

**REPORT BY THE STATE AUDITOR
OF CALIFORNIA**

**A REVIEW OF THE STATE'S
BOND SALES FOR 1993 AND 1994**

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March 1995

A Review of the State's
Bond Sales for 1993 and 1994

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California State Auditor
Bureau of State Audits

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Summary

Results in Brief Chapter 1434, Statutes of 1990 (statute), added Section 5703 to the California Government Code, which specifies that the state treasurer is the sole authority for selecting the underwriters to negotiate state bond sales, except for California Housing Finance Agency (CHFA) bond sales. Section 5703 of the Government Code also requires the state treasurer to use a competitive process to select underwriters for negotiated bond offerings and requires the state treasurer, the financing authorities, and the CHFA to maintain records of the costs of issuance of negotiated bond sales. In addition, this section requires the state treasurer to maintain certain records related to bond issues that are sold by competitive bid. The statute also calls for us to perform two audits. The first audit was issued in January 1994, and this audit completes the mandated reports.

We reviewed the cost records of negotiated bond sales that the State Treasurer's Office (STO), CHFA, and state financing authorities maintained, and we reviewed the records of competitive sales that the STO maintained. In addition, we determined whether the Government Code, Section 5703, was being fully implemented and compared costs with similar initial bond offerings in other states.

During our review, we noted the following conditions:

- From January 1993 through December 1994, the STO selected the lead underwriter and comanaging underwriters (comanagers) from underwriter pools established pursuant to the Government Code, Section 5703, for 78 of the 81 negotiated bond issues we reviewed. For the remaining three sales, which were financings for revenue anticipation notes, the STO selected the comanagers based on various factors, including past performance.
- During 1993 and 1994, all six of the entities we reviewed collected the cost information that the Government Code, Section 5703, requires to be maintained for negotiated bond sales.
- During 1993 and 1994, only the STO sold bonds by competitive bid. We reviewed 15 of 26 bond issues sold by competitive bid during 1993 and 1994 and found that in all 15 bond sales, the STO maintained records of all bids and bid verifications as required by the Government Code, Section 5703(f). In addition, the STO awarded the bonds in each sale we reviewed to the

underwriter who submitted the bid with the lowest true interest cost or net interest cost.

- We compared the true interest costs of nine bond issues sold by other governmental entities with the true interest costs of nine California bond issues. We found no indication from the information obtained in this limited review that California is paying more than necessary for interest costs on state bonds.
- During 1993 and 1994, the state treasurer generally selected comanagers for negotiated bond sales from competitively established underwriter pools. However, the STO does not interpret the Government Code, Section 5703, to require competitive selection of comanagers for negotiated sales. Consequently, the policy of using competitively selected comanagers could change, and the State could award millions of dollars of underwriter's discount annually without the benefit of competition. For the two years we reviewed, the total underwriter's discount earned by all comanagers the state treasurer selected was \$14.3 million. Thus, we believe that more needs to be done to ensure that a competitive process is used to select all underwriters.

Recommendations We recommend that the current state treasurer continue the policy of selecting comanagers through a competitive process. Furthermore, the Legislature should consider amending the Government Code, Section 5703, to specifically require that comanagers as well as lead underwriters be selected through a competitive process.

Agency Comments The state treasurer generally concurs with the report; however, he believes that the Government Code, Section 5703, applies only to the selection of lead underwriters. Nevertheless, he will continue the policy of selecting comanagers from competitively established pools of underwriters whenever possible. The California Housing Finance Agency also concurs with the report. The California Educational Facilities Authority, the California Health Facilities Financing Authority, the California Pollution Control Authority, and the California Alternative Energy Source Financing Agency chose not to respond.

Introduction

The California Government Code, Sections 5700 and 5702, states that the state treasurer must be the sole agent for offering and selling bonds issued by any state department, board, agency, or authority. Chapter 1434, Statutes of 1990, added Section 5703 to the Government Code. This section specifies that, in fulfilling the duties of agent for offering and selling bonds, the state treasurer is the sole authority for selecting the underwriters to negotiate state bond sales, except for California Housing Finance Agency bond sales.

Section 5703 of the Government Code also requires that the state treasurer use a competitive process in selecting underwriters for negotiated bond offerings. Also, the state treasurer, financing authorities, and California Housing Finance Agency must maintain records of the costs of issuance of negotiated bond sales. In addition, this section requires the state treasurer to maintain certain records related to bond issues that are sold by competitive bid. The Government Code, Section 5703(d), and the California Health and Safety Code, Sections 51050(f) and 51358, exempt the California Housing Finance Agency from the requirement to select underwriters for negotiated bond sales through a competitive process.

