CALIFORNIA STATE AUDITOR

# Children's Hospital Program

## Fund Disbursements Are Appropriate, but Estimates of Cash Needs Have Been Consistently High

July 2012 Report 2012-042

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# CALIFORNIA STATE AUDITOR
Bureau of State Audits

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July 12, 2012 2012-042

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As authorized by California Health and Safety Code, sections 1179.25 and 1179.58, the California State Auditor presents this audit report concerning the Children's Hospital Program (program).

This report concludes that the California Health Facilities Financing Authority (authority), which administers the program, complied with laws and regulations related to awarding grants for eligible hospitals to construct or improve children's facilities. Further, the authority has a process for monitoring grants and has processed payments to grantees in accordance with the law. However, the authority's administration of the program could be more efficient. The authority requested bond sales that were in excess of its cash needs at a time when California's credit rating was low and interest-rate volatility was high. As a result, the State paid as much as $16 million in interest annually on the idle capital while the State was facing cash shortfalls.

Although the authority could not have foreseen or mitigated all of the circumstances that led to an excessive fund balance, its estimates of cash needs have consistently been well above actual disbursements. This pattern, as well as some hospital project delays that it could have anticipated, indicate that the authority needs to revise the way it makes yearly projections of cash needs. In particular, the authority currently includes in its estimates the projected cash needs of hospitals that have not yet submitted a project application for approval.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

# Contents

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# Summary

## RESULTS IN BRIEF

In accordance with the Children's Hospital Bond Acts of 2004 and 2008, the California Health Facilities Financing Authority (authority) administers the Children's Hospital Program (program), which provides grants for eligible hospitals to construct or improve children's facilities. The authority's activities related to awarding grants complied with laws and regulations. Further, the authority has a process for monitoring grants and has processed payments to grantees in accordance with the law. However, the authority's administration of the program could be more efficient. The authority, like many other state agencies and departments, has not distributed proceeds promptly from its bond sales. Specifically, the authority, which had a program fund balance of $355 million as of January 2012, requested bonds sales that were in excess of its cash needs at a time when California's credit rating was low and interest-rate volatility was high. Consequently, the State paid as much as $16 million in interest annually on the idle capital while it was facing cash shortfalls.

Although the authority could not have foreseen or mitigated all of the circumstances that led to the excessive fund balance, its estimates of cash needs have consistently been well above actual disbursements. This pattern, as well as some hospital project delays that it could have anticipated, indicate that the authority needs to revise the way it makes yearly projections of cash needs. In particular, the authority currently includes in its estimates the projected cash needs of hospitals that have not yet submitted a project application for approval. Lacking the scrutiny associated with the application process, the authority has requested and obtained multimillion-dollar bond sales for projects that are later delayed or found not to meet regulatory requirements. Further, for hospitals with approved projects, the authority does not currently require written commitments indicating when the hospitals plan to spend awarded funds.

### Recommendations

To avoid contributing to the State's financial strain, the authority should limit future bond sales to the level of disbursements it reasonably expects to make during the following six-month period. Further, the authority should reduce its current cash balance by continuing to make disbursements to hospitals while refraining from requesting additional bond sales.

***Audit Highlights . . .***

*Our review of the California Health Facilities Financing Authority's (authority) efforts to award 2004 and 2008 bond act funds, highlighted the following:*

» *The authority has not distributed proceeds promptly from its bond sales.*

- *It requested bonds sales that were in excess of its cash needs at a time when California's credit rating was low and interest-rate volatility was high.*
- *The State paid as much as $16 million in interest annually on the idle capital while it was facing cash shortfalls.*

» *The authority's estimates of cash needs have consistently been well above actual disbursements.*

- *It includes in its estimates the projected cash needs of hospitals that have not yet submitted project applications for approval.*
- *It has requested and obtained multimillion-dollar bond sales for projects that are later delayed or found not to meet regulatory requirements.*

If the authority believes it needs to retain a portion of its cash balance as a contingency reserve for unforeseen circumstances, it should perform and document an analysis demonstrating the appropriateness of the reserve level it adopts.

To allow for more accurate planning of upcoming cash needs, the authority should refine its cash-projection process to more accurately reflect its near-term cash needs. Specifically, the authority should refrain from requesting additional bond sales for projects that have not yet received project approval from the authority.

For hospitals with existing projects, the authority should request written confirmation from hospitals that details when hospitals will submit disbursal requests for approved funds.

## Agency Comments

The authority agrees with our recommendations and will take various corrective actions to implement them.

# Introduction

## BACKGROUND

In November 2004 California voters approved Proposition 61, the Children's Hospital Bond Act of 2004 (2004 act), establishing the Children's Hospital Program (program) and authorizing the State to sell $750 million in general obligation bonds to fund it. In November 2008 California voters approved an additional $980 million in general obligation bonds for the program (2008 act). However, because of the State's budget crisis, funds from the 2008 act did not become available for grants to eligible hospitals until late 2009. The purpose of the program is to improve the health and welfare of California's critically ill children by providing funds for capital improvement projects for qualifying children's hospitals (see the text box). Eligible projects include those to construct, expand, improve, or finance children's hospitals, including their furnishings and equipment.

