax was reduced from $.37/mo. to $.28/mo. by statute. The reduction for FY07 in projected revenues is based on an overall 5% increase in carrier services and the twenty per cent reduction in the tax.

There is an additional statutory reduction to $.20/mo scheduled for FY08 beginning in July 2007. The overall decrease reduces the revenue by almost 40% over a two year time period.

The wireless revenue for FY07 closed at $11,447.131, a 2% decrease over FY06. As previously noted, the Department of Revenue will not longer be breaking out the wireless revenue generated and therefore, the total funds will have to be evaluated. In the past two fiscal years, the total revenue collected between wire line and wireless was virtually equal. In FY07, wire line services was minimally ahead of wireless, which can possibly be equated to the opinion by the Department of Revenue that existing statutory language includes Voice over Internet Protocol (VoIP) services.

In the FY06 report, there was an assumption that the wireless customer base would continue to increase, but with the aforementioned DOR decision, the wire line customer base actually increased by 2% in FY07. The original projections for FY07 estimated that the wire line base would be reduced by 3%. In reality, the base only reduced by 1%. The wire line (Excise Tax) revenue for FY07 closed at $11,627,037. Again, we offset the wire line revenue with the wireless revenue to come up with an overall 5% increase when preparing the projections.

	FY07 Budget @$.28	FY07 Actual @$.28	% of Difference FY06-FY07
Wireless Tax	11,522,436	11,447,131	-1%
Excise Tax	11,125,184	11,627,037	4%
	22,647,620	23,074,168	2%

In preparing the 911 Project Plan through FY12, the tax decrease, customer base and reduced fees has been taken into consideration indicating that the program will reach a deficit in FY12.

One area where the reductions are immediately evident and is service affecting is the 3% administrative fees. Of this three percent, 2% is used for ADOA administrative services and 1% is distributed to the local level for network contract services.

The State 9-1-1 Office currently has five full time staff members. These individuals not only have fiscal oversight, but work closely with the communities to deploy and support 9-1-1. With the 40% reduction in revenues over the two year time frame and the 2% cap on administrative spending, staff will have to be reduced by one position during FY08. This impact may delay the deployment of Wireless PII.

The Future of 9-1-1

The 911 Project Plan addresses the need to transition to a more robust and technology forward network in coming years. The IP enabled network or Next Generation 9-1-1 designs are on the drawing board today. Once industry standards are developed, costs can be determined. The move toward a single network that provides ubiquitous service will ensure that calls can be routed anywhere without current boundary restrictions.

Beginning in fiscal year 2008, funds have been allocated to begin transitioning to a Next Generation IP enabled network. The initial project plan includes deployment of an IP network in Gila County. There is currently an issue with transfer of calls between Gila County Sheriff's Office in Payson and the office in Globe. The northern portion of Gila County is served out a separate selective router then the southern portion of Gila County as a result of a LATA boundary division. The installation of this Next Generation network including installation of soft switches, will allow for reliable and time sensitive transfer of calls. The four PSAPs in Gila County will be changed out to Positron Viper system designed specifically to transition to NG technology. It should be noted that this project may take several years to come to fruition and during this time all legacy network components will require continued support.

The 9-1-1 system was designed to ensure that in an emergency, citizens have one reliable number to call for public safety assistance. The State 9-1-1 program strives to ensure that this goal is met in the most efficient and cost effective manner.

STATE OF ARIZONA

Joint Legislative Budget Committee

STATE
SENATE

1716 WEST ADAMS
PHOENIX, ARIZONA 85007

PHONE (602) 926-5491

FAX (602) 926-5416

http://www.azleg.gov/jlbc.htm

HOUSE OF
REPRESENTATIVES

DATE: November 16, 2007

TO Representative Russell Pearce, Chairman
Members, Joint Legislative Budget Committee

THRU: Richard Stavneak, Director

FROM: Eric Billings, Fiscal Analyst

SUBJECT: State Treasurer – Review of Changes to Management Fees

Request

Prior to changing their current 8 basis point asset management fee, a General Appropriation Act footnote requires the Treasurer to submit their proposal to the Committee for review. The fees apply to all non-land endowment funds invested by the Treasurer. These monies are deposited in the General Fund and amounted to $7.4 million in FY 2007.

The Treasurer's proposal includes 2 options:

- Eliminate management fees and instead allow the Treasurer to retain a portion of earnings.
- Allow the Treasurer to reduce the management fee to a level that will cover the costs of operation and allow the agency to retain these fees.