A wide variety of state agencies, departments, and financing authorities issue bonds. For example, during 1993 and 1994, bonds were issued by the Department of Water Resources, the Regents of the University of California, the California State University, the State Public Works Board, the California Housing Finance Agency, the California Health Facilities Financing Authority, and the California Educational Facilities Financing Authority, among others.

Financing authorities are governmental entities that issue bonds on behalf of private nonprofit or other public organizations and private businesses. The financing authority issues bonds and uses the proceeds to provide financing for the other organization. The principal and interest of the bonds are repaid by the other organization. The interest on the bonds is tax exempt; therefore, the borrowing organization pays a lower interest rate than if it had issued taxable bonds. This type of financing is referred to as conduit financing and is used to finance projects that serve the public interest. For example, the California

Health Facilities Financing Authority issues bonds on behalf of private nonprofit or public health facilities, such as hospitals, skilled nursing facilities, community clinics, and child care facilities.

**Competitive Bids
and Negotiated
Sales Offer
Different
Advantages**

Bonds may be sold using one of two types of sale procedures: a competitive bid or a negotiated sale. In a competitive bid, the issuer determines the date and principal amount of the bond sale and invites underwriters to submit sealed bids for the bonds. The issuer sells the bonds to the underwriter who offers to buy the bonds at the lowest interest cost. The underwriter then offers the bonds for sale to the public.

In a negotiated sale, the issuer selects the underwriter before the bond sale, and the underwriter works closely with the issuer in activities related to the bond sale, such as developing financing alternatives and preparing legal documents. In a negotiated sale, bonds are usually sold to an underwriter who then offers the bonds for sale to the public. The underwriter's compensation lies in the difference between the price the underwriter pays for the bonds and the price at which it sells the bonds to the public. This difference is referred to as underwriter's discount. In certain instances, bonds are sold through a private placement. In a private placement, the issuer sells the bonds to a limited number of investors who usually do not offer them for sale to the public.

Each type of bond sale offers advantages to the issuer depending on the type of bonds the issuer is selling. When bond issues are not complex in structure and the issuer is well known to the investment community, competitive bids offer the advantage of creating competition among underwriters in an open market. For more complex bond issues or when the investment community is not familiar with the issuer, a negotiated sale allows the underwriter more time to develop a successful marketing plan. Negotiated sales also offer the issuer flexibility in timing the bond sale to take advantage of beneficial market conditions. A private placement generally is used when the issuer anticipates difficulty in marketing the bonds or, for smaller bond issues, when use of a private placement lowers the costs related to issuing the bonds.

The underwriters of a bond issue are liable for purchasing the bonds from the issuer whether or not they are able to sell all the bonds to the public. For large bond issues, underwriter syndicates may be formed to share in the risk of purchasing the bonds. One underwriter usually assumes the role of lead underwriter and, on behalf of the syndicate, negotiates with the bond issuer, executes the bond purchase contract, and manages the syndicate accounts. The lead underwriter is compensated for these activities by being paid a portion of the

underwriter's discount, referred to as the management fee. A syndicate may include one or more comanaging underwriters (comanagers), who assume some of the management duties related to the bond sale and who share in the management fee as compensation for these duties. In addition to the syndicate members, a group of firms called a selling group may be used to assist in the sale of the bonds. Members of the selling group do not assume liability for purchasing any of the bonds. They receive compensation in the form of a commission on the bonds they sell, usually referred to as takedown.

Bonds Sold in 1993 and 1994 Amounted to \$31.2 Billion

During 1993 and 1994, the State Treasurer's Office (STO), four financing authorities, and the California Housing Finance Agency (CHFA) sold a total of 135 bond issues, with a total principal value of \$31.2 billion. The following table shows the principal amount and number of bond issues sold during 1993 and 1994 by type of sale and entity.

