

**Management Audit
of the
Measure B Transportation Improvement Program**

Prepared for the
Board of Supervisors of the
County of Santa Clara

Prepared by the
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August 31, 2006

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August 31, 2006

Supervisor Pete McHugh, Chair
Supervisor Liz Kniss, Vice Chair
Board of Supervisors Finance and Government Operations Committee
70 West Hedding Street
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Dear Supervisors McHugh and Kniss:

At the direction of the Board of Supervisors, we have completed a comprehensive management audit of the Measure B Transportation Improvement Program. This study was conducted pursuant to the authority of the Board of Supervisors under the Board's power of inquiry, as provided in Article III, Section 302 (c) of the County Charter and in conformity with the auditing standards of the United States General Accountability Office. This audit was selected through the Board of Supervisors' Management Audit Program risk assessment analysis that identifies and prioritizes areas of County government for future audits. The Measure B Program had not been previously audited under the Board of Supervisors' Management Audit Program. Because the Measure B Program was responsible for approximately \$1.3 billion in sales tax revenue over the life of the Program, this audit was classified as a high priority audit.

The purpose of this audit was to examine the implementation of the Measure B Program, and its success accomplishing project objectives established by the Board of Supervisors. Consequently, the audit scope included an examination of Measure B Program finances to ensure that sales tax revenue had been expended in accordance with Board directives; an evaluation of the management practices of the Measure B Program; and, an assessment of project implementation activities conducted by Program Administration staff and its consultants, the Valley Transportation Authority, and the County Roads and Airports Department.

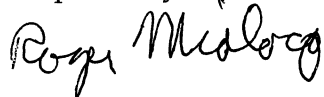
The audit fieldwork commenced in February 2006. A draft report was issued on June 22, 2006, and exit conferences were concluded on July 25, 2006. This audit report includes three sections pertaining to the Measure B Program's ending balance, County overhead charges, and cash management. During the audit, Measure B Program staff and staff of other agencies and departments were interviewed, operational reports and related documents were reviewed, data was collected and analyzed, and various legal issues were examined with County Counsel.

Supervisor Pete McHugh
Supervisor Liz Kniss
August 31, 2006
Page 2

Based on the audit procedures, a total of three findings with nine corresponding recommendations and two topics requiring additional review were developed. The Measure B Program has indicated agreement or partial agreement with 91 percent of the recommendations and other topics. Implementing the recommendations would allow the County to advance the remaining two deferred projects; re-appropriate surplus funds towards other uses, such as un-reimbursed overhead costs and additional transportation improvements; and, maximize the amount of funds held within its custody and minimize the amount of borrowing for similar programs in the future. We estimate that full implementation of the report's recommendations would result in increased revenues and reduced expenditures of approximately \$1.3 million for the Measure B Program and \$1.4 million for similar programs in the future. A one-time General Fund reimbursement amounting to \$645,642 was also identified.

Although most of the recommendations contained in this report are directed to the Measure B Program or County Executive, issues were also raised related to the Valley Transportation Authority and Controller-Treasurer Department. The written response from the Measure B Program begins on page 51 of this report, followed by responses from the other agencies and departments. We would like to thank the Measure B Program Administrator and all other staff involved with this audit for their cooperation and assistance.

Respectfully Submitted,



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Board of Supervisors Management Audit Manager

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Table of Contents

Executive Summary -----	i
Introduction -----	1
1. Ending Balance -----	25
2. County Overhead Costs -----	37
3. Cash Management -----	43
 WRITTEN RESPONSE FROM THE MEASURE B TRANSPORTATION IMPROVEMENT PROGRAM -----	 51
 WRITTEN RESPONSE FROM THE VALLEY TRANSPORTATION AUTHORITY -----	 59
 WRITTEN RESPONSE FROM THE CONTROLLER-TREASURER DEPARTMENT -----	 67

Executive Summary

The Santa Clara County Board of Supervisors authorized a management audit of the Measure B Transportation Improvement Program in FY 2005-06. This audit was conducted in accordance with generally accepted government auditing standards of the United States Government Accountability Office. The audit was performed pursuant to the Board's power of inquiry specified in Article III, Section 302 (c) of the Santa Clara County Charter.

The purpose of the management audit was to examine the implementation of the Measure B Program and its success accomplishing project objectives established by the Board of Supervisors. Consequently, the audit scope included an examination of Measure B Program finances to ensure that sales tax revenue had been expended in accordance with Board directives; an evaluation of the management practices of the Measure B Program, which had been established within the Office of the County Executive to provide project and financial oversight of the Program; and, an assessment of project implementation activities conducted by Program Administration staff and its consultants, the Valley Transportation Authority (VTA), and the County Roads and Airports Department.

This management audit is unique because the local sales tax used to finance the Measure B Program expired on March 30, 2006, and most Measure B project activities had been completed prior to commencement of the study. Consequently, the management audit focused on (a) the historical activities of Program managers to determine overall performance and identify opportunities to increase the efficiency, effectiveness and economy of future voter approved sales tax funded programs; (b) the major financial transactions that occurred during the Program, to ensure that such transactions were consistent with Board policy and in the County's best interest; and, (c) strategies for Program closeout, including estimates of final sales tax collections and the proposed use of funds.

Overall, we found that the Measure B Program has been well run and highly accountable to the public. Despite a downturn in the economy, which resulted in less sales tax revenue than anticipated when Measure B planning first occurred, virtually all of the Program objectives had been met prior to the start of this management audit. In addition, because of the cooperative relationship between the County and VTA, other federal, State and local funds were leveraged to enhance some Measure B projects and ensure the completion of other compatible transportation improvements within the County. The two final projects, which have been deferred and not yet advanced to the Board for funding authorization, are likely to be completed under the Measure B Program as long as the County and VTA continue the cooperative relationship that has been the basis of much of the Program's success.

Consequently, this audit report contains only three substantive findings. A synopsis of each of the findings and related recommendations is provided on the pages that follow.

Section 1: Ending Balance

The Measure B Program has projected an ending balance of approximately \$16.0 million as a result of conservative revenue projections and slightly favorable variances in rail and highway project costs. This projection is based on a zero growth estimate of sales tax collections through March 30, 2006, when the sales tax expired, and a projection of expenditures through the end of the Program. The projection does not include residual sales tax receipts, which are received after the sales tax expiration date and are a result of delinquent or late sales tax returns, audit determinations and merchant investigations by the State Board of Equalization, since these amounts are difficult to estimate.

The current inventory of deferred projects could cost as much as \$17.3 million, or \$1.3 million greater than the ending balance projected by the Measure B Program. As a result, Program staff are working on a plan to fund these projects from the ending balance as well as from local, State or federal sources. However, based on Board actions and other information as of June 20, 2006, the ending balance could reach approximately \$17.3 million, which is equal to the estimated cost of the deferred projects. The adjusted projection is based on recent receipts of sales tax revenue, the availability of funds set-aside in contingency, advancement of a deferred project, and revised projections of administrative and oversight costs.

While the adjusted ending balance may be sufficient to fund the deferred projects, strategies should be implemented that leverage additional funding when possible and cap Measure B obligations going forward. For example, the Valley Transportation Authority should be requested to examine the remaining funding requirements for projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that may be available to support the deferred projects. Furthermore, in order to preserve some surplus funds for other uses and close out the Measure B Program without concern for cost overruns, final payment agreements should be negotiated with implementing agencies that would cap the County's financial obligation for projects that remain open after June 30, 2007.

Based on these findings, the Santa Clara County Board of Supervisors should direct the Measure B Program to:

- 1.1 Increase the Measure B ending balance by as much as approximately \$1.3 million to reflect new information, including recent receipts of sales tax revenue, the availability of funds set-aside in contingency, advancement of a deferred project, and revised projections of administrative and oversight costs. (Priority 1)
- 1.2 At the time that the first payment is due to the Valley Transportation Authority (VTA) for the reimbursement of landscaping costs, estimate whether enough residual sales tax revenue will be collected to reimburse VTA for negotiated commitments and whether any surplus revenue will remain following the reimbursement. If the Measure B Program expects to have excess residual sales tax revenue, these funds should be included in the Measure B ending balance. (Priority 1)

- 1.3 Request that the Valley Transportation Authority examine the remaining funding requirements of projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that could be available to support the deferred projects. (Priority 1)
- 1.4 Negotiate final payments with implementing agencies for each project that will remain open after June 30, 2007. The payment agreements should specify that any surplus funds that exist, once the projects have been fully closed out, should be re-appropriated by the Board of Supervisors. (Priority 1)

There would be no additional costs to implement these recommendations.

By increasing the ending balance to reflect new information, maximizing the amount of external funding that is contributed, and negotiating final payments with the implementing agencies, the County could fully fund the remaining two deferred projects. Since the adjusted ending balance totals approximately \$17.3 million, or \$1.3 million more than the projection developed by the Measure B Program for the *Fiscal Year 2007 Revenue and Expenditure Plan*, the County might also be able to re-appropriate surplus funds towards other uses, such as un-reimbursed overhead costs and additional transportation improvements, as discussed in Section 2.

Section 2: County Overhead Costs

The Measure B Program was established in FY 1998-99, after the California Supreme Court upheld the legality of Measures A and B, and began incurring expenses that same year. However, the Measure B Program was not allocated overhead costs through the County's Cost Allocation Plan until FY 2003-04 and was not charged overhead costs until FY 2004-05. These charges included FY 2002-03 costs, since the Cost Allocation Plan reconciles actual and proposed costs from two years prior and makes an adjustment for costs in the current year.

As a result, the County has not been reimbursed for overhead costs incurred from the start of FY 1998-99 through the end of FY 2001-02, and costs charged in subsequent years have not consistently matched amounts detailed in the Cost Allocation Plans approved by the State. Based on a review of the County's Cost Allocation Plans, the County has not been reimbursed for \$645,642 in overhead costs incurred on behalf of the Measure B Program.

Consequently, if excess regular or residual sales tax revenue remains after the Measure B Program has fulfilled policy directives and financial obligations, the Board of Supervisors should consider using these funds to (a) reimburse the General Fund up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B Program; and/or, (b) support County programs and activities related to transportation improvements, in accordance with the will of voters and intention of the Board.

Based on these findings, the Santa Clara County Board of Supervisors should direct the Measure B Program or County Executive to:

- 2.1 Budget an estimate of overhead costs that will be charged in FY 2008-09 and FY 2009-10, and replace these estimates with the exact amount of costs proposed in the State approved Cost Allocation Plan. (Priority 1)

The Santa Clara County Board of Supervisors should:

- 2.2 Consider using excess regular or residual sales tax revenue to (a) reimburse the General Fund up to \$645,642 for overhead costs incurred on behalf of the Measure B Program; and/or, (b) support County programs and activities related to transportation improvements. (Priority 1)

There would be no additional costs to implement these recommendations.

In future years, the County would ensure that overhead costs are budgeted and charged according to the Cost Allocation Plan approved by the State. The General Fund could also be reimbursed up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B Program, if surplus funds are available and the Board agrees to this reimbursement. Alternatively, County programs and activities related to transportation improvements could be funded with one-time revenue from surplus funds, thereby reducing or enhancing funding from the General Fund or other sources.

Section 3: Cash Management

During Calendar Years 2003 through 2005, the Valley Transportation Authority (VTA) held an average daily cash balance of \$38.0 million in Measure B funds, in an interest bearing checking account with its custodial bank. The large average daily cash balance occurred because VTA was unable to produce an accurate estimate or effectively manage cash flow needs due to unanticipated delays that interrupted the progress of construction and payments due to contractors; and, because of insufficient analysis on the extent to which the prior months' cash advances exceeded actual cash requirements.

In 2003, the County borrowed \$139.9 million in revenue bonds to fund major Measure B projects prior to the receipt of sales tax revenue. If VTA had been able to more precisely estimate its cash needs, and the County had been able to postpone the transfer of funds until required, then the County could have generated substantial savings in the form of reduced borrowing costs. Such savings would have occurred because the effective County interest expense for the bonds issued by the Santa Clara County Financing Authority were as much as four times higher than the rate of return realized on Measure B funds advanced to VTA. Over the three-year period after the bonds were issued, the Measure B checking account yielded an average of 0.77 percent per year in interest income, while the special obligation bonds cost an average of 2.02 percent per year in interest expense.

Therefore, the County should avoid agreeing to any provisions that require it to advance funds based upon an estimate of monthly cash flow requirements for future transportation improvements or other large projects. Instead, the County should require the implementing agency to batch charges for services at bi-weekly intervals and request a transfer of funds just prior to incurring charges. Had this process been implemented for the Measure B Program, an estimated \$1.4 million in net interest expense could have been saved over the life of the Program with a minor impact on processing costs.

Based on these findings, the Santa Clara County Board of Supervisors should direct the County Executive to:

- 3.1 Discontinue the practice of advancing funds based upon an estimate of monthly project cash flow requirements in future agreements with implementing agencies. (Priority 1)
- 3.2 Require implementing agencies selected for future projects to (a) batch charges for labor, design consultants, non-technical services, professional consultants, real estate services, property costs, construction, field operations and other activities at bi-weekly intervals; and, (b) notify the County of the total amount of charges in the batch with detailed information on the charges and a request to wire funds within two to three business days. (Priority 1)
- 3.3 Establish procedures that will ensure the monthly reconciliation of reimbursement claims to authorized expenditures, as defined by Board approved plans, for future projects. (Priority 2)

Since the frequency of fund transfers would increase each month with just-in-time reimbursements, implementing the procedural changes recommended above would generate a small amount of additional processing costs. However, these costs could be contained by maintaining a monthly reconciliation of reimbursement claims to authorized expenditures. Developing procedures for this reconciliation would also generate a small administrative cost that could be charged through the County's Cost Allocation Plan.

Over the three-year period examined, the County would have avoided approximately \$1.4 million in net Measure B Program costs. Savings for future projects would depend upon the dollar amount of the program, interest rates and the frequency of expenditure reimbursements provided by the County. Furthermore, the suggested method of batching and paying charges would allow the County to maximize the amount of funds held within its custody and minimize the amount of any future borrowing, while maintaining the authority to retroactively review reimbursement requests for consistency with authorized expenditures.

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Introduction

This *Management Audit of the Measure B Transportation Improvement Program* was authorized by the Board of Supervisors of the County of Santa Clara as part of the County's FY 2005-06 Management Audit Program, pursuant to the Board's power of inquiry specified in Article III, Section 302 (c) of the Santa Clara County Charter. The Board of Supervisors selected the audit topic after considering the annual County-wide audit risk assessment conducted by the Management Audit Division in accordance with Board directive.

Purpose and Scope

The purpose of the management audit was to examine the implementation of the Measure B Program and its success accomplishing project objectives established by the Board of Supervisors. Consequently, the audit scope included an examination of Measure B Program finances to ensure that sales tax revenue had been expended in accordance with Board directives; an evaluation of the management practices of the Measure B Program, which had been established within the Office of the County Executive to provide project and financial oversight of the Program; and, an assessment of project implementation activities conducted by Program Administration staff and its consultants, the Valley Transportation Authority (VTA), and the County Roads and Airports Department.

This management audit is unique because the local sales tax used to finance the Measure B Program expired on March 30, 2006, and most Measure B project activities had been completed prior to commencement of the study. Consequently, the management audit focused on (a) the historical activities of Program managers to determine overall performance and identify opportunities to increase the efficiency, effectiveness and economy of future voter approved sales tax funded programs; (b) the major financial transactions that occurred during the Program, to ensure that such transactions were consistent with Board policy and in the County's best interest; and, (c) strategies for Program closeout, including estimates of final sales tax collections and the proposed use of funds.