These changes are intended to attract local governments to the Treasurer's pool, increasing total assets under management and allowing higher returns.

In connection with either option, the Treasurer proposes the revertment of the $3.4 million in General Fund money that was appropriated to the office for FY 2008. Both options would require statutory changes.

In addition, the Treasurer is proposing an expenditure plan that would increase the office's budget by $917,200 while potentially enhancing the return of assets under management.

Recommendation

The net General Fund impact depends on the combination of higher General Fund interest earnings and budget savings versus the loss of management fees. The Treasurer estimates a minimum 3 basis point

(Continued)

gain in investment yields; however, at 3 basis points, the net General Fund loss is between $(2.3) million and $(2.4) million. The Treasurer has stated that the 3 basis point estimate is conservative and actual increases could generate 12 basis points. At a 13.5 – 14 basis point gain, the higher interest earnings would be sufficient to offset the loss of management fees and the cost of funding the operating costs of the Treasurer. The combination of the higher interest earnings and retention of the state agency management fees could potentially produce a net positive gain to the General Fund.

The Committee has at least the following 3 options:

1. A favorable review of the plan to eliminate management fees in favor of funding the Treasurer's operations from earnings with the provision that the Legislature enact the necessary statutory changes.
2. A favorable review of the plan to reduce management fees to a level commensurate with the expenditure authority of the office with the provision that the Legislature enact the necessary statutory changes.
3. An unfavorable review.

Analysis

The Treasurer invests most state agency funds. At their option, local governments may also use the Treasurer to invest their funds as well. Currently, the Treasurer charges an 8 basis point management fee to all General Fund, state agency, and local government monies under management. This fee equates to an $8 fee for every $10,000 in assets. For FY 2007, the Treasurer reports management fee collections of $7.4 million, of which $2.8 million was collected from local government participants, $2.7 million from state agencies, and $1.9 million from the General Fund. All monies collected were deposited in the General Fund.

The overall net General Fund impact of the proposal will depend on the following factors:

- General Fund savings from the shift of the operating budget to a non-General Fund source.
- Loss of General Fund revenue due to lower or eliminated management fees.
- The General Fund cost associated with the new earnings financing mechanism.
- The General Fund gain from higher investment yields.

<u>Option 1 – Elimination of Management Fees and Funding Shift to Retained Earnings</u>

Under this option, management fees would no longer be collected. Instead, a percentage of earnings would be retained by the office at a rate commensurate with the operational costs of the agency as appropriated by the Legislature. Currently, statute does not allow monies to be retained from investment earnings managed by the Treasurer.

The Treasurer estimates that their proposal will have the following benefits:

- Increased resources will increase yields by at least 3 basis points on the $12 billion in assets under management, or $3.7 million to all participants.
- $571,800 in cost avoidance due to increased contract oversight and efficiency savings. Of the $571,800 in cost avoidance, $200,000 results from contract auditing, $104,800 from operating inefficiencies, and $267,000 from reduced processing time for state agencies.
- Additional savings through improvements in pricing due to the increased magnitude of the transactions that the Treasurer will be able to conduct.

These potential General Fund gains would be offset by the loss of management fees.

(Continued)

As shown in *Table 1*, the net impact of option 1 on the General Fund would be a loss of $(2.3) million utilizing a 3 basis point yield on assets. The components of that estimate are as follows:

● General Fund savings from the shift of the Treasurer's operating budget	$3.4
● Loss of General Fund revenue due to eliminated management fees	(5.5)
● The General Fund cost of the new earnings financing mechanism	(0.9
● The General Fund gain from higher investment yields	0.7
Total gain or loss to the General Fund	(2.3)

Both state agencies and local governments would realize a benefit of approximately $2.5 million and $2.3 million, respectively, due to management fee savings in excess of the retained earnings. The Treasurer would gain an additional $612,400 in funding above the FY 2008 appropriated level of $3.4 million. The $612,400 includes $917,200 for enhanced investment capability less the $(304,800) in contract oversight savings and operational efficiencies.

The additional $917,200 in funding for the Treasurer would be used to increase interest earnings through subscriptions to major ratings agencies, enhanced trading analytics, and increased efficiency in trading execution. The first component of this package is a subscription to the 3 major ratings agencies (Moody's, S&P, and Fitch) which would allow for real-time notification of any changes to the credit rating of securities. The package also includes a subscription to Trade-Web, an electronic, multi-dealer online trading network for fixed income, and Yield Book, a fixed-income analytics program. Lastly, this package includes a credit analyst position which will augment the analytical capabilities of the 3 staff members who currently manage trading and securities analysis.