Table 1 Bonds Sold During 1993 and 1994 by Type of Sale and Entity

Type of Sale and Entity	Number of Issues	Principal Amount (in Millions)
Competitive Bid Sales		
State Treasurer's Office		
General obligation bonds	8	\$ 4,052
Revenue bonds	15	2,687
Revenue anticipation warrants	3	9,200
Negotiated Sales		
State Treasurer's Office		
General obligation bonds	1	18
Revenue bonds	22	3,315
Revenue anticipation notes	3	8,000
California Housing Finance Agency	17	1,892
California Educational Facilities Authority	21	398
California Health Facilities Financing Authority	28	993
California Pollution Control Financing Authority	16	590
California Alternative Energy Source Financing Authority	1	55
Totals	135	\$31,200

Section 5703(g) of the Government Code required the Office of the Auditor General to audit the cost records of negotiated bond sales that the STO, the CHFA, and the state financing authorities maintained and to review the records of competitive sales that the STO maintained. In

addition, Section 5703(h) of the Government Code required the Office of the Auditor General to report whether Section 5703 was being fully implemented; to make cost and interest rate comparisons with similar initial bond offerings in other states, where possible; and to submit a report to the Legislature for bonds sold during 1993 and 1994. Thus, for purposes of this report, any reference to the state treasurer refers to the state treasurer holding office during this period unless otherwise stated.

In accordance with the Government Code, Section 8546.8, the Bureau of State Audits has assumed responsibility for the audits statutorily assigned to the Office of the Auditor General.

To determine how the state treasurer selected underwriters during 1993 and 1994, we interviewed STO and financing authority officials and examined documents on file at both the STO and with the financing authorities. These documents included the requests for qualifications (RFQ) issued by the state treasurer for the competitive process conducted during 1993 and 1994, underwriter responses to the RFQ, lists of selected underwriters, and the STO's reports on underwriters' assignments for bond sales during 1993 and 1994. We determined whether the state treasurer selected the lead underwriters and comanagers during 1993 and 1994 from the underwriter pools in effect for each negotiated bond issue. We did not review the propriety of the state treasurer's selection or rejection of specific underwriters who responded to the RFQ. Additionally, we did not review the process by which the state treasurer assigned underwriters from pools to a particular bond sale.

To determine if the state treasurer maintained the required records relating to bond issues sold by competitive bid, we reviewed the STO's records for a sample of bond issues that the STO sold by competitive bid during 1993 and 1994. To determine if the state treasurer, the California Housing Finance Agency, and the four financing authorities maintained the required cost of issuance information for negotiated bond sales, we selected a sample of bond issues sold during 1993 and 1994 at each entity and reviewed the detailed summary of costs of issuance contained in its files. We compared the total of the cost records contained in the files with the total costs of issuance set forth in the official closing documents of the bond issue.

We determined whether the cost of issuance summaries identified all the costs of issuance paid from bond proceeds. We did not determine the propriety of the identified expenditures. When possible, we examined invoices related to individual cost of issuance items. However, we could not examine invoices for most of the bond issues the financing authorities made. In these instances, another party makes the cost of issuance disbursements; the financing authorities

receive only summary cost of issuance information from the underwriter or the issuing private organization. This information usually is not supported in the files by copies of invoices or other supporting documentation; therefore, we were unable to audit this information.

To obtain information about similar bonds issued by other governmental entities, we compared California state revenue bonds, general obligation bonds, and revenue anticipation notes sold through negotiation during 1993 and 1994 to similar negotiated bond and note sales of other states and large municipalities. We obtained the information about similar bonds and notes from Securities Data Company, a firm that collects and maintains information about government bond issues.

**Results of the
Previous Bureau
of State Audits
Report**

In January 1994, the Bureau of State Audits issued its report, entitled "A Review of the State's Bond Sales for 1991 and 1992." We found that the state treasurer and financing authorities generally complied with requirements of the Government Code, Section 5703. Specifically, we determined the following:

- The STO selected lead underwriters through a competitive process except in one instance in which it believed a relatively small sale would be a good opportunity for a Target Business Enterprise Firm to obtain the experience of being a lead underwriter.
- The STO did not believe that the law required it to select comanagers through a competitive process; however, it established a policy to do so. Because the law is not clear on how comanagers are selected, we recommended that the Legislature change the Government Code to specifically require that comanagers be selected through a competitive process. The Legislature has not yet acted on our recommendation.
- Three of the five entities we reviewed did not maintain some of the required cost information for negotiated bond sales.
- The STO maintained records of all bids and bid verifications on competitive sales, and it awarded the bonds in each sale we reviewed to the underwriter who submitted the bid with the lowest true interest cost.
- Based on our comparison of nine California bond issues to ten comparable bond issues sold by other governmental entities, California did not pay more than was necessary for interest costs on state bonds.