**Specific Hospital Eligibility Requirements for Grants Under the Children's Hospital Program**

A general acute care hospital that is, or is an operating entity of, a California nonprofit corporation established prior to January 1, 2003, and that:

- Has a mission of clinical care, teaching, research, and advocacy that focuses on children.
- Provides comprehensive pediatric services to a high volume of children eligible for government programs and with special health care needs eligible for the California Children's Services program—a combined federal-, state-, and county-funded program to treat chronic medical conditions that affect children.
- Provided evidence of the following, based on information hospitals reported for their fiscal year ending between June 30, 2001, and June 29, 2002, to the Office of Statewide Health Planning and Development on or before July 1, 2003:
    - At least 160 licensed beds for pediatric acute care, pediatric intensive care, and neonatal intensive care.
    - More than 30,000 total pediatric patient days, excluding nursery acute days.
    - Medical education of staff to include at least eight full-time-equivalent pediatric or pediatric subspecialty residents.

Sources: California Health and Safety Code and the Department of Health Care Services.

The 2004 and 2008 acts identify two groups of general acute care hospitals as eligible for the program—five University of California (UC) hospitals and eight non-UC hospitals. Of the total funds available under both acts, 20 percent is earmarked for grants to the five UC hospitals. Each of these hospitals may receive more than one grant, but the total for all grants awarded to each UC hospital is limited to $30 million for the 2004 act and $39.2 million for the 2008 act, for a total of $69.2 million per UC hospital. As shown in the Table on the following page, eight other hospitals are eligible for the program, based on the eligibility requirements in the act. The remaining 80 percent of the total bond funds for the 2004 and 2008 acts is earmarked for these eight hospitals. These hospitals may also receive more than one grant, but the total for all grants awarded to each hospital is limited to $74 million for the 2004 act and $98 million for the 2008 act, for a total of $172 million per hospital.

**Table**
**Total Awards and Disbursements From the Children's Hospital Bond Acts of 2004 and 2008 as of January 2012**
**(In Millions)**

| HOSPITAL | MAXIMUM AVAILABLE | TOTAL AWARDED | TOTAL DISBURSED | FUNDS REMAINING* |
|---|---|---|---|---|
| **University of California Hospitals Specifically Identified as Eligible†** | | | | |
| University of California, Davis Children's Hospital | $69.2 | $23.6 | $23.6 | $45.6 |
| University Children's Hospital at University of California, Irvine | 69.2 | 29.8 | 29.8 | 39.4 |
| Mattel Children's Hospital at University of California, Los Angeles | 69.2 | 54.7 | 54.7 | 14.5 |
| University of California, San Diego Children's Hospital | 69.2 | 29.8 | 29.8 | 39.4 |
| University of California, San Francisco Children's Hospital | 69.2 | 0.0 | 0.0 | 69.2 |
| **Hospitals Eligible Under Specific Requirements Listed in the Children's Hospital Bond Acts of 2004 and 2008‡** | | | | |
| Children's Hospital Los Angeles | $172.0 | $171.4 | $171.4 | $0.0 |
| Children's Hospital Central California, Madera | 172.0 | 83.4 | 72.8 | 99.2 |
| Children's Hospital and Research Center Oakland | 172.0 | 78.8 | 73.9 | 98.1 |
| Children's Hospital of Orange County | 172.0 | 171.3 | 166.7 | 5.3 |
| Loma Linda University Children's Hospital | 172.0 | 6.1 | 6.1 | 165.9 |
| Lucile Packard Children's Hospital at Stanford | 172.0 | 171.4 | 73.6 | 98.4 |
| Miller Children's Hospital Long Beach | 172.0 | 95.8 | 82.7 | 89.3 |
| Rady Children's Hospital San Diego | 172.0 | 98.7 | 97.6 | 74.4 |
| **Totals** | **$1,722.0** | **$1,015.0** | **$883.0** | **$839.0** |

Sources: California Health and Safety Code and California Health Facilities Financing Authority.

* *Funds Remaining* includes funds unallocated to hospitals and funds awarded but not yet disbursed. Hospitals with zero funds remaining were awarded the full amount allowed under the acts, minus state administrative costs.

† Receive 20 percent of program funds.

‡ Receive 80 percent of program funds.

The California Health Facilities Financing Authority (authority) is authorized by the 2004 and 2008 acts to award grants for the purpose of funding eligible projects. Established in 1979, the authority was created to administer the State's programs to provide loans, funded through the issuance of tax-exempt bonds, to public and nonprofit health care providers. The authority employs a process to review applications for grants, evaluate the proposed projects, and make recommendations to its governing board for approval or rejection of the grant applications. In addition to the program requirements contained in the acts, the program is governed by regulations that detail program requirements regarding eligibility, applying for funding, closing out grants, and remitting to the authority any investment earnings grantees earn on advances of program funds. As of January 2012 the authority had awarded about $637 million in program grants authorized by the 2004 act and disbursed about $621 million to the grantees. From the 2008 act, the authority had awarded about $378 million and disbursed about $262 million.

Prior to 2009 the authority would borrow money at comparatively low interest rates from the State's Pooled Money Investment Account (PMIA) to make disbursements to hospitals. The Office of the State Treasurer (state treasurer) periodically sold bonds to pay off these PMIA loans. However, according to the Pooled Money Investment Board (PMIB), due to the State's fiscal crisis, the state treasurer was unable to issue bonds or commercial paper between June and December of 2008, and thus was incapable of replenishing the PMIA account. As a result, in order to conserve cash for high-priority payments, such as debt service, special funds, and schools, in December 2008 PMIB voted to freeze disbursements for projects funded by general obligation bonds. Following the PMIB action, the Department of Finance (Finance) directed all agencies that have expenditure control and oversight of general obligation bond programs to cease authorizing any new grants or obligations for bond projects. This suspension of funding activity affected disbursements of bond proceeds from both the 2004 act and the 2008 act. As a result, no funds from the 2008 act were disbursed until December 2009.