Overall, we found that the Measure B Program has been well run and highly accountable to the public. Despite a downturn in the economy, which resulted in less sales tax revenue than anticipated when Measure B planning first occurred, virtually all of the Program objectives had been met prior to the start of this management audit. In addition, because of the cooperative relationship between the County and VTA, other federal, State and local funds were leveraged to enhance some Measure B projects and ensure the completion of other compatible transportation improvements within the County. The two final projects, which have been deferred and not yet advanced to the Board for funding authorization, are likely to be completed under the Measure B Program as long as the County and VTA continue the cooperative relationship that has been the basis of much of the Program's success.

Consequently, this audit report contains only a few substantive findings, as fully discussed in the body of the report and summarized below:

1. Based on Board actions and other information as of June 20, 2006, the Measure B Program is likely to realize an uncommitted sales tax balance of approximately \$17.3 million, which is \$1.3 million more than the amount estimated by the Measure B Program in the *Fiscal Year 2007 Revenue and Expenditure Plan*. These unbudgeted funds will permit the County to advance both of the remaining Measure B deferred projects, provided the County's financial obligations are limited to available Measure B funds and VTA finances a portion of the project cost from other sources, such as uncommitted local revenue funds remaining from prior year Measure B revenue swaps.
2. The County has incurred approximately \$645,642 in unreimbursed overhead costs to support the Measure B Program. If surplus funds remain after the Measure B Program has fulfilled the Board of Supervisors' policy directives and financial obligations, the Board should consider using these funds to (a) reimburse the General Fund up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B Program; and/or, (b) support County programs and activities related to transportation improvements, such as the County Roads and Airports Department's Pavement Management Program, in accordance with the will of the voters and intention of the Board.
3. During Calendar Years 2003 through 2005, VTA held an average daily cash balance of \$38.0 million in Measure B funds, in an interest bearing checking account with its custodial bank. If VTA had been able to more precisely estimate its cash needs during this period, and the County had been able to postpone the transfer of funds until required, then the County could have generated substantial savings in the form of reduced borrowing costs amounting to an estimated \$1.4 million. In the future, the County should avoid agreeing to any provisions that require it to advance funds based upon an estimate of monthly cash flow requirements. Instead, the County should pay for the cost of major capital projects with just-in-time reimbursements of planned expenditures.

Throughout the remainder of this Introduction, other aspects of the Measure B Program are discussed to provide the reader with an understanding of the significant areas examined as part of this review. Included are assessments of management performance in each of these areas. Where potential issues were identified, but fell outside of the scope of this review, they are discussed in the Introduction section entitled, "Topics Requiring Additional Review."

Audit Methodology

This management audit was conducted in accordance with generally accepted government auditing standards issued by the United States Government Accountability Office (USGAO). Pursuant to these requirements, the following management audit procedures were followed:

- Audit Planning – The management audit was selected by the Board of Supervisors using a risk assessment tool and estimate of audit work hours, developed at the Board’s direction by the Management Audit Division. After audit selection by the Board, a detailed management audit work plan was developed and provided to Measure B Program managers for review and comment.
- Entrance Conference – An entrance conference was held with senior management of the Measure B Program, Valley Transportation Authority (VTA), and County Roads and Airports Department to introduce the management auditors, describe the management audit program and scope of review, and respond to questions. A letter of introduction from the Board, a management audit work plan, and a request for background information were also provided at the entrance conference.
- Pre-Audit Survey – A preliminary review of documentation and interviews with managers from the involved agencies were conducted to obtain an overview understanding of the Measure B Program, and to identify areas of operations that warranted more detailed assessments. Based on the pre-audit survey, the work plan for the management audit was refined and major changes were communicated to Measure B Program managers.
- Fieldwork – Fieldwork was conducted to obtain additional information and data on Measure B Program implementation. Fieldwork activities included: (a) interviews with management and line staff of the various agencies responsible for Measure B Program implementation; (b) a further review of documentation and other materials provided by the various Measure B agencies and available from other sources; and, (c) analyses of data that was manually and electronically collected during the audit.
- Status Reporting – At the completion of the pre-audit survey and in the middle of fieldwork, reports were provided to the Measure B Program Administrator and Senior Fiscal Officer to describe the study’s progress, provide general information on the areas being research and analyzed, and address any other issues.
- Draft Report – A draft report was prepared and provided to Measure B Program managers and managers from the involved agencies. The draft report was also provided to County Counsel to review based on legal questions that surfaced during the course of the study. Other internal and external organizations described or discussed substantively in the draft report were provided applicable sections of the report for review and comment.
- Exit Conference – For quality assurance purposes, an exit conference was held with Measure B Program managers and managers from the involved agencies to discuss the content of the draft report, ensure factual accuracy, and obtain management’s views on findings, conclusions and recommendations.
- Final Report – A final report was prepared and submitted to the Board of Supervisors. The Measure B Program Administrator, VTA management and the County Roads and Airports Department Director were provided opportunities to submit written responses to the report, which are attached.

Overview of the Measure B Program

In November 1996, voters approved two measures on the Santa Clara County ballot that led to the establishment of the Measure B Program. The first, Measure A, was an advisory measure that identified a specific “package” of transportation improvements that should be funded from new sales tax revenues, should such funds become available to the County. The Citizens Coalition for Traffic Relief developed the project package contained in Measure A with input from local officials and transportation professionals. When developing the package, the Coalition considered need, project readiness and geographic diversity; and, worked to create a close to even split in planned expenditures between highway/road- and transit-oriented projects.

Measure B, the second measure approved by the voters, increased the County-wide local sales tax by one-half-cent for a period of nine-years, beginning on April 1, 1997. In addition to authorizing the sales tax, Measure B required that an independent Citizens Watchdog Committee be established to review expenditures and oversee annual audits on the use of the funds. The half-cent sales tax was authorized as a general tax available for “general County purposes,” giving the Board of Supervisors broad discretion on how the funds would be spent. However, consistent with the voters’ intent, at the outset of the Measure B Program the Board decided that the revenues should be used to fund the transportation improvements specified in Measure A.¹

Nonetheless, shortly after voters approved Measure A and Measure B, some taxpayers filed a lawsuit challenging the legality of the two measures by arguing that the measures “were effectively one measure” and that they imposed a “special tax to fund the specific expenditures identified in Measure A.” The taxpayers argued that because the two measures were joined in this manner, “Measure B required . . . (and did not receive) the approval of two-thirds of the voters,” pursuant to the California Constitution, Article XIII A. After approximately two years, the California courts ruled that the sales tax was legal and could be collected by the County.²

Initially uncertain of how the courts would rule in the matter, the State Board of Equalization (SBE) began collecting the sales tax on April 1, 1997, and continued throughout the period of the litigation. The taxes collected by the SBE during this period were remitted to the County, and the County held the collected taxes in an interest bearing account until the litigation was settled in FY 1997-98. Since that time, the revenues have continued to be collected regularly and remitted to the County monthly, in accordance with State apportionment schedules for other local sales taxes.

Since the County had not established a program for administering the funds prior to the court ruling, the former administrator of the Traffic Authority was initially hired as a consultant to help develop a blueprint for delivering the traffic improvements outlined

¹ Measure B Program Policies adopted by the Board state, “**1. Adherence to Measure A/B Ballot Language:** The Measure B Transportation Improvement Program should closely adhere to the Measure A ballot measure list of projects, and is not intended to imply a new list of projects (refer to the Measure A/B Ballot Language, Resolution adopted by the Board on May 11, 1999, to restrict use of Measure B funds and the Base Case Plan).”

² Coleman v. The County of Santa Clara

in Measure A and funded by Measure B. The Board of Supervisors adopted this *Blueprint for Delivery: Measure B Transportation Improvement Program* on September 1, 1998. With the further aid of consultants, the County developed “Base Case” revenue projections, and the Board approved a plan for accomplishing the Program objectives. Despite the delays caused by the litigation, the Board directed that the Measure B package of programs be completed within the original nine-year window of the tax. Accordingly, the timetable for completing the transportation improvement program was reduced from nine to seven years due to the litigation delays. Despite this compressed timetable, Santa Clara County should be able to complete the majority of these projects on schedule and within budget.

Organizational Structure

As mentioned above, in September 1998, the County adopted the *Blueprint for Delivery: Measure B Transportation Improvement Program*, which identified a framework for delivering the transportation improvement program outlined in the advisory measure. This framework specified that the Board of Supervisors would retain program level responsibilities and authority, but that the Valley Transportation Authority (VTA), the County Roads and Airports Department and local cities would be responsible for project delivery. The success of this partnership necessitated a clear understanding of the Measure B Program’s “Base Case” and formalized agreements defining relationships between the various Program participants.

Under the plan, VTA was selected as the primary “implementing agency” in its dual role as a Countywide Transportation Authority (CTA) and Congestion Management Agency (CMA). This meant that VTA assumed significant responsibility regarding the management of Measure B funds allocated to the County and cities (e.g., Pavement Management Program funds); the construction of major highway and interchange improvements (which could have alternatively been performed by Caltrans); and, the construction of transit improvements. During this management audit, we found that the selection of a primary agency to serve as the point for all Measure B projects was a significant reason for the Program’s success.

Because it is a County general tax, the Board of Supervisors has complete appropriation authority over the use of the 1996 Measure B sales tax. However, the Board chose to establish a separate joint meeting process with the VTA Board of Directors to oversee Program implementation. This joint meeting was held once each year in June to review the annual *Revenue and Expenditure Plan* that is developed by Measure B Program staff. Interim modifications to project scope, schedule or cost were also brought to the two boards at their regular meetings during the year. A *Master Agreement*, which was separately agreed to by the two boards, governs the relationship between the County and VTA.

The Measure B Program is a division of the County Executive’s Office. The Measure B Program Administrator reports directly to the Deputy County Executive for Intergovernmental Relations and leads a team consisting of a Senior Fiscal Officer, an Accountant II/III and an Administrative Coordinator. These individuals are responsible for developing program-wide policies for the County Executive; monitoring compliance

with the *Master Agreement* between the County and VTA; developing the annual *Revenue and Expenditure Plan*; accounting for all project and program costs; and, ensuring the closeout of Measure B projects administered by VTA and the County Roads and Airports Department. Measure B Program staff also support the Citizens Watchdog Committee with its mandated audit and reporting responsibilities, as defined by Measure B.

Throughout the Program, the Program Administrator has also relied on the services of a team of engineering consultants who have provided Program Management Oversight services, including the technical review of Measure B projects throughout the design and implementation phases. These individuals monitor the reasonableness of design decisions, project timetables and costs, and work with the Measure B Program Administrator to determine the most cost effective alternatives for project implementation.

The Measure B Program also relies on the County Counsel for legal services; the Finance Agency for accounting, debt service, investment and payroll services; and, the Public Information Office for marketing support and press releases. Lastly, the Measure B Program retains the services of an independent financial auditor who serves the Citizens Watchdog Committee by preparing an annual financial audit and an audit of VTA's compliance with the *Master Agreement*.

Revenues and Expenditures

The size of the Measure B Program has grown from a base case budget of approximately \$1.46 billion to a current modified budget of more than \$1.59 billion. While this growth has been made possible because of various contributions of local, State and federal funds, the primary source of Measure B funding continues to be the half-cent sales and use tax approved by the voters in 1996. Additional sources of funding include interest income on surplus cash balances and transportation improvement funds from other governmental agencies.

The table on the following page shows how the Measure B Program's estimates of available resources and recommended appropriations have changed over the life of the Program. The table illustrates the following:

- In the *1999 Base Case Plan*, the County projected that approximately \$1.330 billion in sales tax revenue would be collected over the life of the Measure B Program. In the *Fiscal Year 2007 Revenue and Expenditure Plan*, this estimate was revised upward to \$1,333,463,000. More recent projections made by the Measure B Program and confirmed through this audit indicate that actual collections will likely be approximately \$1.336 billion, or \$5.7 million more than the 1999 estimate.
- The *Fiscal Year 2007 Revenue and Expenditure Plan* projects that over the life of the Program, approximately \$73.3 million in investment income will be earned. This is about \$19.3 million more than originally estimated in the *1999 Base Case Plan*, but less than could potentially have been earned with more effective cash management.

Table 1
Historical Changes in Revenue and Expenditure Projections
Santa Clara County Measure B Transportation Improvement Program
(Dollars in Thousands)

Source/Use Category	FY 2007 Revenue & Expenditure Plan	FY 2006 Revenue & Expenditure Plan	FY 2005 Revenue & Expenditure Plan	FY 2004 Revenue & Expenditure Plan	FY 2003 Revenue & Expenditure Plan	FY 2002 Revenue & Expenditure Plan	FY 2001 Revenue & Expenditure Plan	1999 Base Case Plan
Net Income								
Sales Tax	1,333,463	1,323,911	1,300,915	1,307,295	1,421,822	1,610,893	1,444,657	1,330,000
Interest Income	73,342	70,312	69,319	62,235	70,793	58,819	52,049	54,000
Other Revenue *	188,363	189,549	185,225	188,450	297,514	154,563	134,615	77,100
Net Revenue	\$1,595,168	\$1,583,772	\$1,555,459	\$1,557,980	\$1,790,129	\$1,824,275	\$1,631,321	\$1,461,100
Rail								
Capitol Light Rail Extension	156,952	156,752	159,802	166,542	166,542	149,643	136,262	111,000
Vasona Light Rail Extension	313,205	314,705	316,827	320,363	320,913	283,396	216,191	212,000
Tasman East Light Rail Extension	272,637	272,837	275,087	282,401	287,371	271,298	270,175	268,000
Low Floor Light Rail Vehicles	93,888	94,163	94,163	94,163	96,013	97,078	97,078	97,000
Caltrain Service Improvements	53,950	54,347	52,166	54,230	127,070	81,656	81,656	80,000
Freemont/South Bay Commuter Rail	3,229	3,275	3,275	3,275	3,275	97,955	97,955	96,000
Contingency	-	-	-	-	-	25,000	25,683	49,000
Subtotal Rail	\$893,861	\$896,079	\$901,320	\$920,974	\$1,001,184	\$1,006,026	\$925,000	\$913,000
Highway								
Route 880 Widening	76,112	76,112	76,301	73,871	69,552	60,386	53,386	38,000
Route 85/87 Interchange	43,100	43,064	42,831	44,297	44,706	51,027	51,027	41,000
Route 101 Widening	54,401	54,516	55,187	54,169	63,975	63,975	63,975	55,000
Route 85/101 Interchange (North)	125,294	125,294	122,589	124,234	141,754	130,892	130,892	127,000
Route 237/880 Interchange	51,446	51,170	48,701	47,843	48,487	46,171	46,171	42,000
Route 87 HOV Lanes (North)	10,996	10,996	10,953	10,548	46,604	34,010	34,010	33,000
Route 17 Improvements	26,536	28,191	11,758	12,017	40,000	51,600	51,600	50,000
Route 85/101 Interchange (South)	68,380	68,436	66,763	65,833	62,146	58,314	58,314	23,000
Route 87 HOV Lanes (South)	15,465	15,465	15,060	14,530	75,215	31,315	27,815	31,000
Route 152 Safety Improvements	26,196	22,746	21,909	15,014	22,971	11,220	11,220	11,000
Route 85 Noise Mitigation	8,044	9,044	1,130	1,159	9,251	9,263	9,263	9,000
Contingency	-	-	-	-	-	60,000	-	-
Subtotal Highway	\$505,970	\$505,034	\$473,182	\$463,515	\$612,899	\$608,173	\$537,673	\$460,000
Ancillary and Program-wide								
Pavement Management Program	90,000	90,000	90,000	90,000	90,000	90,000	90,000	90,000
Level of Service Program	14,047	11,244	11,244	11,244	11,244	11,836	10,000	10,000
Signal Synchronization Program	25,435	24,135	24,135	24,135	24,135	25,405	22,000	22,000
Bicycle Program	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Community Oriented Design Enhancements	6,697	6,797	7,187	7,187	7,787	13,752	12,100	-
Consolidated Biological Mitigation Site	7,331	7,331	6,621	6,921	9,400	10,400	-	-
Program Administration	6,422	5,982	5,262	5,708	5,253	5,253	4,923	6,600
Program Management Oversight	7,756	7,456	6,406	5,513	5,540	5,540	5,191	5,800
Interest Expense	9,601	9,607	9,932	9,932	9,798	22,470	26,933	51,800
Subtotal Ancillary and Program-wide	\$179,289	\$174,552	\$172,572	\$172,640	\$175,157	\$196,656	\$183,147	\$192,400
Total Expenditures	\$1,579,120	\$1,575,665	\$1,547,074	\$1,557,129	\$1,789,240	\$1,810,855	\$1,645,820	\$1,565,400
Projected Surplus/(Shortfall)	\$16,048	\$8,107	\$8,385	\$851	\$889	\$13,420	(\$14,499)	(\$104,300)

Note:
* Fund swap expenditures have been subtracted from other revenue.