Chapter 1 A Review of the State Treasurer's Process for Selecting Underwriters of Negotiated Bond Sales

Chapter Summary The California Government Code, Section 5703, identifies the state treasurer as the sole authority for selecting underwriters for state bonds, except bonds sold by the California Housing Finance Agency. It also requires the state treasurer to develop and implement a competitive process for selecting the underwriters of negotiated bond offerings. However, for certain negotiated bond offerings by state financing authorities, the law gives the treasurer the authority to approve an underwriter without competitive solicitation.

Although the law requires the state treasurer to establish a competitive process for selecting underwriters, it does not specifically require the state treasurer to establish a process for selecting comanaging underwriters (comanagers) as well as lead underwriters. According to the general counsel for the State Treasurer's Office (STO), the Government Code, Section 5703, requires the state treasurer to select only the lead underwriter of negotiated bond sales through a competitive process. Nevertheless, the state treasurer implemented a policy for selecting comanagers as well as lead underwriters through a competitive process. During 1993 and 1994, for the 81 negotiated bond sales we reviewed, all the lead underwriters and comanagers either were selected through a competitive process or met the requirements for selection without competitive solicitation, except for the comanagers on three sales of revenue anticipation notes (RANs). For the RANs, which accounted for 13 percent of the amount that comanagers earned during the two years we reviewed, the state treasurer selected the comanagers based on various factors, including past performance on RANs financing.

However, because the STO does not interpret the law to require competitive selection of comanagers, the policy of selecting comanagers for the other negotiated sales could change under a succeeding state treasurer, in which case the State could award millions of dollars of underwriter's discount annually without the benefit of competition. For the two years we reviewed, the total underwriter's

discount earned by all comanagers selected by the state treasurer was \$14.3 million. Thus, we believe that more needs to be done to ensure a competitive process is used to select all underwriters.

Background The Government Code, Section 5703(a), identifies the state treasurer as the sole authority for selecting underwriters for state bonds. The law requires the state treasurer to develop and implement a competitive process for selecting the underwriters of negotiated bond offerings. This competitive process is different from the sale of bonds through competitive bid. We describe the differences between selling bonds through competitive bidding and selling bonds through a negotiated sale in the introduction of this report. The competitive process that the state treasurer developed and implemented pursuant to the Government Code, Section 5703, is a process for selecting underwriters for negotiated bond sales.

The STO may conduct this competitive process on an issue-by-issue basis, or the STO may use this competitive process to establish one or more pools of underwriters for various types of negotiated issues. For the purpose of this report, any reference we make to the competitive process for selecting underwriters refers to either one of these two methods of selecting underwriters.

The competitive process must do the following:

- Solicit written qualifications from at least 20 underwriting firms;
- Consider the goals for the participation of minority- and women-owned businesses in contracts for professional bond service;
- Have the written submissions available for inspection at the STO for at least six months; and
- Reestablish the pool of underwriters through the competitive process at least every 24 months.

The Government Code, Section 5703, states that a competitive process may be implemented by establishing a pool but does not require an additional competitive process for a particular bond sale. Thus, the state treasurer's selection of any underwriter from the pool to participate in a bond sale constitutes the competitive process.

In certain circumstances, the state treasurer may select underwriters for a negotiated sale of bonds by means other than the competitive process set out in Section 5703(a). One example is when the state treasurer makes a written finding that extraordinary market conditions do not allow enough time to do so without risking financial detriment to the State.

Underwriter Selection Process

In January 1994, the state treasurer established four pools of underwriters through a request for qualifications (RFQ) process. The state treasurer established one pool for state-negotiated offerings (SNO pool) and one pool each for the California Educational Facilities Authority (CEFA) and the California Health Facilities Financing Authority (CHFFA). The treasurer also established one pool that the California Pollution Control Financing Authority (CPCFA) and the California Alternative Energy Source Financing Authority (CAESFA) share. The state treasurer established the pools for selecting lead underwriters and comanagers for all negotiated bond sales, except RANs. According to a letter from the state treasurer to underwriters, the state treasurer planned to select the lead underwriters for the RANs from the SNO pool but planned to select the comanagers based on various factors, including past performance on RANs financings.

The state treasurer established the following minimum qualifications that the underwriters must meet to be considered for inclusion in the pool:

- Minimum net capital of \$100,000;
- Proper licensure by the Securities Exchange Commission, the National Association of Securities Dealers, and the California Department of Corporations, if applicable; and
- A commitment to furthering the STO's Target Business Enterprise goals for participation of minority-, women-, and disabled veteran-owned firms in underwriting services.