In order for the General Fund to avoid a loss under Option 1, the gain from the Treasurer's additional funding proposal would have to exceed 13.5 basis points. This is determined by utilizing the FY 2007 average daily balance of $2.3 billion for the General Fund. The Treasurer's Office reports that it is 80% confident that returns from the additional funding will fall between 3 and 12 basis points on assets under management.

The General Fund would also gain if the state agency management fee savings of $2.7 million were deposited in the General Fund. State agencies, however, are paying these fees from dedicated funds. As a result, the management fee savings will accrue to the dedicated fund. There would have to be a transfer from the dedicated fund to the General Fund to achieve any General Fund savings. The State Highway User Revenue Fund, Classroom Site Fund, and State Lake Improvement Fund are examples of dedicated funds. Alternatively, state agency management fee savings could be retained in the General Fund.

<u>Option 2 – Reduction of Management Fees</u>

Under the second option, the management fee would be reduced to a rate that would allow the Treasurer's operating expenses to be fully funded. In order for this to be possible, legislation would have to be enacted that would allow the Treasurer to keep these fees.

For FY 2009, the management fee would have to be set at approximately 4.7 basis points in order to meet funding needs as illustrated in *Table 2*. In this scenario the General Fund would realize losses of approximately $(2.4) million over FY 2007. The components of that estimate are as follows:

● General Fund savings from the shift of the Treasurer's operating budget	$3.4
● Loss of General Fund revenue due to lower management fees	(6.6)
● The General Fund savings of the new earnings financing mechanism	0.1
● The General Fund gain from higher investment yields	0.7
Total gain or loss to the General Fund	(2.4)

(Continued)

Table 1

Option 1: Full Year Impact of Eliminating Management Fees
General Fund Gain (+) / General Fund Loss (-)

	Impact on General Fund	Impact on Local Governments	Impact on State Agencies	Impact on Treasurer
Revertment of Operating Costs	$ 3,420,400	$ 0	$ 0	$(3,420,400)
Management Fees				
Local Government	(2,846,500)	2,846,500	0	0
State Agency	(2,690,500)	0	2,690,500	0
General Fund	0	0	0	0
Subtotal	(5,537,000)	2,846,500	2,690,500	0
Retained Earnings				
General Fund	(796,200)	0	0	796,200
Local Government	0	(1,313,200)	0	1,313,200
State Agency	0	0	(1,311,000)	1,311,000
Additional Resources	(210,000)	(345,800)	(361,400)	917,200
Cost Savings	69,800	114,900	387,100	(304,800)
Subtotal	(936,400)	(1,544,100)	(1,285,300)	4,032,800
Higher Interest Earnings	677,300	955,400	1,120,600	0
Total	**$(2,375,700)**	**$2,257,800**	**$2,525,800**	**$612,400**

Local governments and state agencies would realize gains of approximately $2.2 million and $2.6 million, respectively, on an annual basis due to lower effective fees and higher interest earnings. The Treasurer would gain $612,400 in additional funding above the FY 2008 appropriated amount of $3.4 million. The $612,400 includes $917,200 for enhanced investment capability less the $(304,800) in contract oversight savings and operational efficiencies.

In order for the General Fund to avoid a loss under option 2, the gain from the Treasurer's additional funding proposal would have to exceed 13.8 basis points. This is determined by utilizing the FY 2007 average daily balance of $2.3 billion for the General Fund.

The General Fund would also gain if the state agency management fee savings of $1.1 million were deposited in the General Fund.

Other Issues

During the previous administration, the Treasurer reports that it lost 2 major clients which represented $653 million in assets under management. This translates to a $522,400 loss in General Fund revenues under the current management fee structure. Treasurer reports that another $578 million in assets are under threat of leaving due to the current level of management fees.