- The County and VTA have been able to leverage approximately \$188,363,000 in other funding from local jurisdictions, the State and federal government to support and enhance several Measure B projects. This is approximately \$111.3 million more than originally anticipated in the *1999 Base Case Plan*.³
- The *Fiscal Year 2007 Revenue and Expenditure Plan* anticipates that the Measure B Program will expend approximately \$893.9 million on rail projects through its end. This is approximately \$19.1 million less than anticipated in the *1999 Base Case Plan*. However, the Program spent considerably more on the three major light rail extension projects (i.e., Capitol, Vasona and Tasman East), but plans to spend considerably less than anticipated on Caltrain Service Improvements and the Fremont/South Bay Commuter Rail. (As described below, spending for the Caltrain Service Improvements may actually be more than planned levels, thus exceeding the amount included in the *Fiscal Year 2007 Revenue and Expenditure Plan*, since two of the planned improvements are included in the Measure B deferred projects list and will likely be presented to the Board of Supervisors for funding authorization as final Measure B sales tax collections become available. However, no additional appropriations are anticipated for the Fremont/South Bay Commuter Rail.)
- The *Fiscal Year 2007 Revenue and Expenditure Plan* indicates that approximately \$46.0 million more will be spent on highway projects than originally envisioned in the *1999 Base Case Plan*. Higher than anticipated expenditures occurred for many projects, but particularly for the Route 880 Widening Project (\$38.1 million), Route 85/101 Interchange (South) Project (\$45.4 million), and Route 152 Safety Improvements (\$15.2 million). Offsetting savings occurred from many other projects, including the Route 87 HOV Lanes (North and South) Projects (\$37.5 million), which were completed using other VTA funding (i.e., GARVEE bonds secured by State Transportation Improvement Program funds awarded to VTA); and, Route 17 Improvements (\$23.5 million), due to reductions in scope.⁴
- The *Fiscal Year 2007 Revenue and Expenditure Plan* indicates that approximately \$13.1 million less will be spent on ancillary and program-wide activities. This includes approximately \$21.8 million in additional expenditures for Community Oriented Design Enhancements, Consolidated Biological Mitigation activities and Program Management Oversight. These services were added and centrally funded to ensure that multiple projects continued to move forward during the compressed implementation timeframe caused by the lawsuit. Offsetting these amounts and other smaller project components that resulted in higher than anticipated costs, was approximately \$42.2 million in interest savings from more advantageous cash flow and borrowing conditions during the Program.

³ This does not include funds from six revenue swap agreements entered into between the County and VTA. The first swap provided Measure B with net additional income of approximately \$4.9 million. However, the other five swaps resulted in no additional net income for the Measure B Program.

⁴ All changes to project scope, schedule and cost were first reviewed by Measure B Program staff and then authorized by the Board of Supervisors, as required by the *Master Agreement*.

As specified in Measure A, the vast majority of Measure B funding has been expended on project delivery. Approximately 56.6 percent of Measure B funds have been programmed for rail transportation and 32.0 percent for highway construction, with an additional 11.4 percent of the funds being appropriated to support various ancillary programs and program-wide expenses.

Administrative Costs

Program Administration and Program Management Oversight are generally categorized as program-wide expenses. Advisory Measure A stipulates that, "Only 0.5 percent of the funds can be used for staff salaries and administration, reserving 99.5 percent of the funds for project delivery." According to the Measure B Program financial auditors, as of June 30, 2005, administrative costs totaled approximately \$4.61 million and sales tax receipts received since the Program's inception totaled approximately \$1.22 billion.⁵ Consequently, administrative costs through FY 2005 were approximately 0.38 percent of total sales tax revenue. This amount is below the 0.5 percent threshold established by Measure A.

Strategies to Ensure Timely Project Implementation

Given the shortened Measure B implementation timeframe, the County and VTA embarked on several initiatives to ensure project delivery with a minimum amount of delay. Key among these were: 1) decisions to establish reasonable project budgets and contingency reserves, with appropriation control overseen by the County's Measure B Program Administrator, to reduce the need to request budget modifications from the Board of Supervisors; 2) a decision to secure \$134.3 million in bond funding so that projects could proceed uninterrupted prior to the collection of the voter approved sales tax; and, 3) the use of "design-at-risk" implementation strategies, whereby design and environmental review project phases proceed on a parallel vs. sequential track.

Project Contingencies

At the outset of the Measure B Program, component costs could not be well defined for all projects, since many were in initial planning stages. Further, for many projects, implementation would take many years so that projecting future costs was inherently imprecise. Therefore, engineering cost estimates were liberally defined and significant contingencies were built into project budgets to ensure that sufficient resources had been appropriated to accomplish Measure B Program goals. For rail and highway projects, these contingencies ranged between 2.8 percent and 6.9 percent of estimated project costs, and 6.9 percent and 17.3 percent of estimated project costs, respectively.⁶ Contingencies were smaller for the rail projects because the projects were better defined early in the Measure B planning process. Nonetheless, as both rail and highway projects

⁵ Per Board policy, costs associated with the PMO consultants are excluded from the calculation for determining compliance with the administrative cost limitation, since these consultants perform technical review functions supporting the implementation of individual projects.

⁶ Percentages were calculated using the baseline cost estimates approved by the County Board of Supervisors and VTA Board of Directors in amendments to the *Master Agreement*.

progressed through planning and design phases, contingency amounts were reduced, and funding was redirected toward specific project elements.

The *Master Agreement* between the County and VTA specified the method by which project contingencies would be managed. Based on the terms of the *Master Agreement*, VTA was required to report on the amount and reason for utilizing project contingency for base scope items that were unforeseen when the baseline cost estimate was prepared. *Amendment No. 4 of the Master Agreement* permitted VTA to make cumulative budget transfers within the contingency category of up to 75 percent of the original contingency budget, as long as the project budget remained constant. Budget transfers that exceeded this threshold required the approval of the County Board of Supervisors.⁷ Furthermore, if VTA requested an augmentation of project contingency, *Amendment No. 15 of the Master Agreement* gave the Measure B Program Administrator the authority to approve this augmentation with a commensurate reduction of contingency from one or more other projects. Once the majority of contract activities were complete for a project, VTA was also required to reduce the project budget by the amount of any surplus contingency funds that were available. Finally, upon completion of a project, any remaining contingency funds were to be used in a way that benefited the Measure B Program as a whole.

We reviewed VTA's management of project contingency for both rail and highway projects and verified that the Authority was complying with the terms of the *Master Agreement*. It is also our finding that the contingency budgets that were established for each project at the outset of the Measure B Program and the expenditures that were funded from these budgets due to change orders, scope changes and other factors were appropriate. We base this finding on interviews with Program Management Oversight consultants and analyses of project contingencies over time.

Program Contingencies

In addition to project contingencies, the *1999 Base Case Plan* established a reserve of \$49 million that was to be held in a special contingency reserve for the light rail projects. If project costs exceeded their approved baseline cost estimate, the *Master Agreement* allowed VTA to request supplemental funding from the Light Rail Program Reserve, which was controlled by the County Board of Supervisors. Since the reserve was depleted in order to accommodate Board approved budget adjustments, an additional \$25 million was added in FY 2001-02 as part of the annual budgeting process. While the majority of funds held in this reserve were applied to the light rail projects, the reserve was eliminated in FY 2002-03 when the economy worsened. At this time, approximately \$9.0 million was used as a deficit reduction strategy, and the remaining \$16.0 million was applied to the light rail projects to fund construction or adjust project contingencies.

⁷ Caltrain Service Improvements were exempt from this requirement. For this project, *Amendment No. 4 of the Master Agreement* allowed the VTA and County Project Liaisons to recommend and the VTA General Manager and County Executive to approve cumulative budget transfers in the contingency category that exceeded 75 percent of the original contingency budget.

For highway projects, a program contingency reserve was not established at the outset of the Measure B Program. However, as part of the budgeting process for FY 2001-02, a \$60 million reserve was established for the Highway Program in order to ensure that there would be sufficient funds to complete the projects. This reserve was short-lived due to the downturn in the economy and was eliminated a year later, in FY 2002-03. Similar to the reserve for light rail projects, approximately \$20.7 million of the \$60 million reserve was used as a deficit reduction strategy.

Borrowing to Finance Construction

During the first two years of the Program, when the sales tax was being litigated, Measure B funds accumulated in an interest bearing account held by the County. Once the litigation was resolved in the County's favor, the Board of Supervisors and VTA were able to immediately utilize the accumulated funding to implement projects that had been staged by VTA for immediate delivery. However, as the Program progressed, project expenditures were projected to surpass revenue collections on a cash flow basis. Therefore, in FY 2002-03, the Board of Supervisors authorized the issuance of approximately \$139.9 million in special obligation bonds through the Santa Clara County Financing Authority, which resulted in bond proceeds of approximately \$134.3 million.⁸ The interest cost to the Measure B Program for the issuance of these bonds will amount to approximately \$9.6 million after all debt is paid. Given the compressed timeframe established by the Board of Supervisors, this borrowing was appropriate, otherwise delays would have occurred due to the cash flow needs of the Program.

Design at Risk

Many jurisdictions progress through the project planning, design and environmental review stages sequentially to ensure that possible complications are known before investing considerable staff time and resources into efforts to obtain final project plans (e.g., obtaining environmental clearances prior to final design). While the sequential process provides increased assurance that potential obstacles are known and can be mitigated prior to construction, this method of project development can result in unnecessary delays when characteristics of the project are well known. Sequential processing is the method most commonly used by Caltrans for major highway construction projects that it manages.

Recognizing the potential delays that can result from sequential processing, VTA chose to employ a method known as "design-at-risk" to conduct planning, design and environmental review steps concurrently rather than sequentially. VTA felt this approach was reasonable, given existing knowledge of the projects and the success that it had experienced using the design-at-risk process for other non-Measure B projects that it had managed. This strategy appeared to have worked well, and we did not identify any instances where the design-at-risk implementation strategy caused

⁸ Santa Clara County Financing Authority, Special Obligation Bonds, Series 2003 approved by Resolution of the Board of Supervisors, January 14, 2003.

significant project delays or increased cost, due to costly mitigation or redesign requirements.

Project Definitions

Highway and Rail Programs

As discussed previously, initial planning for transportation improvement projects included in Measure A began in December 1998, with the development of the *Base Case Plan*. As part of this process, meetings were held with the project stakeholders, including the County, VTA, Caltrans, cities and other interested parties, to determine the appropriate scope of each project. During the meetings, the proposed scope of the projects, design constraints and potential implementation obstacles were discussed. Because some project designs had not been extensively developed, the scope meetings identified a range of potential improvements that would be analyzed during the preliminary engineering phase. The product of these efforts was the *1999 Base Case Plan*, which was adopted by the County Board of Supervisors in June 1999.

All of the Measure A projects were included in the *Base Case Plan* along with a preliminary scope statement, initial schedule and estimated cost to develop and construct the project. Over the years, each of these elements (e.g., scope, schedule and cost) were refined in amendments to the *Master Agreement* and updated at semi-annual intervals through the *Revenue and Expenditure Plan* and *Semi-Annual Report* processes.

As stated previously, the Valley Transportation Authority (VTA) was selected as the implementing agency for the Rail and Highway Programs, and the terms and conditions of implementation were included in the *Master Agreement* between VTA and the County. This agreement has been amended 18 times over the past seven years to refine the baseline scope, schedule and cost of rail and highway projects, and to amend some of the requirements included in the original *Master Agreement*.

Rail Program

Measure B sales tax revenue helped to fund six rail projects. Additional funding was secured from local, State and federal sources in order to accomplish the project objectives. As previously discussed, when the economy was in a downturn, leveraging external funding and securing external contributions played an important role in moving projects forward. Each of the rail projects is described below.

Low Floor Light Rail Vehicles – Purchased 30 low floor light rail vehicles that allow level boarding from 14” high platforms at light rail stations were purchased to serve the Tasman West, Tasman East and Capitol lines. These vehicles provide enhanced accessibility and improved service by minimizing loading times for all riders and providing additional space for bicycles at a cost of \$93.9 million, including \$90.0 million from Measure B.

Tasman East Light Rail – Extended the Tasman East line 4.8 miles from North First Street along Tasman Drive, Great Mall Parkway and Capitol Avenue to Hostetter Road

in northeast San Jose. The project includes three park-and-ride facilities and an elevated segment near the Great Mall. The project cost a total of \$272.6 million, including \$72.1 million from Measure B, and opened for revenue service in June 2004.

Capitol Light Rail – Extended the Capitol line 3.3 miles along Capitol Avenue from Hostetter Station to the Capitol Avenue/Capitol Expressway intersection. The project includes four new stations and one future station. The project cost a total of \$157.0 million, including \$112.2 million from Measure B, and opened for revenue service in June 2004.

Vasona Light Rail – Extended the Vasona line 5.3 miles from Downtown San Jose to Winchester along the Union Pacific Vasona corridor. Connections in Downtown San Jose link the San Jose Diridon Caltrain Station and the Guadalupe Light Rail corridor service. The project cost a total of \$313.2 million, including \$163.2 million from Measure B, and opened for revenue service in October 2005.

Caltrain Service Improvements – Added trains and improved facilities between Gilroy and Palo Alto in order to increase the service level in the Caltrain system within Santa Clara County. The improvements cost a total of \$54.0 million, including \$26.9 million from Measure B, and are being completed between 2002 and 2006. At the time of the audit, two projects remained on the list of deferred projects.

Fremont/South Bay Commuter Rail – Initially, involved establishing an interim commuter rail service between Fremont and San Jose; however, the project scope was changed to purchase the right-of-way from the Union Pacific Railroad with 2000 Measure A funding. Measure B paid for professional services expended prior to the scope change at a cost of \$3.3 million. These services were required to complete the right-of-way purchase.

Highway Program

Eleven highway projects were also funded from a combination of Measure B sales tax revenue and funding from local, State and federal sources. These projects consisted of highway widenings, interchange improvements, high occupancy vehicle lanes and various other improvements, as discussed below.

Route 880 Widening – Widened Route 880 between Route 101/North First Street and Montague Expressway from a four to a six-lane freeway. Widening occurred within the existing 40-foot median and included a 12-foot lane in each direction with a center barrier. A new eight-lane Coyote Creek/Brokaw Road Interchange Bridge was also required, and a southbound auxiliary lane from Route 101 to North First Street and ramp improvements at the southbound Brokaw Road exit ramp were also included. The project cost a total of \$76.1 million, including \$61.2 million from Measure B, and construction was completed in April 2004.

Route 101 Widening – Widened Route 101 from four to six lanes plus two high occupancy vehicle lanes in the existing median between Cochrane Road and Metcalf Road, providing an additional two lanes in each direction and a 10-foot shoulder. The

project cost a total of \$54.4 million, including \$50.4 million from Measure B. Construction was completed in July 2004.

Route 85/101 Interchange (South) – Included high occupancy vehicle direct connectors from northbound Route 101 to northbound Route 85 and southbound Route 85 to southbound Route 101, as well as the southbound Route 101 to northbound Route 85 branch connector. The project also included the widening of Route 101 to eight lanes between Bernal Road and Metcalf Road. The project cost a total of \$68.4 million, including \$43.0 million from Measure B. Construction was completed in January 2005.