The state treasurer issued the RFQ in October 1993 to 148 underwriting firms that were invited to apply for inclusion in any or all of the pools. Eighty-two of the 148 firms applied for inclusion in at least one of the four pools. Most of the firms applied for all four pools. Seventy-seven firms applied for the SNO pool, 68 applied for the CEFA pool, 67 applied for the CPCFA and CAESFA pool, and 70 applied for the CHFFA pool.

The STO Trust Services Division and the financing authorities (evaluators) reviewed the qualifications of each firm applying to their pool. Only firms meeting the minimum qualifications were considered

for inclusion in the pool and subjected to additional review. For example, if a firm had participated in one or more of the four previous pools, the evaluators rated the firm's performance in the previous pools. For firms that had not participated in previous pools, the evaluators rated the firms based on their responses in certain areas such as the size and nature of their business in California. Based on this review, the evaluators submitted their recommendations to the state treasurer, who made the final selection of firms for each of the four pools.

Through this review and evaluation process, the state treasurer selected 57 firms for inclusion in one or more of the underwriter pools: 53 firms for the SNO pool, 28 firms for the CEFA pool, 32 firms for the CPCFA and CAESFA pool, and 23 firms for the CHFFA pool. These pools became effective for bond sales occurring during or after January 1994.

**Lead Underwriter
and Comanager
Selection During
1993 and 1994**

From January 1993 until December 1994, the state treasurer and the financing authorities negotiated 92 bond sales, 11 of which were private placements without underwriters. Of these 11, some were private placements with the Student Loan Marketing Association and some were private placement equipment financings with General Electric Equipment Corporation. No underwriters were involved in these private placements. Thus, we concluded that the requirements of the Government Code, Section 5703(a), did not apply to these bond sales.

However, the Government Code does apply to the remaining 81 of the 92 sales. Consequently, we reviewed the state treasurer's selection of lead underwriters and comanagers for the 81 bond sales negotiated by the STO and the financing authorities. The state treasurer selected both the lead underwriter and comanagers from the applicable pool for 78 of the 81 negotiated bonds sales we reviewed. For three negotiated sales—the April 1993, July 1993, and July 1994 RANs—the state treasurer selected the lead underwriters from the pool; however, the state treasurer selected the comanagers based on various factors, including past performance on RANs financing.

Under certain circumstances, the Government Code, Section 5703(b), allows the state treasurer to make additions to a financing authority pool without competitive solicitation, on a case-by-case determination on the recommendation of a project applicant. The law allows such additions when the state treasurer finds that the underwriter to be added

has provided significant services to the project applicant with the expectation of compensation for those services from underwriting the revenue bonds that will fund the applicant's project.

The financing authorities negotiated 55 of the 81 bond sales with underwriters. For 32 of these 55 sales, the state treasurer selected the lead underwriter from a pool established through a competitive process, and for 23, the state treasurer added the lead underwriter to the pool without competitive solicitation. In each instance, the state treasurer approved the addition of the lead underwriter based on the recommendation of the project applicant.

Additionally, 38 of the 55 sales negotiated by the financing authorities had one or more comanagers. For 34 of these 38 sales, the state treasurer selected all of the comanagers from a pool established through a competitive process. For the remaining four sales, the state treasurer added a comanager to the pool without competitive solicitation. In each instance, the state treasurer approved the addition of the comanager based on the recommendation of the project applicant.

**Comanager
Participation in
Negotiated Bond
Sales**

The purpose of the Government Code, Section 5703, was to expand competition in the selection of underwriters for the State's bond sales. This expanded competition has occurred, as we have discussed on the previous pages of this chapter. However, because of the STO's interpretation of the Government Code, Section 5703, the objective of attaining competition in the selection of all underwriters for state bond sales may not be fully realized.

The Government Code, Section 5703(a), makes the state treasurer "responsible for developing and implementing a competitive process for selection of underwriters for negotiated offerings of bonds." The issue surrounding this law relates to whether the law was intended to require the state treasurer to select both the lead underwriter and the comanagers through a competitive selection process or only the lead underwriter.

The law refers simply to "implementing a competitive process for the selection of underwriters" but does not specify whether the competitive process should include only lead underwriters or both lead underwriters and comanagers. According to the STO's general counsel, the intent of the law was to require the state treasurer to use a competitive process solely for selecting the lead underwriters; thus, the STO's interpretation of the law is that it does not pertain to comanagers. In similar situations in the past, the Legislative Counsel has advised the former Office of the Auditor General that the courts afford great weight in the interpretation of statutes to the agency charged with the administration

of these statutes unless the interpretation is clearly erroneous or unauthorized.