In early 2009 state officials implemented new procedures for accessing bond funds by obtaining estimates of funding needs from agencies and then selling bonds equal to those needs. This new procedure is designed to be used by entities that were denied access to funding through PMIA. To authorize the issuance of bonds to carry out the purposes of the program, the 2004 and 2008 acts created the Children's Hospital Bond Act Finance Committee, comprising the Office of the State Controller, director of Finance, and state treasurer, or their designated representatives. A program official explained that although this committee authorizes a maximum borrowing amount for a specific time period, the total of the bonds sold is based on the agencies' need estimates submitted to and compiled by Finance.

## Scope and Methodology

The 2004 and 2008 acts state that the California State Auditor may conduct periodic audits to ensure that bond proceeds are awarded in a timely fashion and in a manner consistent with the requirements of the acts, and that grantees of bond proceeds are using funds in compliance with applicable provisions. In May 2009 we published the results of our review of the authority's efforts to award 2004 bond act funds. Generally, we found that the authority's procedures were adequate but that it could improve its program management in some areas. In the year following the May 2009 report, the authority implemented the recommendations stemming from that report. In early 2012 we began this subsequent review, which covers both the 2004 and 2008 acts.

To gain an understanding of the program requirements, we reviewed the laws and regulations for the program, interviewed management and staff of the authority, and reviewed applicable documentation, such as grant applications and instructions for grant applications.

To determine whether bond proceeds were awarded in a manner consistent with the requirements of the acts, we reviewed the process used by the authority to award grants, and reviewed five of the 29 previously unaudited grants awarded thus far to determine whether the hospitals and their proposed projects met the requirements to receive program funds. We determined that the checklists the authority uses to ensure that required documentation has been submitted and to assist staff in making grant award determinations are essentially the same as those it was using during our 2009 review of the program. In our 2009 review we determined that the checklists used by the authority matched the criteria outlined in the regulations. In addition, we determined whether information prepared by the authority's staff regarding its evaluation of proposed grants and presented to its board for consideration was consistent with the information contained in the grant applications. Lastly, we reviewed the resolutions by the authority's board to ensure that the grants were approved, and we reviewed the grant agreements to ensure that they contained critical elements required by the regulations.

To determine whether the authority processed applications and awarded grants in a timely fashion, we compared the date on the application to the date of the formal approval by the authority's board. We found the grants were generally awarded within the 60 days required by state law.

To determine whether grantees are using bond proceeds in compliance with applicable program requirements, we randomly selected 15 program disbursements and reviewed the largest two invoices for each, along with their related grant agreements and contracts. The disbursements were adequately supported by documents such as invoices, purchase orders, or contracts provided by the grantee hospitals. We did not visit hospitals to evaluate their controls to ensure that the invoices they presented to the authority for payment represented only eligible project costs. To assess the authority's monitoring and closeout procedures, we reviewed four of the 16 previously unaudited grants for which the projects were completed. Lastly, we reviewed the authority's compliance with its regulations requiring that interest earned by grantees on previously released grant funds be paid back to the authority or offset against future disbursements of grant funds.

While performing the steps described previously, we identified a cash balance of roughly $355 million from proceeds of general obligation bond sales used to support the program. To determine the factors contributing to this cash balance, we reviewed and evaluated the methodology used by the authority to estimate its cash needs. We also compared the amounts the authority requested for each period to its disbursements to the qualifying hospitals for those same periods.

# Audit Results

### Efforts to Award Grants and Disburse Funds Appear to Be Appropriate

The California Health Facilities Financing Authority (authority) properly awarded grants to eligible hospitals by establishing and carrying out an evaluation process for project applications and by ensuring that disbursements were for activities and costs allowed under the Children's Hospital Bond Acts of 2004 (2004 act) and 2008 (2008 act). The authority uses checklists to award and manage grants, including three checklists to evaluate the applications submitted to it by hospitals to ensure that the applications are complete and that the projects meet the eligibility requirements of the Children's Hospital Program (program). It uses two other checklists to ensure adherence to regulations for the release of funds and project completion. Through these five checklists, the authority determines whether grant applications and fund requests meet critical requirements contained in the acts and in program regulations.

Our review of five grant applications showed that the authority properly evaluated the applications and awarded the grants. Specifically, the projects described in the applications met the requirements set in regulation, and the applications were processed within the allowable time frame. For all five grants we reviewed, the application was supported by the checklist information, and the hospitals met the necessary requirements to receive the grants.

Our review of invoices for 15 disbursements found that the authority properly evaluated and processed these disbursement requests and subsequent transactions. Hospitals submit invoices to the authority to document allowable project expenditures associated with each disbursement request. We found that all 15 invoices were for allowable costs, as described in regulation. Additionally, the authority followed its procedures and did not exceed the award amount stated in the grant agreement.

The authority indicated that staff monitor projects through the disbursement process, regular communication with hospitals, and periodic site visits. We selected four projects from the 16 hospitals that had completed projects and that were not reviewed in our 2009 report, and found that the authority conducted site visits at each. Further, we found that any interest earned on program funds was recovered by the authority during the final grant disbursal. Finally, the project completion documentation, such as the checklist and certificate of occupancy, was completed for each of the grants.

## The Authority's Bond Sales in Excess of Disbursements to Hospitals Have Been an Inefficient Use of State Funds

The authority's request for, and the subsequent sale of, general obligation bonds to finance the program without an imminent need for these bond proceeds was an inefficient use of state funds. As of January 2012 the authority had a fund balance of $355 million in unspent proceeds from bond sales, costing the State roughly $16 million in interest annually. Further, the authority requested these bond sales in excess of need at a time when the State was both paying higher interest due to a poor credit rating and experiencing a cash shortfall. The authority cited issues surrounding new methods for accessing grant funds, unexpected delays in the development of hospital projects, and other factors as contributing to its fund balance. However, our analysis indicates that the authority could have known about some of these issues and revised its bond requests accordingly.