Route 85/87 Interchange – Completed the existing interchange by adding two connector ramps, including southbound Route 85 to northbound Route 87 and southbound Route 87 to northbound Route 85. The project also provides a high occupancy vehicle lane in each direction of Route 87 in the median between Route 85 and Branham Lane. The project cost a total of \$43.1 million, including \$39.6 million from Measure B, and construction was completed in October 2003.

Route 85/101 Interchange (North) – Improved mainline weaving operations and increased Route 85 and Route 101 interchange capacity while maintaining the existing local interchange access at Old Middlefield Way, North Shoreline Boulevard, and Moffett Boulevard. The project replaced the Route 85/Route 101 connector, modified interchange ramps at Moffett Boulevard, North Shoreline Boulevard and Old Middlefield Way; constructed additional lanes; and, constructed high occupancy vehicle direct-connector ramps between northbound Route 85 to northbound Route 101 and southbound Route 101 to southbound Route 85. The project cost a total of \$125.3 million, including \$122.6 million from Measure B, and construction was completed in May 2006.

Route 237/880 Interchange – Consisted of three phases, including: 1) constructing direct high occupancy vehicles connectors for southbound Route 880 to westbound Route 237 and eastbound Route 237 to northbound Route 880; 2) constructing a southbound braided exit ramp from Route 880 to Tasman Drive interchange; and, 3) constructing a direct connector ramp from northbound Route 880 to westbound Route 237 with a braided ramp for the northbound Tasman Drive entrance. The project cost a total of \$51.4 million, including \$27.3 million from Measure B. Construction was completed in April 2005. The third phase was never intended to be a Measure B project, and will be completed at a future date when other funding becomes available to VTA.

Route 17 Improvements – Accomplished the following improvements: 1) modified San Tomas Expressway between Winchester Boulevard and White Oaks Road; 2) constructed an auxiliary lane on northbound Route 17 between Route 85 and Camden Avenue; 3) constructed an auxiliary lane on northbound Route 17 between Camden Avenue and Hamilton Avenue; 4) improved the merge of I-280 with southbound Route 17; and, 5) improved the Hamilton Avenue off-ramp. The project cost a total of \$26.5 million, all of which was funded from Measure B, and construction is scheduled to be completed in September 2006.

Route 87 HOV Lanes (South) – Constructed a high occupancy vehicle (HOV) lane in each direction in the existing median between Branham Lane and Route 280. The project also included construction of HOV on-ramp bypasses and enhanced landscaping as well as repair pavement, median barrier, sound wall, and drainage systems. A collector-distribution system and an auxiliary lane will also be constructed in the southbound direction between Route 280 and Almaden Expressway. The project cost a total of \$15.5 million,⁹ including \$12.6 million from Measure B, for development costs. The cost of construction is being paid for with State and federal funding, and construction is scheduled to be completed in November 2006.

Route 87 HOV Lanes (North) – Widened Route 87 from four to six lanes, including a high occupancy vehicle lane in each direction. The project also consisted of installing ramp meters at the entrance ramps and widening the northbound Route 280 to northbound Route 97 connector ramp. The project cost a total of \$11.0 million for development costs, all of which was funded from Measure B.¹⁰ The cost of construction is being paid for with federal funding, and construction is scheduled to be completed in November 2006.¹¹

Route 152 Safety Improvements – Provided safety and operational improvements on Route 152 between Route 101 and Route 156. The project cost a total of \$26.2 million, including \$20.7 million from Measure B, and construction is scheduled to be completed in March 2007.

Route 85 Noise Mitigation – Reduced freeway noise along a segment of Route 85 between Route 87 and Route 280 by applying a micro-grinding technique. The project cost a total of \$8.0 million, all of which was funded from Measure B, and construction was completed in February 2006.

Ancillary Programs

In addition to rail and highway projects, Measure A specified several general transportation improvements. These consisted of maintaining streets and filling potholes, traffic signal synchronization, and bicycle facility improvements. Since programs already existed that could address these areas, Measure B sales tax revenue was used to augment work already underway. Santa Clara County also decided to use a portion of Measure B funds to improve the level of service at intersections on the County's expressways and to enter into agreements with VTA for swapping funds. The Measure B Program thus incorporated a total of five ancillary programs, which will be discussed in more detail below.

Pavement Management Program – Improved pavement conditions of local streets and filled potholes in all 15 cities and on County roads and expressways using \$90 million from Measure B. Early in the Program, the County adopted an agreement with VTA

⁹ Total project cost, including amounts funded by GARVEE Bonds, amounted to \$75.1 million.

¹⁰ Total project cost, including amounts funded by GARVEE Bonds, amounted to \$46.8 million.

¹¹ VTA now estimates that the project will be completed by April 2007.

that required the Authority to administer and disburse Measure B funds for a Pavement Management Program. Of the \$90 million in funding, \$27 million was allocated to the County Roads and Airports Department based on an approved allocation formula.

Signal Synchronization Program – Reduced traffic delays on the County’s expressway system due to inefficient signal timing using approximately \$25.4 million from Measure B. Similar to the Level of Service Program, the County Roads and Airports Department identified signal synchronization improvements that would be funded by Measure B.

Bicycle Program – Provided funding and oversight for a portion of improvements based on a 30-year Countywide Bicycle Plan, which includes a Bicycle Expenditure Program (BEP) that will receive funding from a variety of sources subject to local jurisdiction match requirements. The BEP includes \$169 million in the cost of improvements and identifies approximately \$99 million in sources of funds to be used for the projects. Measure B contributed \$12.0 million for improvements to bicycle lanes on roadways, bicycle and pedestrian bridges, and the construction of grade separated bike paths.

Level of Service Program – Identified and funded intersection improvements on the County’s expressway system to enhance traffic flows and reduce driving delays. The County Roads and Airports Department based the selection of intersections and specific improvements on cost/benefit analyses of traffic flow data. Measure B funding of approximately \$14.0 million has been used to finance \$29.0 million in improvements by providing a local match for federal funds, and leveraging contributions from local jurisdictions and developers, which together funded the remaining \$15.0 million in project cost.

Swap Agreements

After settlement of the legal challenges to Measure B, the County began to enter into agreements with the Valley Transportation Authority (VTA) to exchange Measure B sales tax revenue for other sources of federal and State categorical grant income and local restricted funds. Known as “swap” agreements, these exchanges provided VTA with the ability to maximize spending flexibility, expedite capital projects, and avoid more stringent federal and State design and construction review requirements on numerous smaller projects.

This strategy resulted in decisions by the County Board of Supervisors to enter into six swap agreements with the VTA Board of Directors between FY 2000-01 and FY 2005-06. These agreements are summarized in the table on the following page.

Table 2

**Summary Schedule of Measure B Swap Agreements Between the
County of Santa Clara and Valley Transportation Authority
(Dollars in Millions)**

Swap	Project Funded with Swap Sources	Year	Source Amount	Measure B Amount	Net M-B Gain (Loss)	Source Description	Qualified Measure B Expenditure
2000-02	Tasman East Light Rail	2000	\$ 72.8	\$ 67.9	\$ 4.9	State and Federal Funds	Local Projects
2001-02	Vasona Light Rail	2001	\$ 51.6	\$ 51.6	\$ -	State and Federal Funds	Local Projects
2001-03	Tasman East, Vasona, Capital Light Rail	2001	\$ 198.3	\$ 198.3	\$ -	Measure A Revenue Bonds	70 low floor light rail vehicles
2003-01	CalTrain Palo Alto Transit Project	2002	\$ 0.5	\$ 0.5	\$ -	Federal Funds	Guadalupe Corridor Ticket Machines
2003-02	Vasona Light Rail	2003	\$ 7.2	\$ 7.2	\$ -	Federal Funds	VTA Operations
2004-01	Route 237/880 Project	2004	\$ 22.5	\$ 22.5	\$ -	STIP	Reimbursement of STIP
2004-01	Measure B Project Landscaping	2006	\$ 7.2	\$ 7.2	\$ -	VTA Contributions	Reimbursement of VTA Contributions
	Total Swap		\$ 360.2	\$ 355.3	\$ 4.9		

The amount of funding exchanged as a result of these agreements was significant. As shown in the table, the County exchanged approximately \$355.3 million of sales tax revenue through these swap agreements, or 26.6 percent of the total Measure B projected collections of approximately \$1.336 billion over the life of the Program.

The data in Table 2 further illustrates the following:

- Although the County exchanged \$355.3 million in Measure B Sales Tax revenue with VTA, it received \$360.2 million in other sources of revenue that were applied toward Measure B projects. As a result, the swap agreements increased the amount of available Measure B resources by approximately \$4.9 million.
- The entire amount of this \$4.9 million surplus was realized in the first swap agreement, which was entered into in October 2000. At the time, the County Executive explained that, in part, the surplus was intended to offset interest losses that would be occurring because “grant fund reimbursements are expected to trail fund swap project expenditures.”
- Each swap agreement included requirements that VTA would spend Measure B funds on specific projects or categories of projects, termed “qualified projects.” Of these, the 2003 swap agreement for \$7.2 million allowed VTA to use the exchanged Measure B sales tax income for operations during FY 2003-04 and FY 2004-05, in exchange for funding Vasona Light Rail improvements from federal grant funds. The final swap agreement for an additional \$7.2 million, anticipates reimbursement of payments made by VTA to fund the cost of landscaping projects in FY 2005-06 and FY 2006-07, but could be modified if residual sales tax collections are less than that amount after the Measure B sales tax expires.

As part of this study, the reasonableness of each swap agreement was analyzed to determine the degree to which the exchange of funding benefited the overall transportation program in Santa Clara County. The following discussion summarizes findings related to the four largest swap agreements entered into between the two jurisdictions.

Swap 1: \$72,797,000 in State and federal funding for the Tasman East Light Rail Project, exchanged for \$67,890,000 in Measure B funding for Local Projects

The first swap occurred in late 2001, requiring VTA to secure \$72.8 million in federal and State grant funds, and contribute local match toward construction of the Tasman East Light Rail Project. The exchanged funds included approximately \$43.3 million in Congestion Mitigation and Air Quality Improvement Program (CMAQ) TEA-21 funding and approximately \$29.5 million in State Transportation Improvement Program (STIP) Reserve.¹²

In exchange, the Measure B Program provided approximately \$67.9 million in discretionary Measure B sales tax revenue to fund a number of local projects. Approximately \$37.5 million, or 55.2 percent of this amount, was used to supplement funding for the pavement management program and roadway repair activities of the County and cities. The balance was used to fund a variety of highway, expressway, and transit planning and design projects. According to representatives from the VTA, the swap was used to increase resources available for the pavement management program and to streamline federal regulatory requirements, and move design and planning activities forward, while simultaneously securing other funds for construction and right of way.

Swap 2: \$51,594,000 in State and federal funding for the Vasona Light Rail Project, exchanged for \$51,594,000 in Measure B funding for Local Projects

The second swap occurred in 2001, requiring VTA to secure \$51.6 million in federal and State funds toward construction of the Vasona Light Rail Project. The exchanged funds included approximately \$46.6 million in year 2000 STIP funds and approximately \$5.0 million in RABA federal Surface Transportation Program (STP) Fund Augmentation.

Similar to the first swap, the Measure B Program provided an equal amount of discretionary sales tax revenue to fund a number of local projects. Significant among these were 1) approximately \$25.0 million for the US Highway 101/ State Route (SR) 85 Northbound Interchange High Occupancy Vehicle (HOV) Direct Connection; 2) approximately \$3.7 million for the environmental impact and design phases of the SR 152/SR 156 Interchange; and, 3) approximately \$4.7 million for the County and city pavement management programs.

This final funding exchange for pavement management resulted in a total augmentation for County and city pavement management programs of approximately \$42.2 million (the \$37.5 million from Swap 1 and the \$4.7 million from Swap 2). With the \$90 million in direct Measure B funding for pavement management, total pavement management funds provided or leveraged by the Measure B Program therefore amounted to approximately \$132.2 million. As with the first swap, VTA representatives stated that other funding exchanged in the second swap was used primarily to streamline federal

¹² Approximately \$1.4 million of the STIP reserve was used to fund local CMAQ match.

regulatory requirements, and move design and planning activities forward, while simultaneously securing other funds for construction and right of way.

Swap 3: \$200,000,000 in Measure A Series A Bond Proceeds for the Vasona, Tasman East, and Capitol Light Rail Extensions, exchanged for \$200,000,000 in Measure B funding for the acquisition of 70 Low Floor Light Rail Vehicles

The third swap also occurred in 2001 to provide VTA with \$200 million in immediate discretionary funding to purchase 70 Low Floor Light Rail Vehicles (LRV) that were initially going to receive funding from future 2000 Measure A sales tax revenue.¹³ Through a series of transactions, the swap allowed VTA to *advance* purchase the vehicles with Measure B funds and concurrently proceed with financing the construction of the Vasona, Tasman East, and Capitol Light Rail Projects from sales tax revenue bonds secured by VTA's half-cent sales tax, approved by the voters for general VTA operations and its capital program in 1976.¹⁴ This had the effect of using currently available resources for the equipment purchases, while financing the major capital improvements with long term debt, improving VTA's current cash position.

At the time of the swap, VTA was already purchasing 30 Low Floor LRVs to provide additional vehicles to serve the new light rail extensions. These 30 LRVs were included in the *1999 Base Case Plan*, and were being funded directly by the Measure B sales tax. However, the purchase of these vehicles would have resulted in a mix of vehicle types within the VTA light rail system and created maintenance and operations difficulties. Therefore, VTA decided that it would be prudent to purchase an additional 70 Low Floor LRVs to replace existing rolling stock and provide for other system expansion.

Initially, VTA was planning on advance purchasing the vehicles with VTA Enterprise Fund resources, so that it did not have to await receipt of 2000 Measure A sales tax in mid-2006 before the purchase could be made. Instead, the Measure B swap transaction provided VTA with the ability to retain a greater amount of Enterprise Fund general revenue for operations during the short term, instead of using such funds as bridge financing for the 2000 Measure A Capital Program low floor vehicle purchase. The circumstances at the time allowed VTA to move toward accomplishing these objectives and provided the following advantages:

1. Because the contractor was in the process of manufacturing the original order of 30 Low Floor LRVs, VTA was offered the option to purchase additional vehicles at a reduced price. This occurred because the contractor, Kinkisharyo International LLC, was able to produce additional vehicles without interrupting its production run. While the original 30 vehicles were purchased for an average price of approximately \$3.1 million, the second 70 vehicles were purchased for an average price of approximately \$2.8 million. The difference equated to a discount of approximately \$301,000 per vehicle, or 11.0 percent.

¹³ Although approved in the year 2000, this sales tax increment did not go into effect until April 1, 2006, coinciding with the expiration date for the Measure B Sales Tax.

¹⁴ 2001 Series A Bond Proceeds

2. VTA had included the purchase of 70 Low Floor LRVs in the Valley Transportation Plan 2020, to be funded with 2000 Measure A resources for both an expansion of service and to replace vehicles that did not provide optimum senior and disabled rider access. However, because 2000 Measure A sales tax collections were not scheduled to begin until April 1, 2006 (five years from the date of the purchasing opportunity), Measure B sales tax provided an immediate source to finance the acquisition. Before the decision to use Measure B funds, VTA management was contemplating the use of Enterprise Fund revenues to fund the acquisition, which would have temporarily drawn funds away from operations.

So that the Measure B Program would not be harmed, VTA simultaneously committed to provide an equal amount of 2001 Series A Bond funds to finance the Tasman East, Vasona and Capitol Light Rail Projects. Because these three projects were included on the Measure B Base Case list of projects, the use of bond funds freed up the Measure B sales tax for the purchase of the Low Floor LRVs.