(Continued)

Table 2

Option 2: Full Year Impact of Utilizing a 4.7 Basis Point Management Fee
General Fund Gain (+) / General Fund Loss (-)

	Impact on General Fund	**Impact on Local Governments**	**Impact on State Agencies**	**Impact on Treasurer**
Revertment of Operating Costs	$ 3,420,400	$ 0	$ 0	$(3,420,400)
Management Fees				
Local Government	(2,846,500)	1,170,300	0	1,676,200
State Agency	(2,690,500)	0	1,106,100	1,584,400
General Fund	(1,077,000)	0	0	1,077,000
Cost Savings	69,800	114,900	387,100	(304,800)
Subtotal	(6,544,200)	1,285,200	1,493,200	4,032,800
Higher Interest Earnings	677,300	955,400	1,120,600	0
Total	**$(2,446,500)**	**$2,240,600**	**$2,613,800**	**$612,400**

RS/EB:sls

OFFICE OF THE
ARIZONA STATE TREASURER

HON. DEAN MARTIN
TREASURER

Wednesday October 31, 2007

Hon. Representative Russell Pearce
Chairman of the Joint Legislative Budget Committee
Arizona House of Representatives
1700 W. Washington
Phoenix, AZ, 85007

Dear Representative Pearce,

As the bank for the State of Arizona, we are quite aware of the financial problems the state is facing. You will recall that within the first 45 days of my administration we alerted the budget offices that our daily tracking of all cash was turning negative and to expect a slowdown in revenues. During discussion on our budget proposal for this year, we also talked about the Treasurer's office becoming self-supporting as well as the importance of lowering the management fees charged by the office in an effort to attract more voluntary participants for the investment pools we operate on behalf of the state and its political subdivisions which would improve yields for all. In accordance with Laws 2007 Chapter 255, I'm requesting the JLBC review the following proposed change in the management fees charged by the Arizona State Treasurer's Office. We believe these changes will also help address the General Fund Budget deficit in FY 2008 and FY 2009.

HISTORICAL BACKGROUND:

As background, ARS 35-316 was amended by Laws 1992, Chapter 312, Sec. 5 to give the State Treasurer the ability to charge a management fee of between zero and 12 basis points on Assets Under Management (AUM), except those investments in the Arizona Endowment. A footnote in the 1993 General Appropriations Act for Fiscal Year 2004 required the Treasurer to charge the full 12 basis points. The subsequent year, the footnote was changed to 8 basis points and has remained there ever since. (A basis point represents a hundredth of one percent and is numerically displayed as .01, to calculate a basis point requires multiplying a number by .0001. Therefore, 8 basis points charged on $1 billion would equate to $1,000,000,000*.0008 = $800,000.) Since the inception of the management fee, the Treasurer's office has not been given the ability to set the management fee or charge a range of fees depending on assets under management.

To calculate the management fee we currently take the average daily balance invested each month by participant, multiply by the number of days in the month and divide by 365 days in a year and then multiply by 8 basis points. This fee is charged on all monies under management, including the General Fund.

PRESENT DAY:

In FY 07, the Treasurer's office earned more than $732 million on all of its investments. With a total operating budget of only $2,820,300, that's a 26,800% return on investment. The Treasurer's office is truly a profit center for the state. Earnings by category were: General Fund - $111 million; State Agencies - $166 million; Political subdivisions and external participants - $185 million; Endowment - $267 million. Actual earnings distributed are less due to a one month lag in paying out earnings. In the case of the Endowment, a 5-year rolling average formula contained in the Arizona Constitution determines distributions each year to beneficiaries.

For the just completed fiscal year, the total management fees earned was $7,365,938. Total management fees actually received was $7,205,938. (The main difference between fees earned and collected is some management fees do not get paid until investments mature. However, of the $7,365,938 of fees earned, only $2,846,497 was collected from external participants. The remaining fees are charged against state agencies and the general fund and are then returned to the state as interest earnings. Therefore, $4,495,886 of the management fees from FY 07 are simply returning to the state the same earnings it has already received in interest in the form of interest earnings.

With a total operating budget of $2,820,300, external management fees collected during FY 2007 represented a net gain of only $26, 197 for the state general fund. The attached table demonstrates that during the past decade, the management fees were a net **loss** to the state of $423,233.

Furthermore, total AUM for external participants amounted to about 32% of the total AUM of the office in FY 2007. Therefore one class of customers is funding 100% of the cost of the entire operations of the office. This inequity will be difficult to sustain in the future as more options arise for political subdivisions to invest their funds. This ultimately would then hurt the state's General Fund since the less cash to invest each day reduces liquidity and yield in the remaining investment pools.

Lowering or eliminating the fee would also lead to attracting more investments. Currently the largest political subdivisions in the state run their own investment pools because the 8 basis points charge is substantially more than what it costs those shops to run their internal investments or other external options. For example, the Maricopa County Treasurer's office manages about $4 billion in investments. Assuming all of their investments were pooled with the state, the mandated 8 basis points would cost Maricopa County $3.2 million, their entire office budget is less than $5 million. Therefore, to offset the management fee, the state's LGIP pools would have to outperform the political subdivisions own performance by at least 8 basis points in order to breakeven. While this is clearly possible, the fee is a large psychological hurdle for any internally managed investment operation to overcome.