### *The Authority Contributed to the State's Financial Strain by Selling Bonds Before the Proceeds Were Needed*

Like many other state agencies and departments, the authority has not promptly distributed proceeds from bond sales. According to the Office of the State Treasurer (state treasurer), as of December 2011, the State had a balance of $7.9 billion in unspent proceeds from general obligation bonds.[1] Of this amount, the Department of Finance (Finance) reported that roughly $2.1 billion (nearly 27 percent) was from bonds issued in 2009 that had been idle for almost three years. Finance reported that this large cash balance resulted in more than $100 million in interest payments each year, without any tangible benefits for the State. As indicated in the text box, the authority had the fifth largest balance of unspent general obligation bonds in the State as of December 2011. We estimated that the State paid about $16 million in interest each year out of its General Fund on the authority's unspent bond proceeds.

**Top Ten General Obligation Bond Balances by Department or Agency, as of December 2011 (In Millions)**

| | | |
|---|---|---|
| 1. | Department of Water Resources | $2,412 |
| 2. | California Department of Transportation | $1,613 |
| 3. | Resources Agency (excluding the Department of Water Resources) | $1,383 |
| 4. | Housing and Community Development | $916 |
| 5. | California Health Facilities Financing Authority | $359 |
| 6. | University of California | $208 |
| 7. | Office of Public School Construction | $178 |
| 8. | Department of Public Health | $169 |
| 9. | California Community Colleges | $153 |
| 10. | California Institute for Regenerative Medicine | $136 |

Source: Office of the State Treasurer.

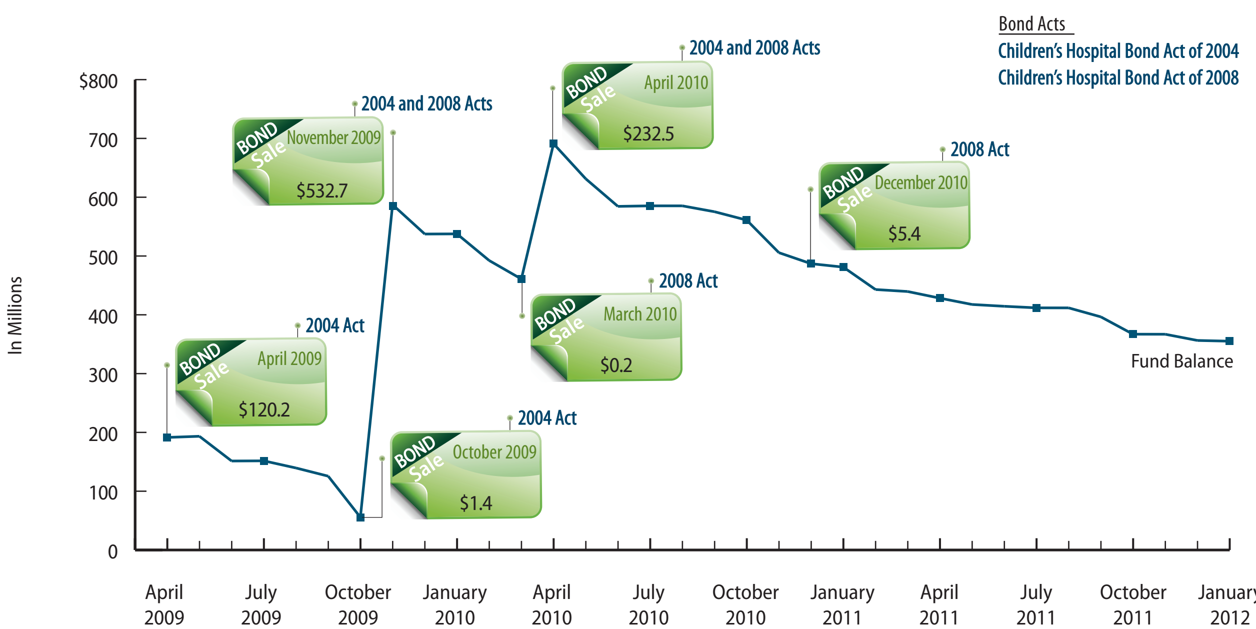
Note: Excludes cash balances associated with bond sales occurring in 2011.

1 This balance excluded bond sales occurring in 2011.

As we described in the Introduction, beginning in 2009, the authority had to discontinue obtaining funds through loans from the Pooled Money Investment Account (which were later paid off by the sale of bonds) and instead had to obtain funds through the sale of bonds in advance of program disbursements. The authority requested $628 million in general obligation bonds for fiscal year 2009–10 to finance the program. However, the authority's total disbursements for fiscal year 2009–10 amounted to about $303 million—less than half the requested amount. The authority stated that it requested these funds for the hospitals because the hospitals were unsure of when the next bond sale might occur and were concerned about having reliable access to program funds. As we discuss later, the authority's inaccurate estimations of fund needs and Finance's unclear instructions also contributed to this over-projection.

As a result of having bonds sold in excess of need, the authority accumulated a fund balance that, at its peak in April 2010, exceeded $690 million. Figure 1 shows the authority's fund balance between April 2009 and January 2012 and illustrates its substantial reserve. We note that, since the last bond sale of roughly $5 million in December 2010, the authority has steadily reduced its cash balance.

**Figure 1**
**California Health Facilities Financing Authority Fund Balance for the Children's Hospital Program**




Source: Office of the State Controller's data.