Swap 6: \$22,500,000 in STIP funding for the 237/880 Stage C project, exchanged for \$22,500,000 in Measure B funding for Local Projects. In addition, the Implementation Letter of Agreement provided an additional \$7,230,000 to reimburse VTA for the future costs of landscaping Measure B highway projects after the tax expires (subject to availability of residual sales tax receipts).

Swap 6, which represented the fourth largest of the swap transactions, occurred in 2004. The swap exchanged \$22,500,000 in STIP funding to be allocated for the construction of the 237/880 Stage C Project for the same amount of discretionary Measure B sales tax to be used for local projects.

At the time of this report, the exchanged Measure B funds had been committed to several highway landscaping projects (\$6.7 million), the State Route 152/156 Interchange Reconstruction (\$3.0 million) and various other projects. Significantly, the *Fiscal Year 2007 Revenue and Expenditure Report* recommended the allocation of \$3.2 million in unallocated Measure B funds for Montague Expressway project costs, leaving approximately \$7.0 million in additional unappropriated reserves in the VTA Local Program Reserve.

Lastly, VTA is to receive up to \$7.23 million in additional reimbursements for future landscaping costs incurred for Measure B projects. The source of these funds will be from “residual sales tax funds the County receives from the State Board of Equalization after the tax expires in March 2006.”¹⁵ According to the Letter of Agreement and discussions with Measure B and VTA staff, the amount of the reimbursement depends upon the amount of actual residual sales tax collections beginning in June 2006.

¹⁵ September 27, 2004 letter from Jeff Davis, Measure B Program Administrator to John Ristow, Manager Programming and Highway Administration, VTA

Assessment of the Measure B Swap Program

Based on this review, the various swaps entered into between the County of Santa Clara and VTA were instrumental in accomplishing the broader public transportation objectives of the County. VTA was able to redirect federal, State and local funding to Measure B projects in exchange for obtaining discretionary sales tax revenue that could be used for a variety of purposes. For example, the first two swaps allowed VTA to increase funding for the Pavement Management Program by approximately \$42.2 million with unrestricted Measure B sales tax revenue. In exchange, VTA applied grant funds that are restricted for transportation projects that improve air quality¹⁶ to the Tasman East and Vasona Light Rail Projects. If this exchange had not occurred, the funding augmentation for County and city pavement management programs would not have been available. The largest swap transaction for the low floor LRVs allowed VTA to use current resources for the equipment purchase, while funding the capital cost of the Vasona, Tasman East and Capital Light Rail Projects with long-term debt. This transaction improved VTA's operating position by increasing the current amount of resources available for operations. These kinds of creative solutions to the financing challenges facing the County and VTA for transportation improvement purposes should be commended.

Measure B Program Accomplishments

Management audits typically focus on opportunities for improvements within an organization. To provide a broader perspective on operations, this section summarizes some of the most important accomplishments of the Measure B Program:

- Although not required by either of the 1996 measures or law, the Board of Supervisors adopted policies and consistently made decisions to ensure that Measure B sales tax would be spent on the transportation improvement projects that had been identified in advisory Measure A.
- The Board of Supervisors and the County Executive enacted a management and administrative structure that resulted in conformity with Board adopted project priorities, ensured strong fiduciary accountability, and resulted in efficient and effective project implementation. The Citizens Watchdog Committee, with the assistance of outside auditors, further strengthened Measure B Program accountability and compliance with policies adopted by the Board.
- Despite the compressed timeframe established for program implementation, and funding uncertainty related to the economic downturn, the Measure B Program, VTA, the County Roads and Airports Department and participating municipalities were able to deliver all major projects on schedule and within budget.
- The selection of VTA as the primary implementing agency, in its dual role as the County Transportation Agency and Congestion Management Agency, invested the

¹⁶ CMAQ TEA-21 Cycle 1 and Cycle 2 discretionary funding for Air Quality Enhancement.

major stakeholder in the program and focused accountability for project implementation. This decision by the Board of Supervisors was perhaps one of the most significant reasons for Measure B Program success.

- The Measure B Program was able to effectively utilize the services of engineering consultants to monitor project implementation, comply with the aggressive program timetable and control costs. In addition, the decision to establish a strong fiscal oversight function in the Measure B Program office considerably strengthened the County's ability to meet its fiduciary responsibilities.
- The County and VTA were able to successfully balance implementation strategies that minimized project delays with its responsibilities to ensure fiscal accountability. The level of contingencies coupled with management controls over the use of such funds is a prime example, as well as the Authority's use of project implementation strategies, such as design-at-risk.
- Through swap agreements, the County and VTA successfully leveraged Measure B funds to maximize the use of restricted federal, State and local funds for purposes of accomplishing the broader transportation improvement objectives in the County. For example, the first two swap agreements provided \$42.2 million for the County and city pavement management programs, which otherwise would not have been available. Similarly, the exchange of Measure B funds to purchase low floor light rail vehicles, while simultaneously constructing the Vasona, Tasman East and Capitol Light Rail Projects with long term debt, allowed VTA to standardize its light rail vehicle fleet years before it might otherwise been able to do so, improved the VTA Enterprise Fund cash position, and provided the Authority with the means to direct a greater portion of its current resources toward operations.

Topics Requiring Additional Review

During the course of a management audit, certain issues may be identified and brought to the attention of the department or agency being audited and the Board of Supervisors, even though a specific finding is not included in the report. Discussed below are topics for which we did not develop specific findings, but are important issues of which the Board of Supervisors should be aware.

General Sales Tax Management

The characteristics of the Measure B Program and the ability to name a primary implementing agency (VTA) were major reasons for the Program's success. Because the sales tax was dedicated for transportation purposes, per Board policy, VTA was able to incorporate project implementation activities into a well established and successful transportation capital projects management structure. These circumstances may not exist if voters approve other general sales tax measures in the future.

For example, the recently defeated 2006 Measure A would have provided general tax dollars to the County that could have been used for a variety of services that, potentially, would have been managed by multiple County departments and other non-

County agencies. In addition, the funds could have been used for operations as well as capital projects. In this example, the Measure B Program structure would not have been appropriate and the County would have needed to augment staffing in the County Executive's Office, the Finance Agency and at the individual internal service and operating department levels to provide appropriate project and fiduciary oversight. Should a general sales tax be adopted in the future, the County should closely examine the characteristics of the particular measure and establish a management structure that ensures sound project and fiduciary accountability to the public, and not assume that the Measure B Program model will appropriately provide such assurances.

Asset Amortization and Allocation

When reviewing overhead charges to the Measure B Program, it was brought to our attention that the costs for the County's new financial accounting and reporting system, SAP, had been amortized over five years and allocated to departments based on annual expenditure levels only rather than some other basis, such as number of annual transactions, number of full time equivalent positions, number of SAP users, or an equitable combination thereof. Although sanctioned by the State Controller, these amortization and allocation methods may have disproportionately attributed costs to programs like Measure B, which are of a short duration and process relatively few transactions for large dollar amounts.

Alternatively, SAP could have been amortized over a longer period of time and allocated according to number of annual transactions or some other basis that better defines its benefit to user departments and programs. While outside of the scope of this audit, the Finance Director should fully explore the amortization and allocation methods used for SAP, and assess the broader impacts of extending the amortization period and changing the allocation basis for future costly asset acquisitions made by the County.

Acknowledgements

We would like to thank the Measure B Program Administrator and his staff for their cooperation and assistance throughout this audit. Staff were cooperative, courteous, and generous with their time. The Measure B Program, Valley Transportation Authority and County Roads and Airports Department personnel provided the majority of data contained in the report, and we appreciate their willingness to respond to our requests.

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Section 1. Ending Balance

- The Measure B Program has projected an ending balance of approximately \$16.0 million as a result of conservative revenue projections and slightly favorable variances in rail and highway project costs. This projection is based on a zero growth estimate of sales tax collections through March 30, 2006, when the sales tax expired, and a projection of expenditures through the end of the Program. The projection does not include residual sales tax receipts, which are received after the sales tax expiration date and are a result of delinquent or late sales tax returns, audit determinations and merchant investigations by the State Board of Equalization, since these amounts are difficult to estimate.
- The current inventory of deferred projects could cost as much as \$17.3 million, or \$1.3 million greater than the ending balance projected by the Measure B Program. As a result, Program staff are working on a plan to fund these projects from the ending balance as well as from local, State or federal sources. However, based on Board actions and other information as of June 20, 2006, the ending balance could reach approximately \$17.3 million, which is equal to the estimated cost of the deferred projects. The adjusted projection is based on recent receipts of sales tax revenue, the availability of funds set-aside in contingency, advancement of a deferred project, and revised projections of administrative and oversight costs.
- While the adjusted ending balance may be sufficient to fund the deferred projects, strategies should be implemented that leverage additional funding when possible and cap Measure B obligations going forward. For example, the Valley Transportation Authority should be requested to examine the remaining funding requirements for projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that may be available to support the deferred projects. Furthermore, in order to preserve some surplus funds for other uses and close out the Measure B Program without concern for cost overruns, final payment agreements should be negotiated with implementing agencies that would cap the County's financial obligation for projects that remain open after June 30, 2007.

As a result of conservative revenue projections and slightly favorable variances in the rail and highway project costs, the Measure B Program has projected an ending balance of approximately \$16.0 million in the *Fiscal Year 2007 Revenue and Expenditure Plan*. On June 2, 2006, staff from the Measure B Program, Valley Transportation Authority (VTA) and County Roads and Airports Department presented this plan at a joint meeting of the County Board of Supervisors and VTA Board of Directors. In accordance with the terms of the *Master Agreement* between the County and VTA, both boards approved the plan, including the projection of the ending balance.

As discussed in the *Fiscal Year 2007 Revenue and Expenditure Plan*, the \$16.0 million projected ending balance is based on a zero growth estimate of sales tax collections through March 30, 2006, when the sales tax expired, and an estimate of expenditures

through the end of the Program. The Measure B Program received the last payment of sales tax receipts from regular collections in late June 2006, since there is a two-month delay between when sales tax receipts are collected from taxpayers and paid to jurisdictions, so this payment was not included in the \$16.0 million projection. The table below shows the Board approved projection of revenues, expenditures and ending balance for the life of the Program.

Table 1.1
Measure B Program Estimate of the Ending Balance
Included in the FY 2007 Revenue and Expenditure Plan¹
(Dollars in Thousands)

Source / Use Category	Amount
Sales Tax	1,333,463
Interest Income	73,342
Other Revenue	188,363
<hr/>	
<i>Total Revenues</i>	<i>1,595,168</i>
Rail Program	893,861
Highway Program	505,969
Ancillary and Program-wide	179,289
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<i>Total Expenditures</i>	<i>1,579,119</i>
<hr/>	
Projected Ending Balance	16,049

The projected ending balance also does not include residual sales tax receipts, which are received after the sales tax expiration date and are a result of delinquent or late sales tax returns, audit determinations and merchant investigations by the State Board of Equalization, since these amounts are difficult to estimate.

Commitments and Obligations

The County Board of Supervisors stated its intention to use “the actual amount of cumulative receipts from the 1996 Measure B sales tax to complete the projects” in Article III, Section 1 (a) of the *Master Agreement* with VTA. This intention has also been reflected in the Board’s policy and budget directives, as included in revenue and expenditure plans and other documents. Although the Board temporarily deferred construction on 14 Measure B projects in September 2002 as a result of the economic

¹ Includes all sources and uses of funds except for revenues and expenditures from fund swaps that did not support Measure B projects, and proceeds from and payments for the issuance of special obligation bonds, excluding the net expense.

downturn, the Board later advanced 11 of these projects as external funding was secured or the economy improved.²

Recently, the Measure B Program has worked with VTA and the County Roads and Airports Department to develop a plan to fund the San Martin-Caltrain Project, one of three projects that remain on the deferred projects list. When developing this plan, the three agencies recognized that an opportunity existed to combine an intersection level of service (LOS) project with the San Martin-Caltrain Project in order to accomplish the following objectives: (1) provide 161 new parking spaces in VTA owned property east of the Union Pacific Railroad (UPRR) tracks to ease future parking constraints; (2) widen San Martin Avenue between Monterey Road and Depot Road, and construct dedicated turn lanes, acceleration lanes and deceleration lanes to ease congestion at the intersection with Monterey Road; (3) improve the grade differential between Monterey Road and the UPRR tracks to improve bicycle and pedestrian mobility; and, (4) improve drainage between Monterey Road and Depot Road to reduce driving hazards. Based on preliminary engineering, the Caltrain project is estimated to cost \$3.35 million, of which only \$1.827 million would be funded from Measure B. Through discussions with the Measure B Program, the County Roads and Airports Department agreed to contribute \$0.4 million to fund this project, and VTA agreed to contribute \$0.133 million from 2000 Measure A sales tax revenue to fund the installation of a second track at the crossing. In addition, the LOS project is expected to cost \$0.672 million and would be funded entirely from the LOS contingency.

The Measure B Program forwarded its recommendation to fund both the San Martin-Caltrain Project and the San Martin-LOS Project based on the cost estimates provided above, and the Board of Supervisors approved the recommendation on June 20, 2006. Therefore, the inventory of deferred projects currently includes only two Caltrain projects, as follows:

California Avenue Underpass-Caltrain Project – In June 2003, the Caltrain Joint Powers Board (JPB) approved \$1.8 million in funding for the reconstruction of the outboard platforms at the California Avenue Station as part of its FY 2004 Capital Program, which allowed the Measure B Program to advance the project. Then, as part of the FY 2005 Capital Program, the JPB increased the funding for the project by \$0.9 million, from \$1.8 million to \$2.7 million. In addition, the construction contract has not been put out to bid because the JPB would like to develop a single contract package that would also include a pedestrian underpass, which is urgently needed at the station. (Because a center platform is presently located between the northbound and southbound tracks, trains approaching the station must stop until the train going in the opposite direction departs the station, which is a problem for the new Caltrain Express service.) Project engineers believe that combining the pedestrian underpass and the outboard platforms into a single construction contract would likely generate cost

² Deferred projects that have already been advanced consist of the following: Route 152 Safety Improvements, Project A, Phase II; Route 87 HOV Lanes (South); Route 87 HOV Lanes (North); Route 152 Safety Improvements, Project B, Phase I; Route 85 Noise Mitigation; Route 17 Improvements, Project E; Route 152 Safety Improvements, Project B, Phase II; Almaden Expressway-LOS Project; San Tomas Expressway at Hamilton-LOS Project; and, the San Tomas and Montague-Signal Synchronization Project.

savings. When the *Fiscal Year 2007 Revenue and Expenditure Plan* was drafted beginning in February 2006, the underpass was estimated to cost \$8.4 million based on 35 percent design plans. However, at the joint meeting with the County Board of Supervisors and VTA Board of Directors that was held on June 2, 2006, staff stated that the cost of the underpass has risen to approximately \$11.7 million. Combined with the outbound platform improvements, the total project cost has risen to \$14.4 million, but only \$11.7 million is needed from Measure B sales tax revenue or other sources.

Palo Alto Underpass-Caltrain Project – The pedestrian underpass at the Palo Alto Station is a priority for the JPB due to time limits imposed by the California Public Utilities Commission on the existing temporary at-grade crossing. The JPB has identified an opportunity to replace the existing outboard platforms in conjunction with the proposed pedestrian underpass. However, the designs for and funding of a combined project are less advanced than those at the California Avenue Station. While the Measure B Program estimated that the underpass would cost \$6.3 million in the *Fiscal Year 2007 Revenue and Expenditure Plan*, staff stated that the cost of the underpass has dropped to \$5.6 million at the joint meeting with the County Board of Supervisors and VTA Board of Directors that was held on June 2, 2006.