By comparison, it costs the ASTO less than 1 basis point to operate the entire investment operation. The regular solicitations this office receives to externally manage the investment pools charge at the minimum 15 to 30 times the cost of our present operations. The performance by external managers would then have to between 15 to 30 basis points higher than current returns – a difficult task to achieve considering the appropriate limitations placed on what debt instruments we can invest in. Further, many of our larger political subdivisions are solicited for business on a sliding scale basis and once their investments reach a certain level, the management fees charged are less than the 8 basis points we are mandated to charge.

Finally, with more than $9.5 billion in AUM subject to the management fees, a slight increase in yield dwarfs any revenue received from management fees. Our proposed budget solution discussed below and in the attached letter will more than account for any loss of revenue by lowering the management fee.

PROPOSAL:

We propose two options for the JLBC to consider as it relates to management fees. Under each option the ASTO would remain subject to legislative appropriation, but eh source of funds would be similar to a 90/10 agency.

Option 1:

Eliminate management fees all together. Due to the relative small net benefit the fees provide the General Fund ($26,197 in FY 07), administering the management fees costs more staff time and effort than the revenue they produce. This would also remove a perceived barrier of entry for some of the larger political subdivisions in the state from participating in the investment pools run by the ASTO. The benefit to the state would be more AUM over time. In Wall Street parlance, the more money you have to invest, the better pricing you can obtain, especially with overnight repurchase agreements. Just one basis point increase in spread across all pools for the year generates an additional $1.2 million in earnings.

We also recommend that at the same time convert the ASTO from General Fund to an Appropriated Other Fund status, by financing operations out of total earnings. This is similar to how the Arizona State Retirement System and the Public Safety Retirement System finance their internal operations. By financing operations out of earnings, all participants in the investment pools would share equally in the cost of operations. On an accounting basis, the General Fund could realized a $3.4 million in savings in FY 08, as we would revert GF funds and finance our FY 08 operating needs out of earnings.(We can make a full FY 08 revertment, even for past months, by a simple transfer of expenditures to date from earnings.)

Option 2:

Reduce the present management fees to cover the present cost of operations of the Treasurer's office. This option would give our office the ability to match management fees to the cost of operation. The fee would be applied in the same fashion as the present day but would be reduced to match the operating budget of the office. For FY 08, the operating budget is $3,420,400, requiring a management fee of between 4 and 5 basis points, depending on the average monthly AUM. We would propose re-investing any excess management fees that are collected back into our operations subject to JLBC review of an expenditure plan. This proposal would also provide the General Fund with a $3.4 million in savings as we would revert GF funds and finance our FY 08 operating needs out management fees charged each month. (We can make a full FY 08 revertment, even for past months, by a simple transfer of expenditures to date from earnings.)

Our preference would be Option 1 from earnings since we believe it provides the simplest, most transparent, and best solution for **all** of the taxpayers of Arizona, both state and local. We would also request an acceleration of our FY 09 budget request to January 2008 so we could increase performance on the investments with some additional tools that are necessary to the investment operations. This will increase performance of the investment pools and therefore revenues to the state. (Please see the attached letter.)

Sincerely

Dean Martin

Dean Martin
Arizona State Treasurer
CC: Hon. Senator Robert Burns
Richard Stavneak, Director of the Joint Legislative Budget Committee

OFFICE OF THE
ARIZONA STATE TREASURER

HON. DEAN MARTIN
TREASURER

October 1, 2007

Governor's Office of Strategic Planning and Budgeting
Mr. James Apperson, Director
1700 W. Washington, Suite 500
Phoenix, AZ 85007

Dear Mr. Apperson,

As the bank for the State of Arizona, we are quite aware of the financial problems the state is facing. The ASTO actually began identifying the negative trends in cash flow within the first 45 days of the new administration and alerted the budget offices that our daily tracking of all cash was turning negative and to expect a slowdown in revenues. Therefore as part of the Fiscal Year 2009 budget submittal, I am offering solutions to help the state meet the challenges it faces in the current FY 2008 GF budget through a combination of changes that will both result in GF savings and bolster revenues generated by this office.