The timing of these bond sales in excess of need was not ideal. The state treasurer issued these general obligation bonds in 2009 and 2010, when the State's credit rating was low and interest-rate volatility was high. This timing increased the State's interest cost. The credit-rating agencies downgraded the State's credit rating beginning in the spring of 2009 and did not affirm a higher rating (with a stable outlook) until the fall of 2011. According to the state treasurer, interest rates on general obligation bonds sold in the fall of 2010 were between 0.7 percent and 1 percent higher than those sold in the fall of 2011. Our calculations indicate that the fall 2009 bonds sold for the program were similarly affected by the credit-rating downgrade.

***The authority requested the sale of these bonds during a period of financial crisis and cash shortfalls for the State and its inaccurate projection of cash needs and the issuance of bonds at a higher interest rate have contributed unnecessarily to the strain on the State's finances.***

Further, the authority requested the sale of these bonds during a period of financial crisis and cash shortfalls for the State. At the same time that it was paying interest on the authority's idle bond proceeds, the Office of the State Controller (state controller) was unable to meet the State's payment obligations due to a General Fund cash shortfall. Between July and September 2009, the state controller issued about $2.6 billion in registered warrants to private businesses, local governments, taxpayers receiving income tax refunds, and owners of unclaimed property.[2] The State's difficult financial condition and General Fund cash shortfall have continued to persist through fiscal year 2011–12, as have the payments on the authority's unused bond proceeds. Although we recognize that, in order to carry out its mandate under the bond acts, the authority would eventually have needed to issue bonds and pay the resulting interest, the authority's inaccurate projection of its cash needs and the issuance of bonds at a higher interest rate have contributed unnecessarily to the strain on the State's finances.

### *The Authority Has Identified Several Causes That Contribute to Its Outstanding Fund Balance*

The authority cited the new method of obtaining capital, regulatory issues, project delays, and other factors as contributing to its fund balance. However, we found that the authority should have been able to mitigate some of these factors. The authority identified new procedures related to bond funding, which were implemented in early 2009, as one factor contributing to its cash balance. In particular, the authority noted that in 2009 and early 2010, Finance's instructions were overly general and unclear. The instructions Finance sent to the authority in September 2009 for completing the fall 2009 general obligation bond cash survey

2 A registered warrant is a "promise to pay," with interest, that is issued by the State when there is not enough cash to meet all of the State's payment obligations.

consisted of a two-paragraph email. By contrast, the fall 2010 survey was accompanied by several pages of specific instructions. In addition, the authority asserted that the short time limits imposed by Finance to complete and return the cash surveys prevented the authority from gathering accurate data and developing more precise cash projections. For instance, the authority indicated that Finance allowed the authority only a few business days to gather information and complete the fall 2009 survey. In contrast, Finance provided the authority two weeks to complete its fall 2010 survey.

Our analysis of the authority's cash-need estimates, however, revealed that it has a long history of over-projecting its cash needs. Figure 2 on page 15 compares the authority's requested cash amounts to its disbursements between June 2005 and January 2012, and indicates that the authority consistently overestimated its cash needs from the beginning of the program. For example, the authority projected cash needs of roughly $347 million for the time period of May 2006 to April 2007, shown in Figure 2, yet it disbursed only $64 million during that same time period. Similarly, it projected a need for $628 million for fiscal year 2009–10 but disbursed only $303 million during that year.

***The authority projected a cash need of $628 million for fiscal year 2009–10, yet it disbursed only $303 million during that year.***

The authority also cited unanticipated project delays as an additional factor contributing to its cash balance. The following three examples help illustrate these project delays:

- In February 2010 the Lucile Packard Children's Hospital at Stanford (Packard hospital) indicated that it had plans to expand its facility and requested $98 million from the authority. Because the project was not yet underway, the authority reduced the amount requested for the Packard hospital project in its cash-projection survey to Finance to $68 million.[3] While the bonds to finance the Packard hospital project were issued in April of 2010, the authority did not approve the Packard hospital's application to fund the project until December 2011—nearly two years after the bonds were sold. As of January 2012 the authority had yet to make any disbursements to the Packard hospital under the 2008 act. The authority indicated that one of the main reasons the application was delayed for nearly two years was lengthy negotiations between the Packard hospital and the city of Palo Alto related to the hospital expansion.

- In fall 2009 the authority requested and received $30 million in general obligation bonds to fund an expansion project for the University of California, San Francisco Children's Hospital (UCSF hospital). However, according to the authority, while

[3] After the bond sale, the authority reduced the Packard hospital's allocation to $58 million.

examining documentation it received in anticipation of an application in December 2008, the authority's staff discovered that the proposed construction extended onto leased land, and that the agreement between the hospital and the property owner was not in compliance with the 2004 and 2008 acts' regulations for construction on leased land. As a result, the authority required the UCSF hospital to amend its lease agreement. The authority indicated that the hospital purchased the leased land in January 2012 and that it expected to receive a grant application from the UCSF hospital by June 2012.