Under the state treasurer's policy, comanagers are selected from the competitively established pools for all negotiated sales, other than RANs. Instead, the RANs, which accounted for 13 percent of the amount that comanagers earned during the two years we reviewed, are selected based on various factors, including past performance on RANs financings.

Comanagers account for a significant portion of the State's underwriting business. For example, the state treasurer selected the underwriters for 81 of the 109 negotiated state bond sales occurring during 1993 and 1994. The remaining 28 bond issues were sold by the California Housing Finance Agency or were private placements without underwriters. According to the STO's 1993 and 1994 reports on underwriter assignments in state bond issues, the state treasurer appointed one or more comanagers for 63 (78 percent) of the 81 bond sales. See the appendix for a listing of bond sales for which the state treasurer selected underwriters during 1993 and 1994. The total amount of underwriter's discount that comanagers of the 63 bond issues earned for the two years was \$14.3 million, 36 percent of the total amount the issuers spent for underwriter's discount. Thus, if the pools are not used to select comanagers in the future, competition in the selection of underwriters would be limited.

Recommendations The current state treasurer should continue the policy of selecting comanagers through a competitive process.

The Legislature should consider amending the Government Code, Section 5703, to specifically state that comanagers as well as lead underwriters be selected through a competitive process.

Chapter 2 Maintenance of Required Records at the State Treasurer's Office, the California Housing Finance Agency, and Four State Financing Authorities

Chapter Summary During 1993 and 1994, the State Treasurer's Office (STO), California Housing Finance Agency (CHFA), California Educational Facilities Authority, California Health Facilities Financing Authority, California Pollution Control Financing Authority, and California Alternative Energy Source Financing Authority collected all the cost and interest rate information that the Government Code, Section 5703, requires to be maintained for negotiated bond sales. We reviewed the files for 66 of the 109 negotiated sales made by these entities and found that each entity maintained the cost and interest rate information the law requires.

During 1993 and 1994, only the STO sold bonds by competitive bid. We reviewed 15 of 26 bond issues sold by competitive bid during 1993 and 1994 and found that in all 15 bond sales, the STO maintained records of all bids and bid verifications as required by the Government Code, Section 5703(f). In addition, for each sale we reviewed, the STO awarded the bonds to the underwriter who submitted the bid with the lowest true interest cost or net interest cost.

Cost Records for Negotiated Sales When state bonds are sold through negotiated offerings, Section 5703(e) of the Government Code requires the state treasurer to maintain records of all cost information pertinent to the initial bond offering. The law makes an exception for bonds issued by state financing authorities, in which case the issuing authority is required to maintain the pertinent cost information. The information must include, but is not limited to, the following:

- All amounts paid out of bond proceeds to the underwriter, detailed by management fee, takedown, risk, and underwriter's expenses;
- All costs paid out of bond proceeds to rating agencies for bond rating;

- All fees paid out of bond proceeds to bond counsel, trustees, or financial advisors relating to the initial offering of the bonds; and
- The interest rate to be paid on the bonds.

Fees paid to underwriters are referred to as underwriter's discount, and the other costs related to issuing bonds are referred to as costs of issuance. The underwriter's discount is compensation paid to the underwriter based on four components: management fee, takedown, risk, and expenses. It is called a discount because it usually is expressed as a deduction from the principal amount of the bonds. The management fee is compensation for underwriter activities, such as developing financing alternatives, assisting in the preparation of legal documents, preparing the official statements, and managing the operations of the underwriter syndicate. Takedown is similar to a sales commission in that it is a discount from the bond's public offering price allowed to the underwriter who sells the bond. Risk is compensation for the risk an underwriter assumes that not all of the bonds will be sold. The expense component is reimbursement of the underwriter's out-of-pocket expenses related to issuing the bonds.

During 1993 and 1994, the state treasurer acted as agent for sale for 109 negotiated bond offerings. Four state financing authorities issued 66 of these bond offerings: the California Educational Facilities Authority issued 21, the California Health Facilities Financing Authority issued 28, the California Pollution Control Financing Authority issued 16, and the California Alternative Energy Source Financing Authority issued one. The CHFA issued 17 of the negotiated bond offerings. The financing authorities and CHFA are required to maintain the cost records for the bonds they sell. Various state agencies sold the remaining 26 bond issues. For these bonds, the STO is required to maintain the cost records.