Last year we distributed more than $484 million in earnings to the state general fund, state agencies and local governments. FY 2006-2007 was an exceptional year for earnings due in large part to the inverted interest rate environment. That is a 17,200% rate of return on the $2.8 million GF operating budget. This does not include investment gains of $267 million earned last year for the Endowment. Combined, the ASTO made more than $751 million for taxpayers, a return of 26,800% on GF resources.

First, we propose that the Arizona State Treasurers' Office become a self-funding entity and no longer rely on the General Fund for its operations. Since we are a significant revenue generating operation, we propose a change that would be similar to a 90/10 agency, except more like a 1/99. This would provide the state with $3,420,000 in immediate General Fund savings in FY 2008. Instead, our current GF operations would be funded out of earnings or management fees that we charge all entities, (with the exception of the Permanent Fund of the Land Endowment). This management fee is currently set at 8 basis points, and we would propose that we be given the flexibility to lower the fee to match expenses and additional resources that are needed in order to improve the performance of the office. This proposal would fund our GF operations similar to ASRS and PSPRS operations, which are both funded out of the earnings they generate. Also similar to other state agencies that provide services such as DOA for rent or risk management for liability insurance.

Second, we propose that our FY 2009 budget request be accelerated into FY 2008 in order to allow for quicker implementation of plans that will generate additional investment income and reduce operational costs. We have been in the process of a complete review of the Treasurer's office operations and have identified a few critical changes that are itemized in our request. We estimate that the sooner we are given the authority to improve our operations, the faster we can improve our performance and earnings for the taxpayers of Arizona.

The combination of our FY 2009 budget requests will conservatively generate at least $3,399,000 in net new revenues annually for the state. Thus, if this plan were adopted today, we could provide an additional $1.7 million in GF revenue this year for a total savings of $5.1 million in FY 2008. The annualized savings would grow to $6.8 million in FY 2009. It is important to note that these are very conservative estimates; the actual numbers are likely to be much higher. Some items could generate millions more in savings once implemented across all state agencies.

Attached are the budget requests for FY 2009, submitted in the regular budget format as required by the Governor's Office of Strategic Planning and Budgeting. My staff is available to answer any and all questions and assist the state in maximizing earnings and savings during the present budget problems. Again, we are continuing our efforts to identify new opportunities to generate additional revenues to the State of Arizona and we will keep you informed as we collect additional data.

Sincerely,

Dean Martin
State Treasurer

Cc: Richard Stavneak, Director, Joint Legislative Budget Committee

1700 W. WASHINGTON, PHOENIX, ARIZONA 85007 • (602) 604-7800 • FAX (602) 542-7176
WWW.AZTREASURY.GOV

ARIZONA STATE TREASURER'S OFFICE
MANAGEMENT FEES - FISCAL YEARS 1996 - 2007

FY	GENERAL FUND	STATE AGENCY	EXTERNAL	FY TOTAL	OP BUDGET	NET GAIN (EXTERNAL FEES MINUS BUDGET)
1998	$ 1,115,610	$ 1,289,581	$ 1,611,980	$ 4,017,171	2,007,800	$ (395,820)
1999	$ 1,110,154	$ 1,466,108	$ 1,994,941	$ 4,571,204	2,083,600	$ (88,659)
2000	$ 1,110,977	$ 1,752,313	$ 2,099,733	$ 4,963,023	2,303,900	$ (204,167)
2001	$ 1,143,454	$ 1,868,801	$ 2,498,010	$ 5,510,264	2,412,700	$ 85,310
2002	$ 924,205	$ 2,193,548	$ 2,727,469	$ 5,845,222	2,389,900	$ 337,569
2003	$ 741,547	$ 1,871,291	$ 2,733,069	$ 5,345,907	2,195,900	$ 537,169
2004	$ 958,736	$ 1,564,040	$ 2,387,196	$ 4,909,972	2,578,600	$ (191,404)
2005	$ 1,225,714	$ 1,816,823	$ 2,279,956	$ 5,322,494	2,785,700	$ (505,744)
2006	$ 1,781,893	$ 1,906,490	$ 2,591,816	$ 6,280,199	2,615,500	$ (23,684)
2007	$ 1,805,391	$ 2,690,495	$ 2,846,497	$ 7,342,382	2,820,300	$ 26,197
INVESTOR TOTAL	**$ 11,917,680**	**$ 19,045,479**	**$ 25,046,838**	**$ 54,107,837**		$ (423,233)

\\HERMES\Users\MarkS\My Documents\strategic planning\AvgBal-MgtFee_FY96-07.xls