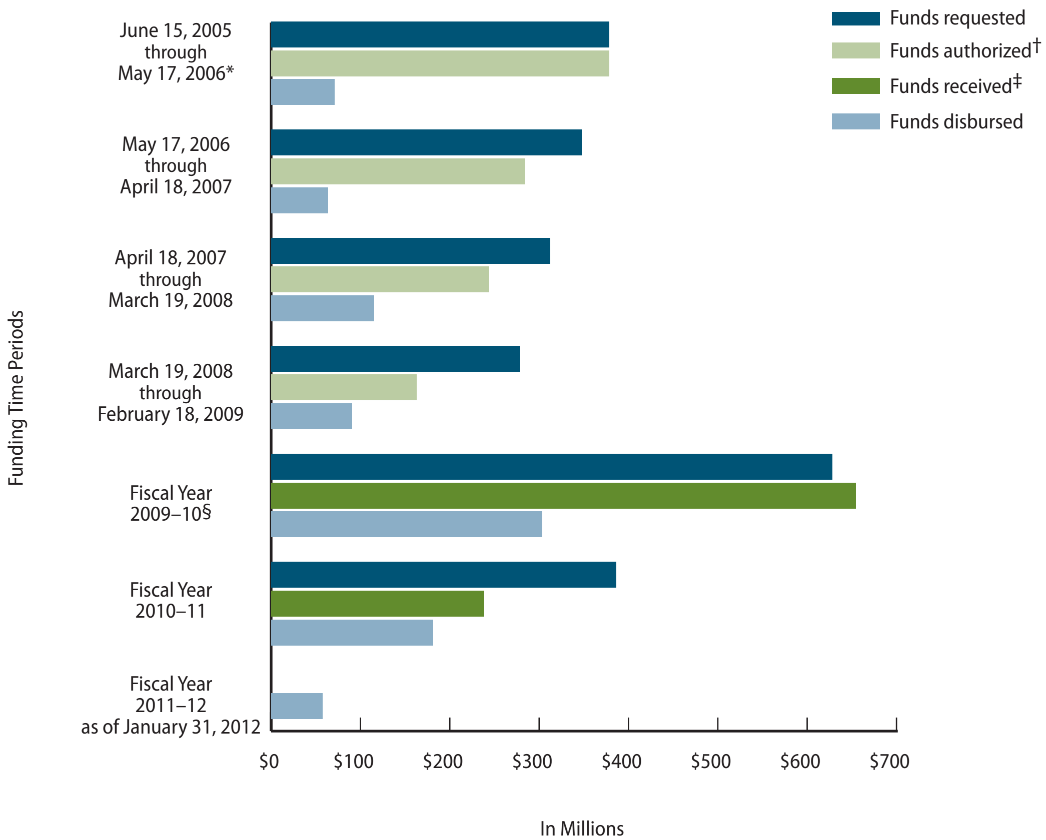
- In February 2010 Loma Linda University Children's Hospital (Loma Linda hospital) requested $90 million for the 2010–11 fiscal year to construct a new facility. Although the authority reduced this projection before submitting its spring 2010 bond survey to Finance, indicating that the project was in its earliest stages of development, it still requested $30 million.[4] The Loma Linda hospital submitted a draft grant application for the funds in June 2010, but the authority's staff found several issues with the application that would not allow for approval. Likewise, the authority's staff found several issues with a revised application submitted in March 2011. As of January 2012, the Loma Linda hospital had yet to submit another application for the grant money, and the authority does not expect to disburse any funds to it before 2014.

The authority attributed the Loma Linda hospital delays to several factors. First, it noted that in its initial reviews its attention was focused on addressing the Loma Linda hospital's eligibility to receive state funds, which had been an issue in the hospital's initial project with the authority.[5] The authority stated that project readiness and feasibility became the focus of later reviews. Second, the authority noted that up until 2011, it believed—based on direction from the Public Finance Division of the state treasurer—that it could not use proceeds from a specific bond issue for a hospital unless that hospital was included in the cash survey list. Thus, it included the Loma Linda hospital in the spring 2010 cash survey so that the hospital could use bond proceeds from that sale if it later decided to submit an application. The authority indicated that in 2011 it learned that its understanding of the regulations surrounding bond sales was incorrect and that it could amend those lists, thus allowing new projects to access existing bond proceeds.

4 After the bond sale, the authority reduced the Loma Linda hospital's allocation to $10 million.

5 The Loma Linda hospital is a nonprofit religious corporation, and as such, the authority had concerns that disbursing state funds, in the form of Children's Hospital Bond Act proceeds, to a religious entity might violate the California Constitution. In October 2009 a superior court ruled that the Loma Linda hospital could use bond funds for the grants examined under the ruling without violating the state constitution.

**Figure 2**
**Children's Hospital Funds Requested and Disbursed by the California Health Facilities Financing Authority June 2005 Through January 2012**




Source: Data obtained from the California Health Facilities Financing Authority (authority).

* The Pooled Money Investment Board issued new loans to the California Health Facilities Financing Authority from the Pooled Money Investment Account (PMIA) every 11 months.

† Prior to fiscal year 2009–10, this bar represents expenditures authorized through PMIA.

‡ For fiscal years 2009–10 through 2011–12, this bar represents the proceeds from hospital bonds sold on the authority's behalf.

§ This figure includes $40 million in June 2009 disbursements associated with the authority's April 2009 bond sale.

The authority also identified a number of other issues that contributed to its large cash balance, such as the funding freeze between late 2008 and early 2009 and uncertainties related to hospitals' perceived future access to funding. The authority noted that the December 2008 decision by the Pooled Money Investment Board to freeze statewide loans delayed disbursements for qualifying expenses for several hospitals. Specifically, the freeze delayed a $10 million disbursement to Rady Children's Hospital in San Diego and a $10 million disbursement to the Packard hospital by about six months. The authority noted that this uncertainty about future funding may have caused the hospitals to overestimate their cash needs. Additionally, the grants that hospitals received from the authority cover only a portion of the proposed project's total costs, and the hospitals also have to rely on other sources of funding. For instance, the turmoil of the bond markets in 2008 hindered hospitals' ability to access the capital markets and borrow money for their projects. The inability of hospitals to access other forms of funding forced them to delay projects and corresponding disbursement requests.