Since advancing the two underpass projects could cost as much as \$17.3 million, including \$11.7 million at the California Avenue Station and \$5.6 million at the Palo Alto Station, the Measure B Program has been working on a plan to fund one or both projects from the ending balance as well as from local, State and federal sources. Previously, on December 6, 2006, the Program submitted a draft completion plan to the County Board of Supervisors that provided potential funding scenarios for projects that remain deferred. This plan indicated that as much as \$4.688 million in federal funding and \$1.172 million in State funding (for a total of \$5.86 million) could be available as a source of funds for the Palo Alto Underpass-Caltrain Project. The plan also indicated that the California Avenue Underpass-Caltrain Project could be funded with as much as \$2.5 million from a federal funding source. If all of these funds are available, the Measure B Program's share of the cost to construct both underpasses would amount to only \$8.94 million.

The Measure B Program also has an obligation to reimburse VTA for \$7.23 million in landscaping costs incurred for Measure B highway projects, with residual sales tax revenue, to the extent funds are available. According to the *Implementation Letter of Agreement 2004-01*, the County agreed to make this reimbursement with two transfers from the Measure B Trust Fund to VTA in the following amounts: \$5.0 million will be disbursed in January 2007, and the remaining \$2.23 million will be disbursed in July 2007. The actual amount to be transferred depends upon the amount of residual sales tax that will be collected, up to the stated total of \$7.23 million.

Adjusted Ending Balance

Based on actions taken by the Board and information received through June 20, 2006, we believe that the Measure B ending balance could be as high as approximately \$17.3 million, or \$1.3 million greater than the projection developed by the Program, due to recent receipts of sales tax revenue, the availability of funds set-aside in contingency,

advancement of a deferred project, and revised projections of administrative and oversight costs. The adjustments that we have made to the ending balance are identified in Table 1.2 below.

Table 1.2

**Adjustments to the Measure B Program Estimate of the Ending Balance
Included in the FY 2007 Revenue and Expenditure Plan
(Dollars in Thousands)**

Description	Amount
<i>Projected Ending Balance</i>	16,049
Growth in Sales Tax Revenue	2,257
Release of Contingency Funds	228
Funding of San Martin-Caltrain Project	(1,827)
Decrease in Administrative Costs	649
Increase in Oversight Costs	(39)
<i>Adjusted Ending Balance</i>	17,317
Change in Ending Balance	1,268

A more detailed discussion of each of these adjustments is provided below:

Sales Tax Revenue – The Measure B Program has projected that sales tax revenue collected through March 30, 2006, when the tax expired, would amount to approximately \$1.333 billion. This figure includes a zero growth estimate of one quarter of sales tax receipts that had not been received at the time the projection was developed, and excludes the collection of residual sales tax revenue that the Program will begin to receive during the first quarter of FY 2006-07. However, based on the final payment of regular sales tax revenue that was received in late June 2006, the actual Measure B sales tax revenue has turned out to be approximately \$1.336 billion, or \$2.257 million more than the projection included in the *Fiscal Year 2007 Revenue and Expenditure Plan*. Program staff are aware of the increase in sales tax revenue and will likely report on the adjustment in December 2006, when the Semi-Annual Report is submitted to the County Board of Supervisors.

Contingency Funds – The County Roads and Airports Department has identified a total of \$0.9 million in LOS contingency that is available to fund projects. Based on the recommendation of the Measure B Program, the County Board of Supervisors recently approved the use of \$0.672 million from the LOS contingency to fund the San Martin-LOS Project, leaving a total of \$0.228 million to add to the ending balance. There are additional funds being held in contingency reserves that could become available and added to the ending balance as claims are received, litigation is resolved, and projects are closed out.

San Martin-Caltrain Project – The Board of Supervisors also recently approved \$1.827 million in funding from Measure B sales tax revenue for the San Martin-Caltrain Project, removing it from the deferred projects list. Therefore, the ending balance should be reduced by \$1.827 million.

Administrative Costs – Since the Measure B Program should be shutting down over the next two years and transferring necessary functions to other County departments, the Program’s estimate of total administrative costs has been reduced by a total of \$648,951. This reduction is comprised of the elimination of \$96,800 for 1.0 Accountant II/III in FY 2008-09; \$340,580 in administrative consultant costs over the next three fiscal years; \$169,751 in financial consultant costs over the next two fiscal years; and, \$50,820 for services and supplies in FY 2008-09. In addition, because a small number of staff could remain with the Program in FY 2006-07 and FY 2007-08, the County will continue to incur overhead expenses on behalf of the Program for these years. However, these costs will not be allocated to the Program until FY 2008-09 and FY 2009-10 through the County’s Cost Allocation Plan, as discussed in Section 2. Since neither the Measure B Program nor the Controller-Treasurer’s Office has estimated the amount that will be charged in these years, we have decided to budget \$200,000 in FY 2008-09 and \$100,000 in FY 2009-10, for a total increase of \$300,000. The Measure B Program allocates the overwhelming majority of overhead costs (97 percent) to the budget for Program Management Oversight, so we have added a total of only \$9,000 to administrative costs, and the remaining \$291,000 to oversight costs, as discussed below.

Oversight Costs – Similar to administrative costs, we have adjusted oversight costs to reflect the closure of the Measure B Program. However, because we have added an estimate of overhead costs to be charged in FY 2008-09 and FY 2009-10, we have increased the Program’s estimate of oversight costs by \$39,000. For consultants, we adjusted their costs to reflect a 3 percent, rather than a 5 percent, rate increase in each of the next two fiscal years and a reduction in their services over the next two fiscal years. As a result, the cost of consultants decreased by a total of \$252,000, but this reduction was offset by the \$291,000 increase in overhead costs, for a net increase of \$39,000.

In addition, in June 2006, the Measure B Program received approximately \$1.05 million from the first advance payment of residual sales tax revenue. The State Board of Equalization estimates that the Program will receive approximately \$1.05 million from the advance payment of residual sales tax revenue in July, approximately \$1.40 million from the advance payment of residual sales tax revenue in August, and an additional allocation from the adjustment in September. As a result, the Program can expect to receive at least \$3.5 million from residual sales tax revenue during the first quarter of FY 2006-07. There could be further adjustments in the second quarter, but they will only occur if there are audit adjustments, reclassifications or escapes, so any payments received after September would likely be small.

Actual and estimated residual sales tax revenue has not been added to the adjusted ending balance. However, by the time the first payment is due to VTA for the reimbursement of landscaping costs, the County will have received the majority of collections from residual sales tax revenue. At that time, the Measure B Program should estimate whether enough residual sales tax revenue will be collected to fully reimburse

VTA and whether any surplus revenue will remain following the reimbursement. If the Measure B Program expects to have excess residual sales tax revenue, these funds should be included in the Measure B ending balance.

Local Program Reserve

During the period of the Measure B Program, the County and VTA entered into a number of revenue swap agreements, which exchanged Measure B sales tax revenue for other funds available to VTA. These swaps generally benefited VTA and other local transportation agencies by providing a large pool of discretionary funding that could be used by VTA to fund multiple local projects, thus streamlining the federal regulatory process, moving design and planning activities forward, while simultaneously securing other funds for construction and right of way, and supplying VTA with immediate infusions of capital to expedite certain non-Measure B project priorities and assist with the Authority's cash flow needs, as well as to support VTA operations during the period of the recent economic downturn.

According to multiple Measure B documents, three of the swap agreements established an expectation that VTA would use the exchanged Measure B funds for local transportation projects, which included many smaller highway, expressway and transit improvement projects that had been identified as priorities by VTA through its transportation planning efforts.³ In addition, these local projects included allocations to support limited administrative, planning and support activities within VTA, and to provide cash reserves for transportation project cash flow purposes.

Under the terms of the last swap agreement, entered into in September 2004, VTA will receive a final transfer of \$12.5 million in Measure B funds during the first quarter of FY 2006-07, after the County is apportioned its last regular payment of Measure B sales tax revenue from the State.⁴ Documentation provided by VTA during the period of the study indicated that, until recently, \$10.243 million of this amount had been allocated to VTA's Local Program Reserve for unspecified purposes. In the *Fiscal Year 2007 Revenue and Expenditure Plan* recently considered by the Board, the Measure B Program reported that "VTA reprogrammed \$3.2 million of Local Program Reserve funding to the Montague Expressway project, since Measure B swapped funds for landscaping of the 87(S) project can now apply toward the local match of this federally funded (GARVEE) project." Accordingly, the \$10.2 million Local Program Reserve reported by VTA during the period of this study has been reduced to approximately \$7.0 million.

While VTA may be considering other uses for these funds, one alternative would be to contribute a portion toward the completion of the two remaining deferred Measure B

³ The annual *Revenue and Expenditure* plans clearly establish this expectation. In addition, the *Semi-Annual Reports* include detailed lists of local projects funded with exchanged Measure B funds. Also, two of the Implementation Letters of Agreement state that the swaps will "permit several non-Measure B projects to be funded with Measure B funds." A third swap states that Measure B funds would be exchanged with VTA to "provide a local source of flexible funding to VTA for future projects." As stated repeatedly in the body of this report, VTA has complete discretion regarding the use of this money and could use such funding to support Measure B Program objectives.

⁴ Excludes additional Measure B funds up to \$7,230,000, which could be paid in Fiscal Years 2006-07 and 2007-08 from residual sales tax collections that could become available after receipt of the last regular payment in June 2006.

projects that have not yet received funding due to uncertainties regarding the level of sales tax collections that will be received in the final quarter of FY 2005-06. If VTA were to make this commitment, approximately \$7.0 million could become immediately available to support Measure B Program costs.

It should be noted that as of June 30, 2006, VTA reported that an additional \$12.6 million in swapped Measure B funds had been designated for local projects but had not yet been disbursed for expenditure. The table below shows the balances by project, as of that date.

Table 1.3
Measure B Swap Funds Budgeted But Not Disbursed
 (As of June 30, 2006)

Project	Appropriation Date	Modified Budget	Amount Disbursed	Balance
San Antonio Access Study	3/2/00	25,000	24,927	73
VTA CM&HP Planning, Programming and Monitoring	10/5/00	1,849,088	1,849,000	88
Dumbarton Rail Corridor Study	6/7/01	235,000	225,877	9,123
Butterfly Habitat Property Acquisition	3/6/03	4,400,000	4,005,258	394,742
I-880 Widening - Landscaping	12/2/04	1,178,000	739,477	438,523
SR-85/US 101 North IC Landscaping	12/2/04	2,654,000	-	2,654,000
SR 87 South Landscaping	12/2/04	2,840,000	-	2,840,000
Monte Sereno 2005/06 - 2006/07 Road Rehabilitation	3/3/05	35,400	-	35,400
I-880 Corridor Study	3/30/05	500,000	248,460	251,540
South County Circulation Study	3/30/05	500,000	-	500,000
SR 25 Safety Project	6/2/05	400,000	3,227	396,773
Downtown LRT Platform Retrofit	8/4/05	2,500,000	220,349	2,279,651
SR 152/SR 156 Interchange Reconstruction - Augmentation	8/4/05	3,000,000	853,680	2,146,320
US 101/Mathilda Ave/SR 237 Interchange PSR	8/4/05	250,000	7,006	242,994
Calaveras Widening PSR	12/1/05	150,000	-	150,000
SR 237 Interchanges w/SR 85 and Middlefield Road	1/6/06	250,000	-	250,000
Monte Sereno 2007/08 - 2008/09 Road Rehabilitation	4/6/06	41,000	-	41,000
Total		20,807,488	8,177,261	12,630,227

Of \$20.8 million in project appropriations, approximately \$6.5 million had been appropriated in FY 2003-04 and previously. Of this \$6.5 million, \$6,105,062 had been disbursed, leaving an un-disbursed balance of approximately \$404,026. For all projects included in this list, VTA has un-disbursed balances of over \$12.6 million remaining.

As part of this study, we did not evaluate the residual need for these funds or VTA's planned use of balances that might exist after the designated projects are completed. However, we believe it would be worthwhile for VTA to closely examine the remaining requirements for this subset of projects and report on available funding to support Measure B project costs. To the extent surplus funds are made available by VTA, they would supplement the approximately \$7.0 million in Local Program Reserve funding previously noted in this report.

Final Payments

Between the adjusted ending balance and potential funding from other internal and external sources, including residual sales tax revenue and the Local Program Reserve, we believe there will be adequate funds to advance the remaining two deferred projects. However, as discussed in Section 2, if excess regular or residual sales tax revenue remains after the Measure B Program has fulfilled policy directives and financial obligations, we are recommending that the Board of Supervisors consider using surplus funds to: (a) reimburse the General Fund up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B Program; and/or, (b) support County programs and activities related to transportation improvements, in accordance with the will of voters and intention of the Board. In order to preserve surplus funds for one or both of these uses and close out the Measure B Program without concern for cost overruns, the County's financial obligation for projects that remain open in FY 2007-08 and beyond should be explicitly capped.

The Measure B Program has already initiated discussions with VTA and the County Roads and Airports Department to negotiate a one-time final payment for each project that has not been fully closed out by June 30, 2007. Capital projects, such as those being funded by Measure B, can take several years to close out once construction has been completed and the project has been opened to the public due to factors such as change orders, late claims, utility relocations, real estate transactions, landscaping or plant establishment periods, acceptance by third parties, and right of way transfers. The *Fiscal Year 2007 Revenue and Expenditure Plan* included the projected dates that construction closeout, landscaping closeout and final closeout will be complete for each of the Measure B highway and rail projects. Of the 17 projects, final closeout on six projects is projected to be completed after June 30, 2007, and final closeout on two projects has yet to be determined, as shown in the table on the next page. This is due primarily to the deferral and subsequent advance of projects, and the completion of landscaping contracts and required plant establishment periods, which range from one to three years. Measure B Program staff indicate that they are working with the implementing agencies to assign final payment amounts on each project in order to end the County's financial obligation by the end of FY 2006-07.

Consequently, we agree that final payments should be negotiated with implementing agencies for each project that will remain open after June 30, 2007. We recommend that these payments be based on an estimate of expenditures that remain to be incurred and include an amount for known and unknown risks that could impact costs. Because of the advanced stage of almost all of the projects, the implementing agencies should be able to develop a solid forecast of the costs to complete each project and reach an agreement with the Measure B Program by the middle of FY 2006-07. Projects that could require more time on which to reach an agreement are those that were recently removed or will be removed from the deferred projects list. Finally, the payment agreements entered into between the County and implementing agencies should specify that any surplus funds that exist, once the projects have been fully closed out, should be re-appropriated by the Board of Supervisors.

Table 1.4

**Projected Closeout Dates for Measure B Highway and Rail Projects
(As of June 2, 2006)**

Project	Construction Closeout	Landscaping Closeout	Final Closeout
Route 87 HOV Lanes (South)	None	None	None
Route 87 HOV Lanes (North)	None	None	None
Caltrain Service Improvements	Jun-06	None	TBD
Route 237/880 Interchange	TBD	TBD	TBD
Route 101 Widening	May-03	None	Jan-06
Fremont/South Bay Connection	N/A	N/A	Jul-06
Low Floor Light Rail Vehicles	Dec-05	None	Aug-06
Tasman East Light Rail	Jun-04	None	Sep-06
Capitol Light Rail	Jun-04	None	Sep-06
Route 85 Noise Mitgation	Jun-06	None	Sep-06
Vasona Light Rail	Dec-06	None	Dec-06
Route 152 Safety Improvements	Oct-07	Jun-06	Jan-08
Route 85/87 Interchange	Oct-03	Dec-07	Mar-08
Route 880 Widening	Oct-04	May-09	Aug-09
Route 85/101 Interchange (South)	May-06	Jun-09	Aug-09
Route 17 Improvements	Jan-07	Jun-10	Sep-10
Route 85/101 Interchange (North)	Dec-06	Sep-06	Dec-10

CONCLUSION

The Measure B Program has projected an ending balance of approximately \$16.0 million as a result of conservative revenue projections and slightly favorable variances in rail and highway project costs. This projection is based on a zero growth estimate of sales tax collections through March 30, 2006, when the sales tax expired, and a projection of expenditures through the end of the Program. The projection does not include residual sales tax receipts, which are received after the sales tax expiration date and are a result of delinquent or late sales tax returns, audit determinations and merchant investigations by the State Board of Equalization, since these amounts are difficult to estimate.