To determine if the STO, CHFA, and four financing authorities maintained complete cost information, we compared the detailed summary of the cost information contained in their files with the total of the costs of issuance and underwriter's discount set forth in the official closing documents related to the bond issue. These documents include the trust indenture, official statement, tax certificate, receipt for purchase price, and Internal Revenue Service Informational Tax Return (Form 8038). Because the financing authorities usually are not responsible for making disbursements for costs of issuance, they obtain the detailed summary for their files from the underwriter.

**Required Records
Maintained**

We selected for review 66 of the 109 bonds issued by the six entities during 1993 and 1994 and found that in 46 of these bond issues, the issuer used bond proceeds to pay costs of issuance, underwriter's

discount, or both. The six entities maintained the interest rate information for all 66 of these bond sales and the required cost information for all 46 sales in which the issuer used bond proceeds to pay costs of issuance. Table 2 presents our sample sizes for each entity reviewed.

Table 2 Testing of Cost Records for Negotiated Bond Sales During 1993 and 1994

Entity	Total Negotiated Bond Sales	Negotiated Bond Sales Reviewed	Number Using Bond Proceeds to Pay Costs
State Treasurer's Office	26	15	15
California Housing Finance Agency	17	14	4
California Educational Facilities Authority	21	10	9
California Health Facilities Financing Agency	28	13	11
California Pollution Control Financing Authority	16	13	6
California Alternative Energy Source Financing Authority	1	1	1
Totals	109	66	46

The State Treasurer's Office Is Maintaining Required Records for Competitively Bid Bond Issues

When a bond issue is sold by competitive bid, Section 5703(f) of the Government Code requires the state treasurer to maintain records of all bids submitted and documentation of bid verifications, including the terms of sale and the calculation of net interest cost or true interest cost. During 1993 and 1994, only the STO sold bonds by competitive bid; the state financing authorities and the CHFA sold bonds only through negotiated offerings. All except one of the State's general obligation bonds were sold by competitive bid. Additionally, the STO sold bonds by competitive bid on behalf of the Department of Water Resources, the California Transportation Commission, the University of California, and

the California State University. In 1993 and 1994, the STO also sold by competitive bid revenue anticipation warrants, which are short-term obligations.

We reviewed the STO's records for 15 of the 26 bond issues sold by competitive bid and found that the state treasurer maintained the required records for all 15 bond sales. The STO places the terms of sale for competitively bid bonds in a document called the notice of sale, and all files we reviewed contained the notice of sale. All 15 files also contained documentation that the STO had verified each bidder's compliance with the terms of sale and calculated each bid's true interest cost or net interest cost. In all 15 sales, the STO awarded the bonds to the underwriter who submitted the bid with the lowest true interest cost for general obligation and revenue bonds or lowest net interest cost for revenue anticipation warrants.

Chapter 3 Comparison of California Bond Issues With Other Government Bond Issues

Chapter Summary

In addition to reporting on the state treasurer's implementation of the competitive process for selecting underwriters, Section 5703(h) of the Government Code requires us to compare, where possible, the costs and interest rates of California's initial bond offerings with bond offerings of other states. For our comparison, we focused on true interest cost because it best reflects the overall cost to the State of issuing bonds. We compared the true interest costs of nine bond issues sold by other governmental entities with the true interest costs of nine California bond issues.

From the information obtained in this limited review, we found no indication that California is paying more than necessary for true interest cost on state bonds. Eight of the nine California bond issues had true interest costs that were about the same or lower than the comparison bond issues. In the other bond offering, the true interest cost of the California bond issue was 0.268 percentage points greater than the comparison bond issue. This difference may be attributable to the different features of the bonds or to differing market conditions at the time of the bond sales.

Selection of True Interest Cost as Basis for Comparison

The Government Code, Section 5703(h), requires us to compare, where possible, the costs and interest rates of California's initial bond offerings with bond offerings of other states. For our comparison, we focused on true interest cost because it best reflects the overall cost to the State of issuing bonds.

Most government bond issues consist of a series of bonds that mature in different years, usually from one to 20 years, and each maturity of bonds may pay a different interest rate to the investor. In addition, government bond issues may have other features, such as capital appreciation bonds or term bonds; therefore, the structure of government bond issues can be complex.

Evaluating complex bond issues requires the calculation of the total interest cost of the bond issue. This calculation is used to determine which structure results in the lowest interest cost, and it serves as the basis for awarding bonds in competitive bond sales. There are two

methods in general use for calculating the total interest cost of complex government bond issues: the net interest cost method and the true interest cost method.