While outside factors may have contributed to the authority's large cash balance, our review of the authority's documentation shows that it could reasonably have mitigated some of those issues. For instance, the authority and the Packard hospital did not anticipate that the negotiations between the hospital and the city of Palo Alto would last more than a year. However, a news clipping provided by the authority shows that the Packard hospital had anticipated issues with the city as early as May 2009 and expected the project to be delayed by up to two years. Therefore, the authority could also have known of this issue and taken it into account before securing bond proceeds for the Packard hospital.

The authority's request for bond proceeds in advance of approving project applications has also contributed to its balance of idle funds. For instance, the authority had bonds sold totaling roughly $68 million for projects at the Loma Linda and Packard hospitals without an approved application for either project. Had the authority refrained from requesting these bond sales until it had approved these hospitals' project applications, the authority could have avoided holding and paying interest on $68 million in idle funds. In addition, although the authority's staff had found issues with the proposed construction of the UCSF hospital as early as December 2008, the authority still requested and received $30 million in general obligation bonds to fund the proposed project in late 2010—two years before the UCSF hospital had resolved the regulatory compliance issue. Because part of the authority's application review is to ensure that proposed projects meet regulatory requirements, it would be prudent for the authority to request funding only after it has approved an application, thus mitigating potential issues before bonds are sold. Had the authority waited to request the bond sale for the expansion of the UCSF hospital until after it approved the hospital's application, it could have avoided holding and paying interest on $30 million in idle bond proceeds since late 2010.

***Had the authority waited to request the bond sale for the expansion of the UCSF hospital until after it approved the hospital's allocations, it could have avoided holding and paying interest on $30 million in idle bond proceeds since late 2010.***

Finally, the authority does not currently require formal, written commitments from hospitals describing when they will spend program funds. Prior to the spring 2011 bond sale, the authority obtained cash-need estimates for eligible projects from the California Children's Hospital Association, an organization representing the 13 hospitals eligible for program funds. The authority indicated that, in order to reduce overestimates, it has contacted and gathered informal information through emails and phone calls directly from the hospitals since 2011. However, the authority still does not require formal, written commitments from the hospitals describing when they will submit disbursement requests for the program funds. Requiring more formal commitments from the hospitals may improve the quality of the cash-need estimates they provide to the authority and that are the basis for the authority's bond-sale requests.

## Recommendations

To avoid contributing to the State's financial strain, the authority should limit future bond sales to the level of disbursements it reasonably expects to make during the following six-month period. Further, the authority should reduce its current cash balance by continuing to make disbursements to hospitals while refraining from requesting additional bond sales.

If the authority believes it needs to retain a portion of its cash balance as a contingency reserve for unforeseen circumstances, it should perform and document an analysis demonstrating the appropriateness of the reserve level it adopts.

To allow for more accurate planning of upcoming cash needs, the authority should refine its cash-projection process to more accurately reflect its near-term cash needs. Specifically, the authority should refrain from requesting additional bond sales for projects that have not yet received project approval from the authority.

For hospitals with existing projects, the authority should request written confirmation from hospitals that detail when the hospitals will submit disbursal requests for approved funds.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

Date: July 12, 2012

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Legal Counsel: Scott A. Baxter, JD

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

*(Agency comments provided as text only.)*

June 29, 2012

California Health Facilities Financing Authority
915 Capitol Mall, Suite 590
Sacramento, CA 95814

Elaine M. Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: California Health Facilities Financing Authority
Bureau of State Audits Report No.: 2012-042 - California Children's Hospital Bond Act

Dear Ms. Howle:

Thank you for the opportunity to review and respond to the draft copy of your report on the Children's Hospital Programs as created by Propositions 61 and 3 in 2004 and 2008, respectively.

We appreciate all the time, effort and good communication invested by your audit team over these past several months. We believe each of your recommendations will further improve our operations and we plan to integrate those recommendations into our operations as more particularly described in our attached comments.

As you are aware, the purpose of the Children's Hospital Program is to improve the health and welfare of California's critically ill children, by providing *a stable and ready source of funds* for capital improvement projects for children's hospitals. Our comments keep this in mind and aim to address your recommendations in this context.

Please contact me anytime to further explore or discuss our comments.

Sincerely,

*(Signed by: Barbara J. Liebert)*

BARBARA J. LIEBERT
Executive Director

* California State Auditor's comment appears on page 23.

Response to Bureau of State Audits Draft Report 2012-042
June 29, 2012

Recommendation #1

> To avoid contributing to the State's financial strain, the Authority should limit future bond sales to the level of disbursements it reasonably expects to make during the following six-month period. Further, the Authority should reduce its current cash balances by continuing to make disbursements to hospitals while refraining from requesting additional bond sales.

Authority Response:

The Authority agrees that reducing its cash balance by continuing to make disbursements while refraining from requesting additional bond funds is a good and essential goal and in fact, the Authority has been striving to do just that for the last several years. The Authority has not made requests for bond funds nor received any additional monies from state bond sales since the Fall of 2010, and that request was small, yielding $5.44 million in bond funds. With disbursements anticipated in the next six months, the Authority expects to reduce its existing cash on hand by half to approximately $163 million.