The current inventory of deferred projects could cost as much as \$17.3 million, or \$1.3 million greater than the ending balance projected by the Measure B Program. As a result, Program staff are working on a plan to fund these projects from the ending balance as well as from local, State or federal sources. However, based on Board actions and other information as of June 20, 2006, the ending balance could reach approximately \$17.3 million, which is equal to the estimated cost of the deferred projects. The adjusted projection is based on recent receipts of sales tax revenue, the availability of funds set-aside in contingency, advancement of a deferred project, and revised projections of administrative and oversight costs.

While the adjusted ending balance may be sufficient to fund the deferred projects, strategies should be implemented that leverage additional funding when possible and cap Measure B obligations going forward. For example, the Valley Transportation Authority should be requested to examine the remaining funding requirements for projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that may be available to support the deferred projects. Furthermore, in order to preserve some surplus funds for other uses and close out the Measure B Program without concern for cost overruns, final payment agreements should be negotiated with implementing agencies that would cap the County's financial obligation for projects that remain open after June 30, 2007.

RECOMMENDATIONS

The Santa Clara County Board of Supervisors should direct the Measure B Program to:

- 1.1 Increase the Measure B ending balance by as much as approximately \$1.3 million to reflect new information, including recent receipts of sales tax revenue, the availability of funds set-aside in contingency, advancement of a deferred project, and revised projections of administrative and oversight costs. (Priority 1)
- 1.2 At the time that the first payment is due to the Valley Transportation Authority (VTA) for the reimbursement of landscaping costs, estimate whether enough residual sales tax revenue will be collected to reimburse VTA for negotiated commitments and whether any surplus revenue will remain following the reimbursement. If the Measure B Program expects to have excess residual sales tax revenue, these funds should be included in the Measure B ending balance. (Priority 1)
- 1.3 Request that the Valley Transportation Authority examine the remaining funding requirements of projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that could be available to support the deferred projects. (Priority 1)
- 1.4 Negotiate final payments with implementing agencies for each project that will remain open after June 30, 2007. The payment agreements should specify that any surplus funds that exist, once the projects have been fully closed out, should be re-appropriated by the Board of Supervisors. (Priority 1)

COSTS AND BENEFITS

There would be no additional costs to implement these recommendations.

By increasing the ending balance to reflect new information, maximizing the amount of external funding that is contributed, and negotiating final payments with the implementing agencies, the County could fully fund the remaining two deferred projects. Since the adjusted ending balance totals approximately \$17.3 million, or \$1.3

million more than the projection developed by the Measure B Program for the *Fiscal Year 2007 Revenue and Expenditure Plan*, the County might also be able to re-appropriate surplus funds towards other uses, such as un-reimbursed overhead costs and additional transportation improvements, as discussed in Section 2.

Section 2. County Overhead Costs

- **The Measure B Program was established in FY 1998-99, after the California Supreme Court upheld the legality of Measures A and B, and began incurring expenses that same year. However, the Measure B Program was not allocated overhead costs through the County's Cost Allocation Plan until FY 2003-04 and was not charged overhead costs until FY 2004-05. These charges included FY 2002-03 costs, since the Cost Allocation Plan reconciles actual and proposed costs from two years prior and makes an adjustment for costs in the current year.**
- **As a result, the County has not been reimbursed for overhead costs incurred from the start of FY 1998-99 through the end of FY 2001-02, and costs charged in subsequent years have not consistently matched amounts detailed in the Cost Allocation Plans approved by the State. Based on a review of the County's Cost Allocation Plans, the County has not been reimbursed for \$645,642 in overhead costs incurred on behalf of the Measure B Program.**
- **Consequently, if excess regular or residual sales tax revenue remains after the Measure B Program has fulfilled policy directives and financial obligations, the Board of Supervisors should consider using these funds to (a) reimburse the General Fund up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B Program; and/or, (b) support County programs and activities related to transportation improvements, in accordance with the will of voters and intention of the Board.**

In 1996, Santa Clara County voters approved the passage of Measures A and B. As discussed in the Introduction of this report, Measure A was an advisory measure that specified a "package" of transportation improvements that voters intended would be financed with new sales tax revenue, while Measure B authorized the levy of a half-cent sales tax for a period of nine years. A group of taxpayers challenged these measures soon after approval by the voters. However, the California Supreme Court upheld the legality of the measures in 1998. The County then established the Measure B Transportation Improvement Program to administer and oversee the implementation of the project package that had been specified in Measure A, using Measure B funds.

The Management Audit Division conducted an evaluation of the County's Cost Allocation Plan in 2004 and noted that several departments that received funding from sources other than general revenue (i.e., discretionary revenue), including the Measure B Program, had not been charged overhead costs. In accordance with recommendations contained in that report, the Board of Supervisors subsequently directed the County Executive to begin charging these programs in FY 2004-05. The Board directive did not require that Measure B, or any other program, be charged retroactively for costs incurred in previous fiscal years.

Therefore, although the Program was established in FY 1998-99 and began incurring expenses that same year, the Program was not charged for County overhead costs until FY 2004-05. However, in the previous fiscal year, FY 2003-04, overhead costs had been

allocated to the Program through the County's Cost Allocation Plan but not charged. Because this plan reconciles actual and estimated costs from two years prior and makes required adjustments when allocating costs in the current year, the County has not been reimbursed for overhead costs incurred on behalf of the Program from the beginning of FY 1998-99 through the end of FY 2001-02. The discussion that follows explains the reasons why these costs were not charged in past years, as well as differences between cost allocations and charges in recent years.

County Cost Allocation Plan

The County's Cost Allocation Plan is based on the County's final actual costs, so the plan cannot be developed until the independent financial auditor has issued an opinion stating that the County's financial statements fairly represent the financial position of the County. This opinion is typically issued with the Comprehensive Annual Financial Report (CAFR), which is produced in the Fall after the end of each fiscal year. Subsequent to the opinion being issued, the Cost Allocation Plan is produced by the County by December 31 and approved by the State in the Spring, unless a field review is needed or other factors impact the timing.

As a result, prior to the start of each fiscal year, the County produces an estimate of costs, based on its most recent audited financial statements, and then allocates those estimated costs to departments based on prior year bases (e.g., amount of actual expenditures, number of positions, number of transactions, etc.). In the following year, the estimated costs are reconciled with the actual costs, as determined from the audited financial statements for the prior year, and appropriate adjustments are incorporated into the cost allocation for the new plan year. Therefore, there is a two-year delay between when actual overhead costs are incurred and when they are fully allocated.

To account for this delay, the Cost Allocation Plan includes the following elements: (a) the actual costs from two years prior (i.e., allocated costs); (b) the proposed costs from two years prior (i.e., fixed costs); (c) the difference between the actual and proposed costs from two years prior (i.e., the roll forward); and, (d) adjustments for costs in the current year. The sum of these elements comprises the total costs proposed for the year for which the Cost Allocation Plan is developed. For example, the *2006-2007 Cost Allocation Plan* allocates a total of \$435,141 to the Measure B Program. Of this amount, \$334,025 represents allocated costs from FY 2004-05 (two years prior), and the remaining \$101,116 represents the sum of the roll forward and adjustments. The summary Cost Allocation Plan data between FY 2003-04 and FY 2006-07 illustrates the structure of the allocation methodology, as displayed in the table on the following page. The services that generated these costs include budget analysis, general accounting, payroll processing, purchasing, legal analysis, and employment services.

Table 2.1

**Overhead Costs Allocated to the Measure B Program in the
Cost Allocation Plans for FY 2003-04 to FY 2006-07**

Year of Cost Plan Year of Costs	FY 2003-04 FY 2001-02	FY 2004-05 FY 2002-03	FY 2005-06 FY 2003-04	FY 2006-07 FY 2004-05	All Years
County Executive	56	218	7,745	10,202	18,221
Budget and Analysis	8,408	11,597	102,718	42,230	164,953
Controller-Treasurer	315,119	172,610	533,719	275,182	1,296,630
Procurement	322	610	622	1,010	2,564
County Counsel	12,422	5,684	(3,168)	2	14,940
Employment Services	1,427	2,445	2,801	2,369	9,042
Intergovt Services	2,408	3,070	3,147	2,963	11,588
Other Services	144	99	61	67	371
Allocated Costs	340,306	196,333	647,645	334,025	1,518,309
Fixed Costs	-	-	340,306	348,004	688,310
Roll Forward	-	-	307,339	(13,979)	293,360
Allocated Costs w/Roll Forward Adjustments	340,306	196,333	954,984	320,045	1,811,668
	-	151,671	264,789	115,096	531,556
Proposed Costs	340,306	348,004	1,219,773	435,141	2,343,224
Charged / Budgeted Costs	-	350,000	912,434	435,148	1,697,582
Charged Over (Under) Proposed	(340,306)	1,996	(307,339)	7	(645,642)

In addition, as shown in the preceding table, the amount of costs allocated to the Measure B Program more than doubled between FY 2004-05 and FY 2005-06. This occurred primarily because the County Controller-Treasurer allocated the amortized cost of implementing the new financial accounting and reporting system, SAP. This cost, which is being amortized over a five-year period, has been allocated to departments based on their actual expenditures, which is the method that was suggested and approved by the State Controller's Office. (An additional discussion of this topic is included in the Introduction on Page 23.)

Allocations and Charges

Since the Measure B Program was established in FY 1998-99, the first allocation of overhead costs should have appeared in the 2000-2001 *Cost Allocation Plan*. However, we reviewed the plans developed since FY 2000-01 and found that overhead costs were not allocated to the Program until FY 2003-04. We then requested work papers from the Controller-Treasurer's Office that might show the amount of any costs that should have been allocated to the Program in prior years. Upon reviewing these work papers, we determined that the Program was grouped with the County Executive's Office for the purpose of allocating costs incurred during the first three years of the Program. Since separating the costs that should have been allocated to the Program would require a time consuming review of source documents, only the costs allocated since FY 2003-04 have been included in our analysis, based on costs incurred in FY 2001-02.

Since FY 2003-04, the County has allocated a total of \$645,642 in overhead costs that have not been charged to the Measure B Program. Of this amount, \$340,306 represents

actual costs from FY 2001-02 that were allocated to the Program in FY 2003-04 but not charged. The remaining \$305,336 represents the sum of differences between the amount of costs proposed in the Cost Allocation Plan and the amount of costs actually charged to or budgeted by the Program. For example, in FY 2005-06, the Program is being charged \$912,434 in overhead costs, while the proposed costs approved by the State total \$1,219,773. This is a difference of \$307,339, which is equal to the roll forward amount, or the difference between actual and proposed costs for FY 2003-04. The Controller-Treasurer's Office has adjusted the billing by this amount to take account of the fact that the Program was not charged overhead costs in FY 2003-04, even though these costs should have been charged.

For FY 2007-08, the Measure B Program has estimated that overhead costs could be as high as \$350,000 and has budgeted this amount in the *Fiscal Year 2007 Revenue and Expenditure Plan*. The Controller-Treasurer's Office may have a better estimate of these costs in Fall 2006 that will replace the Program's preliminary estimate. In addition, neither the Measure B Program nor the Controller-Treasurer's Office has estimated the amount of overhead costs that will be charged in FY 2008-09 and FY 2009-10, for actual costs incurred in FY 2006-07 and FY 2007-08, respectively. Since staff could still be working on closing out the Program over the next two years, and the County would incur overhead expenses as long as staff remain with the Program, an estimate of overhead costs should be budgeted in FY 2008-09 and FY 2009-10. The Measure B Program should anticipate budgeting at least \$200,000 in FY 2008-09 and \$100,000 in FY 2009-10, and then adjust these figures as better estimates become available.¹

Finally, once the Cost Allocation Plan for future years has been developed and approved by the State, the exact amount of costs proposed for the Measure B Program should be budgeted and charged, thereby replacing the estimates developed previously. Since the functions of the Measure B Program are expected to transfer to other County departments as the Program closes out, staff within the County Executive's Office may be responsible for implementing this recommendation.

Excess Sales Tax Revenue

There may also be an opportunity to reimburse the County for overhead costs that have not been charged to the Measure B Program in past years using excess regular or residual sales tax revenue, the latter of which currently cannot be estimated. Based on recent information, as discussed in Section 1, the fund balance should reach approximately \$17.3 million after adjusting for recent receipts of sales tax revenue, the availability of funds set-aside in contingency, advancement of a deferred project, and revised projections of administrative and oversight costs. The adjusted fund balance is approximately \$1.3 million greater than the \$16.0 million projection developed by the Measure B Program for the *Fiscal Year 2007 Revenue and Expenditure Plan*. Consequently, once the Measure B Program has made a good faith effort to advance the remaining two deferred projects, the Board of Supervisors should consider using surplus Measure B

¹ In Section 1, the budgets for Program Administration and Program Management Oversight have been adjusted to include the \$200,000 and \$100,000 estimates for overhead costs that we suggest should be allocated in FY 2008-09 and FY 2009-10, respectively.

funds to reimburse the General Fund up to \$645,642 for overhead costs incurred on behalf of the Measure B Program.

Since a large portion of overhead has been driven by actual expenditures, the Measure B Program allocates 97 percent of these costs to the budget for Program Management Oversight and the remaining 3 percent to the budget for Program Administration. Based on this allocation, if surplus funds are used to pay outstanding overhead costs, administrative costs would rise by only \$19,369. This is important since Measure A stipulates that "Only 0.5% of the (sales tax) funds can be used for staff salaries and administration, reserving 99.5% of the funds for project delivery." However, as discussed in Section 1, we reduced the Program's estimate of total administrative costs by \$648,951 to reflect the elimination of staff, consultants, services and supplies as the Program shuts down over the next two years. We thus project that administrative costs will total \$5.773 million, or 0.43 percent of estimated sales tax revenue, through the life of the Program. Consequently, adding an additional \$19,369 to the administrative budget will not cause such costs to exceed the cap specified in Measure A.

If excess regular or residual sales tax revenue remains after reimbursing the General Fund, or the Board decides against making this reimbursement, the Board should also consider recognizing surplus funds as one-time revenue to support County programs and activities related to transportation improvements, in accordance with the will of voters and intention of the Board. These improvements could include pavement management, intersection level of service or expressway signal synchronization projects, since the County already has the infrastructure to implement these types of projects through the County Roads and Airports Department.

CONCLUSION

The Measure B Program was established in FY 1998-99, after the California Supreme Court upheld the legality of Measures A and B, and began incurring expenses that same year. However, the Measure B Program was not allocated overhead costs through the County's Cost Allocation Plan until FY 2003-04 and was not charged overhead costs until FY 2004-05. These charges included FY 2002-03 costs, since the Cost Allocation Plan reconciles actual and proposed costs from two years prior and makes an adjustment for costs in the current year.

As a result, the County has not been reimbursed for overhead costs incurred from the start of FY 1998-99 through the end of FY 2001-02, and costs charged in subsequent years have not consistently matched amounts detailed in the Cost Allocation Plans approved by the State. Based on a review of the County's Cost Allocation Plans, the County has not been reimbursed for \$645,642 in overhead costs incurred on behalf of the Measure B Program.

Consequently, if excess regular or residual sales tax revenue remains after the Measure B Program has fulfilled policy directives and financial obligations, the Board of Supervisors should consider using these funds to (a) reimburse the General Fund up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B

Program; and/or, (b) support County programs and activities related to transportation improvements, in accordance with the will of voters and intention of the Board.