The most important difference between the two methods is that true interest cost takes into consideration the time value of money while net interest cost does not. We chose true interest cost as our basis for comparison of the bonds because it more closely reflects the value the investment community places upon the future cash flows of a bond issue. Because it is calculated on the net proceeds for the bonds, less the underwriter's discount, it also reflects the effect of the underwriter's discount on the interest cost of the bonds. The total amount paid in underwriter's discount is balanced against the results of the underwriter's efforts; therefore, if one underwriter is able to structure and sell the bonds in a way that results in a lower interest cost than another underwriter, it may be worth a larger expenditure for underwriter's discount. True interest cost is also the method used by the state treasurer in evaluating the bids for long-term bonds sold competitively.

Selection of Bonds and Related Information for Comparison

We limited our comparison to bonds that were publicly offered and sold through negotiation rather than by competitive bid. We did not include bonds sold by competitive bid because the issuer has little control over the interest cost for these bonds. They must be awarded to the underwriter submitting the bid that results in the lowest interest cost. We also did not include bonds that were privately placed, that is, sold to a single investor. Issuers do not always obtain a credit rating for privately placed bonds, so we could not compare the relative risk of these bonds. Risk has a significant influence on the interest rates.

We obtained the necessary information about 95 of the bond sales negotiated during 1993 and 1994 from the bond files at the State Treasurer's Office or from the issuing state financing authority. Then we obtained information about similar bond issues from Securities Data Company. Securities Data Company provides information about government bond issues to the financial community, maintaining a data base of information about government bond issues. We did not audit the data provided by Securities Data Company. When necessary, we supplemented the data from Securities Data Company with data obtained from the issuers or underwriters of the selected bond issues.

We defined similar bond issues based on the bond issue's credit rating, sale date, average life, principal amount, bond-financed project, and security. The credit rating is a measure of the risk involved from investing in the bonds. This rating is the only attribute that we determined must be exactly the same in comparing bond interest rates. The sale date is important because market conditions can change

rapidly; therefore, we limited our comparison to bond issues that were sold within three days of each other. Five of the nine bond issues selected for comparison with California bonds were sold within one day of each other.

If the bond issuer purchased bond insurance, which ensures the payment of principal and interest if the issuer defaults, this purchase would be reflected in the rating because the rating for insured bonds is based on the credit of the bond insurer instead of the issuer. The purpose of insuring bonds is to obtain a better credit rating, which results in a lower interest rate.

We also present information about each bond issue's average life and optional redemption feature, which affect a bond issue's interest cost. Average life is the average number of years a bond in the issue is outstanding and is a measure of how rapidly the principal is to be repaid. This measure in particular would affect true interest cost because the timing of principal payments is part of the calculation of true interest cost. An optional redemption feature allows a bond issuer to "call" a bond for redemption before the bond's maturity date. It is also referred to as the call option. A typical call option allows an issuer to begin calling bonds ten years after the bond issue date at a redemption price of 102 percent of the bond's principal value. The presence of a call option represents additional investment risks, such as reinvestment risk. This is the risk that the investor will not be able to reinvest his or her principal at the same interest rate as the bonds paid.

The search of Securities Data Company's data base resulted in the identification of nine bond issues with features similar to nine California bond issues. We could not identify similar issues for the other issues sold during 1993 and 1994. Of the nine California bond issues, one was issued by the California Health Facilities Financing Authority, two were issued by the California Housing Finance Agency, and three each were issued by the California Public Works Board and the California Educational Facilities Authority.

Table 3 on pages 22 and 23 presents the information about each California bond issue, the comparison bond issue, and the Bond Buyer Revenue Bond Index for the date closest to the bond issues' sale dates. The Revenue Bond Index is a measure of market conditions for government revenue bonds on the date of its compilation. The index provides additional information about market conditions during the week the bonds were sold. We obtained this information from the Bond Buyer, which is a news publication for the government bond industry.

See Table 3 on the following page.

Insert page 1 of Table 3.

Insert page 2 of Table 3.

As shown in the table above, the true interest cost of eight of the nine California bond issues was lower than or within 0.05 percent of the true interest cost reported for the comparison bond issue. In the other bond issue, the true interest cost was greater than the true interest cost of the comparison bond issue by 0.268 percentage points. This difference may be attributable to differences between the features of the California bond and the comparison bond or to differing market conditions during the sale of the bonds.

The data presented here are intended to be informative and to satisfy the request for a comparison of bond costs and interest rates. The attributes used to define and select similar bond issues are not intended to be a comprehensive list of all the attributes that affect the interest cost of a bond issue.

We conducted this review under the authority vested in the state auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope of this report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

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