In addition, the Authority has worked closely with the Department of Finance ("DOF") over the last several years and the children's hospital grantees since the program's inception in 2004 to make more precise estimates of funds needed for children's hospital projects. The process for requesting bond funds has substantially changed over the last several years. As noted in the BSA's report, prior to 2010, the state managed bond sales and funding through the Pooled Money Investment Account (PMIA), which functioned in many ways like a line of credit so that an agency like the Authority could request and receive funds for hospital projects without necessarily prompting a bond sale and without the need to hold funds on deposit as is the State's current practice. With that methodology, overestimates of cash needs had no fiscal impact. When the State eliminated the PMIA loan process in 2010, DOF initiated a new process for assessing funding needs. This process was an imperfect one as reflected in the significant amount of idle bond funds ($7.9 billion) for programs in two dozen State agencies. The process however has evolved and greatly improved such that requests for funding, at least from the Authority, have been greatly curtailed.

Though the Authority agrees in concept with the BSA's recommendation to limit future bond fund requests
1 to the level of disbursements the Authority reasonably expects to make during the following six month
period, the reality is that hospital commitments to draw down funds can waver in the face of unanticipated delays associated with such things as local permitting snags and a hospital's ability to piece together all of its other funding sources (such as conduit or local bond transactions, fund raising campaigns, etc.), all of which ebbs and flows with the state of the economy. These types of delays in the hospitals' plans are outside the control of the Authority and are very difficult for both hospitals and the Authority to anticipate, notwithstanding frequent and continuing efforts to communicate with the hospitals regarding the many factors that might influence their timing. The Authority is also sensitive to its charge, as stated in the bond acts approved by voters, to provide *a stable and ready source of funds* for capital improvement projects for children's hospitals. (Health & Saf. Code, §§ 1179.21, 1179.54.)

Because of the continuing variability in timing and amount of California's general obligation bonds sales (which the Authority cannot control and which are heavily dependent upon market conditions and other factors), it is possible that a six month window is too short to meet the actual funding needs of the thirteen different hospitals entitled to funding from the program. The Authority is statutorily required to have a stable and ready source of funds available, and thus must have funds on hand to disburse for the hospitals' projects. Although the Authority can make a request that bonds be sold for the program, the Authority cannot dictate if or when bonds are sold or how much is sold and allocated for the program within a six month window. If bonds cannot be sold to meet the hospitals' needs within that limited timeframe, then it may be difficult for the Authority to meet is statutory function.

Notwithstanding our concerns, the Authority will implement this recommendation, in concert with the contingency reserve, as described in Recommendation #2, and a more thorough cash projection process as described in Recommendation #3.

<u>Recommendation #2</u>

> If the Authority believes it needs to retain a portion of its cash balance as a contingency reserve for unforeseen circumstances, it should perform and document an analysis demonstrating the appropriateness of the reserve level it adopts.

<u>Authority Response</u>

The Authority agrees with this recommendation and will proceed to make and document this analysis.

<u>Recommendation #3</u>

> To allow for more accurate planning of upcoming cash needs, the Authority should refine its cash-projection process to more accurately reflect its near-term cash needs. Specifically, the Authority should refrain from requesting additional bond funds for projects that have not yet received project approval from the Authority.

<u>Authority Response</u>

The Authority currently refrains from requesting additional bond funds for projects that have not yet received project approval from the Authority and has been doing so for the last two years in a conscious effort to spend down existing funds on hand.

The Authority plans to establish a contingency reserve pursuant to the second recommendation of the BSA (above) and will continue to refrain from requesting bond funds until such time as the Authority has spent down existing funds to the reserve to be established. The Authority believes a reserve is imperative both because of its charge to provide <u>*a stable and ready source of funds*</u> under the Children's Hospital Bond Acts of 2004 and 2008, and because of the potential consequences of not having sufficient cash on hand to fund approved grants. Grantees often pair their grants with other funding sources, including other grants and public offerings of debt through conduit issuers. When a grantee chooses to fund a project with a public offering, the grantee must disclose all risks inherent to the project, which would include the potential for incomplete funding because of uncertainty regarding access to grant funds under the Children's Hospital Program. This disclosure can steer prospective investors away from the public offering leading to a smaller investor pool and higher interest rates for the borrower. Possible delays in funding can also increase the costs of construction associated with delayed or suspended construction.

The Authority is also dependent upon when the State will issue bonds to generate funding. Though the Authority may request additional bond funds, the State may decline to issue bonds or may designate bond proceeds for other programs, leaving the Authority without the funds to fulfill its purpose of providing a ready source of funding for California's children's hospitals. The Authority will nevertheless employ this recommendation to strike the right balance of protecting the State's resources yet having sufficient monies available for grantees and their projects. The Authority will utilize the subsequent reporting periods to advise the BSA of the nature and extent of any consequences of employing this recommendation.

Recommendation #4

> Further, for hospitals with existing projects, the Authority should request written confirmation from hospitals that details when hospitals will submit disbursal requests for approved funds.

Authority Response

The Authority is in frequent and continuing contact with all of the thirteen hospitals eligible for Propositions 61 and 3 grants, as well as the California Children's Hospital Association and the U.C. Office of the President, regarding their timing. Oftentimes, these communications are memorialized in an e-mail. However, the Authority agrees these communications could benefit from more structure and formality. The Authority will thus seek written confirmation from hospitals that details when approved funds will be requested.

# Comment

## CALIFORNIA STATE AUDITOR'S COMMENT ON THE RESPONSE FROM THE CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY

To provide clarity and perspective, we are commenting on the response to our audit report from the California Health Facilities Financing Authority (authority). The number below corresponds to the number we placed in the margin of the authority's response.

We agree that hospitals' commitment to draw down funds can waver in the face of unanticipated delays. However, some delays could have been reasonably anticipated by the authority, including the local permitting issues between the Packard hospital and the city of Palo Alto, as we describe on page 16 of the report. We believe the authority can mitigate its risk of potential delays by more effectively communicating with the participating hospitals, as we recommend on page 17. 1

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press