RECOMMENDATIONS

The Santa Clara County Board of Supervisors should direct the Measure B Program or County Executive to:

- 2.1 Budget an estimate of overhead costs that will be charged in FY 2008-09 and FY 2009-10, and replace these estimates with the exact amount of costs proposed in the State approved Cost Allocation Plan. (Priority 1)

The Santa Clara County Board of Supervisors should:

- 2.2 Consider using excess regular or residual sales tax revenue to (a) reimburse the General Fund up to \$645,642 for overhead costs incurred on behalf of the Measure B Program; and/or, (b) support County programs and activities related to transportation improvements. (Priority 1)

COSTS AND BENEFITS

There would be no additional costs to implement these recommendations.

In future years, the County would ensure that overhead costs are budgeted and charged according to the Cost Allocation Plan approved by the State. The General Fund could also be reimbursed up to \$645,642 for overhead costs that have been allocated but not charged to the Measure B Program, if surplus funds are available and the Board agrees to this reimbursement. Alternatively, County programs and activities related to transportation improvements could be funded with one-time revenue from surplus funds, thereby reducing or enhancing funding from the General Fund or other sources.

Section 3: Cash Management

- **During Calendar Years 2003 through 2005, the Valley Transportation Authority (VTA) held an average daily cash balance of \$38.0 million in Measure B funds, in an interest bearing checking account with its custodial bank. The large average daily cash balance occurred because VTA was unable to produce an accurate estimate or effectively manage cash flow needs due to: unanticipated delays that interrupted the progress of construction and payments due to contractors; and, because of insufficient analysis on the extent to which the prior months' cash advances exceeded actual cash requirements.**
- **In 2003, the County borrowed \$139.9 million in revenue bonds to fund major Measure B projects prior to the receipt of sales tax revenue. If VTA had been able to more precisely estimate its cash needs, and the County had been able to postpone the transfer of funds until required, then the County could have generated substantial savings in the form of reduced borrowing costs. Such savings would have occurred because the effective County interest expense for the bonds issued by the Santa Clara County Financing Authority were as much as four times higher than the rate of return realized on Measure B funds advanced to VTA. Over the three-year period after the bonds were issued, the Measure B checking account yielded an average of 0.77 percent per year in interest income, while the special obligation bonds cost an average of 2.02 percent per year in interest expense.**
- **Therefore, the County should avoid agreeing to any provisions that require it to advance funds based upon an estimate of monthly cash flow requirements for future transportation improvements or other large projects. Instead, the County should require the implementing agency to batch charges for services at bi-weekly intervals and request a transfer of funds just prior to incurring charges. Had this process been implemented for the Measure B Program, an estimated \$1.4 million in net interest expense could have been saved over the life of the Program with a minor impact on processing costs.**

In accordance with the terms of the *Master Agreement* entered into between the Valley Transportation Authority (VTA) and Santa Clara County, the Measure B Transportation Improvement Program was required to advance funds to VTA on a monthly basis. The purpose of the monthly advance was to provide VTA with the necessary cash flow to finance construction on rail and highway projects. At the time this process was established, VTA did not believe that it had sufficient cash balances to advance the funding for Measure B rail projects and then receive reimbursement from the County. VTA was also precluded from using transit funds on highway and other non-transit projects.¹ Furthermore, the County did not intend to hire a large staff to review, approve and process individual payments to vendors. This would have required that all agreements and contracts involve three parties – the County, VTA and vendors – such

¹ *Amalgamated Transit Union, Local 265, AFL-CIO, et al. vs. Santa Clara County Transit District et al.*, State of California Sixth District Court of Appeal, August 21, 1989.

that VTA would be responsible for vendor selection and management, and the County would be responsible for vendor payment. Streamlining this process while maintaining oversight and control of Measure B funds was thus made possible by advancing funds and then reconciling advances against actual expenditures.

When drafting the *Master Agreement*, the County anticipated that VTA would generate interest income on balances, since Measure B funds would be paid to VTA in advance of being expended. The County also recognized that such interest income should be used as a source of funds for Measure B transportation improvements. Consequently, the *Master Agreement* required VTA to offset interest generated on available cash balances from future requests for advances. Article III Section 4 (c) (iv) states, "Adjustments made relating to interest earnings will be accomplished on a quarterly basis."

The *Master Agreement* also identified three alternatives for VTA to invest Measure B funds, as follows:

- The State of California Local Agency Investment Fund (LAIF);
- A separate mutual fund agreeable to both VTA and the County; or,
- VTA's main account (referred to as its sweep account).²

During the course of the audit, we met with financial staff at VTA to discuss the advantages and disadvantages of each of these alternatives. The following is a summary of the assessment provided by VTA.

Local Agency Investment Fund – This option would have offered same day access to as much as \$10 million in funding with an unlimited number of withdrawals per month. Additionally, during the past several years, LAIF offered investment returns comparable to that of the Santa Clara County commingled pool of investments. LAIF invests in high quality fixed income securities of a relatively short duration. As such, LAIF offered the most attractive combination of safety, liquidity and yield of the three options available. However, since LAIF places a maximum of \$40 million in holdings from any governmental agency, and since VTA already had approximately \$33 million invested in LAIF, VTA concluded that placing Measure B funds with LAIF would have been impractical.

Mutual Fund – While mutual funds offered the prospect of investment returns equivalent to or greater than that of LAIF, VTA did not consider mutual funds because fluctuations in asset values, transaction costs and other considerations made the use of mutual funds impractical.

Interest Bearing Checking Account – VTA ultimately settled on an interest bearing checking account as the appropriate choice for the placement of Measure B funds because of the safety and liquidity that a checking account would offer. While yielding less in the form of interest income, VTA expected that Measure B Program advances

² *Master Agreement Between the County of Santa Clara and the Santa Clara Valley Transportation Authority*, Article III, Section 4 (b), July 1, 1999

would be expended in relatively short order and account balances would be minimized, so that the opportunity cost associated with the relatively low yields would be minor.

However, rather than place the funds in VTA’s main account, as is consistent with the requirements of the *Master Agreement*, VTA established a separate checking account with terms similar to that of its main account at Union Bank of California.³ Establishing a separate checking account allowed VTA to segregate Measure B funds and establish an audit trail while conforming to the intent of the *Master Agreement*. Measure B funds deposited in this account consist of monies advanced to VTA for rail and highway construction, as well as ancillary projects, such as bike paths and pavement management. VTA also established three escrow accounts in which Measure B funds were deposited in order to serve as a guarantee on the performance of contractors and reimburse utilities for their costs related to projects. Interest earned on Measure B funds in both the checking account and escrow accounts was to be used to offset advances to VTA on a quarterly basis.

Approximately \$18.59 million was deposited in the escrow accounts in Calendar Years 2000 and 2001, and approximately \$17.45 million has been disbursed for utility related costs to date. In comparison, hundreds of millions of dollars in Measure B funds have been deposited in and disbursed from the checking account. Because of the magnitude of the amount of Measure B funds that have moved through the checking account, we requested data on the average daily cash balance and interest earnings by month for Calendar Years 2003 through 2005. Upon receiving and analyzing this data, we found that VTA allowed substantial cash balances to accumulate in the account during the past three years. This condition is illustrated in the following table along with the interest earned and rate of return.

Table 3.1

Average Daily Cash Balance, Interest Earnings and Annual Interest Rate in the Measure B Checking Account for Calendar Years 2003 through 2005

Calendar Year	Average Daily Cash Balance (a)	Net Interest Earnings (b)	Annual Interest Rate (b/a)
2003	\$ 57,701,885	\$ 351,426	0.61%
2004	37,155,314	157,116	0.42%
2005	19,128,358	365,080	1.91%
Average / Total	\$ 37,995,186	\$ 873,622	0.77%

³ The agreement with the bank stated that, “Effective 6/1/01, the initial monthly interest rate for the Measure B Pavement Management and Bikeways Account (#7020015513) and the VTA Congestion Management and Highways Account (#7020021513) will be calculated to match the Repurchase Agreement Sweep Service interest rate in effect the first Wednesday of that month. The interest earnings will then be adjusted based upon that month’s average ledger balance less adjustments and 10% legal reserve requirement, times that month’s earnings credit rate which is based in part upon a 91-day auction T-bill rate less 35 basis points. This adjustment will be reflected on that month’s Account Analysis statement.”

Based upon a review of VTA's method of forecasting the cash flow requirements for rail and highway projects and seeking advances from the Measure B Program, the accumulation of large cash balances was a result of the following factors:

- VTA's estimate of cash flow was based primarily upon expected progress payments that would be made to contractors who provided management, design and construction services for rail and highway projects;
- On occasion, unanticipated delays occurred on certain projects that interrupted the progress of construction and payments due to contractors, and that resulted in lower than expected cash flow requirements;
- To prevent VTA from experiencing negative cash balances in the Measure B checking account, advances were received monthly but only reconciled to actual expenditures quarterly. This had the effect of exaggerating cash needs; and,
- When requesting advances for a subsequent month, VTA did not fully analyze the extent to which prior months' cash advances exceeded actual cash requirements, nor did VTA appropriately consider the cash balance that had accumulated as a source of funding.

This forecasting was not necessary for ancillary projects, since they were generally less costly and had a smaller cash flow impact than rail and highway projects. Instead, the Measure B Program chose to advance \$6.0 million to VTA to cover expenses related to ancillary projects and to replenish these funds when the balance fell to \$3.0 million or less. As part of this process, VTA submitted a separate ancillary invoice.

To analyze the financial impact of retaining a large balance in the interest bearing checking account set up by VTA, we compared it with the expense that the Measure B Program incurred as a result of borrowing funds through the Santa Clara County Financing Authority, which issued approximately \$139.9 million in special obligation bonds. Although these bonds qualified for tax-exempt status and were offered on exceptionally favorable terms to the County, the effective yield of such bonds turned out to be as much as four times higher than the rate of return realized on the funds advanced to VTA. During Calendar Years 2003 through 2005, the Measure B checking account yielded an average of 0.77 percent per year in interest income, while the special obligation bonds yielded an average of 2.02 percent per year in interest expense. As a result, if the County had been able to reduce the amount of funds advanced to VTA, the County could have generated substantial savings in the form of reduced borrowing costs.

We thus compared the effective yield and interest earned on Measure B funds held in the interest bearing checking account with the effective yield and interest paid on bonds issued by the Santa Clara County Financing Authority. Using this information, we then calculated the opportunity cost associated with holding excess Measure B funds in the checking account established by VTA based on the average daily cash balance and the differential yield between the account's rate of return and the County's cost of borrowing. As shown in the following table, the effect of advancing on average \$38.0

million more than what was required to finance rail and highway construction and ancillary projects amounted to a net additional borrowing cost of more than \$1.4 million over three years, or an average of \$475,568 per year.

Table 3.2

**Analysis of the Effective Yield on Measure B Funds and
Special Obligation Bonds in Calendar Years 2003 through 2005**

Calendar Year	Average Daily Cash Balance (a)	Effective Yield Measure B Funds (b)	Effective Yield Special Oblig. Bonds (c)	Differential Yield (c-b)	Cost of Borrowing less Net Interest (a*(c-b))
2003	\$ 57,701,885	0.61%	1.97%	1.36%	\$ 785,301
2004	37,155,314	0.42%	2.03%	1.61%	597,137
2005	19,128,358	1.91%	2.14%	0.23%	44,267
Average / Total	\$ 37,995,186	0.77%	2.02%	1.25%	\$ 1,426,705

In the future, if the County enters into an agreement with VTA or another agency to implement another large program funded with general government resources, the County should avoid agreeing to any provisions that require an advance of funds based upon an estimate of monthly cash flow requirements. Instead, the County should establish an expense reimbursement process that requires the implementing agency to:

- Batch charges for labor, design consultants, non-technical services, professional consultants, real estate services, property costs, construction, field operations and other activities at bi-weekly intervals; and,
- Notify the County of the total amount of charges in the batch with detailed information on the charges and a request to wire funds within two to three business days.

Under this approach to financing, monthly advances would no longer be required of the County, and significant cash balances would no longer be retained by the implementing agency. That agency also would not be required to use its own funding to finance project cash flow, thereby avoiding complications that might arise due to funding limitations and restrictions. Instead, the implementing agency would receive just-in-time reimbursements of planned expenditures that would provide the agency with required funding just prior to incurring charges. The method of batching charges and requesting funds to pay those charges would allow the County to maximize the amount of funds retained within its custody and minimize borrowing. The County should also retain the authority to review reimbursement requests for consistency with authorized expenditures. Using this process, adjustments could be made when the County wires funds for a subsequent batch. Since the frequency of fund transfers would increase each month, implementing these procedural changes would generate a small amount of additional processing costs. However, these costs could be contained by

maintaining a monthly, rather than a bi-weekly, reconciliation of reimbursement claims to authorized expenditures.

Procedures should therefore also be established to ensure that authorized expenditures, as defined by Board approved plans, are reconciled with reimbursement claims on a monthly basis. The task of developing these procedures should be assigned to the County Executive's Office if general government resources, such as sales tax receipts, become available to fund another large program in the future. This activity would generate a small administrative cost that could be charged through the County's Cost Allocation Plan.

CONCLUSION

During Calendar Years 2003 through 2005, the Valley Transportation Authority (VTA) held an average daily cash balance of \$38.0 million in Measure B funds, in an interest bearing checking account with its custodial bank. The large average daily cash balance occurred because VTA was unable to produce an accurate estimate or effectively manage cash flow needs due to unanticipated delays that interrupted the progress of construction and payments due to contractors; and, because of insufficient analysis on the extent to which the prior months' cash advances exceeded actual cash requirements.

In 2003, the County borrowed \$139.9 million in revenue bonds to fund major Measure B projects prior to the receipt of sales tax revenue. If VTA had been able to more precisely estimate its cash needs, and the County had been able to postpone the transfer of funds until required, then the County could have generated substantial savings in the form of reduced borrowing costs. Such savings would have occurred because the effective County interest expense for the bonds issued by the Santa Clara County Financing Authority were as much as four times higher than the rate of return realized on Measure B funds advanced to VTA. Over the three-year period after the bonds were issued, the Measure B checking account yielded an average of 0.77 percent per year in interest income, while the special obligation bonds cost an average of 2.02 percent per year in interest expense.

Therefore, the County should avoid agreeing to any provisions that require it to advance funds based upon an estimate of monthly cash flow requirements for future transportation improvements or other large projects. Instead, the County should require the implementing agency to batch charges for services at bi-weekly intervals and request a transfer of funds just prior to incurring charges. Had this process been implemented for the Measure B Program, an estimated \$1.4 million in net interest expense could have been saved over the life of the Program with a minor impact on processing costs.

RECOMMENDATIONS

The Santa Clara County Board of Supervisors should direct the County Executive to:

- 3.1 Discontinue the practice of advancing funds based upon an estimate of monthly project cash flow requirements in future agreements with implementing agencies. (Priority 1)
- 3.2 Require implementing agencies selected for future projects to (a) batch charges for labor, design consultants, non-technical services, professional consultants, real estate services, property costs, construction, field operations and other activities at bi-weekly intervals; and, (b) notify the County of the total amount of charges in the batch with detailed information on the charges and a request to wire funds within two to three business days. (Priority 1)
- 3.3 Establish procedures that will ensure the monthly reconciliation of reimbursement claims to authorized expenditures, as defined by Board approved plans, for future projects. (Priority 2)

COSTS AND BENEFITS

Since the frequency of fund transfers would increase each month with just-in-time reimbursements, implementing the procedural changes recommended above would generate a small amount of additional processing costs. However, these costs could be contained by maintaining a monthly reconciliation of reimbursement claims to authorized expenditures. Developing procedures for this reconciliation would also generate a small administrative cost that could be charged through the County's Cost Allocation Plan.

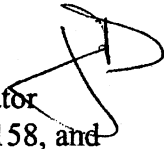
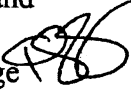
Over the three-year period examined, the County would have avoided approximately \$1.4 million in net Measure B Program costs. Savings for future projects would depend upon the dollar amount of the program, interest rates and the frequency of expenditure reimbursements provided by the County. Furthermore, the suggested method of batching and paying charges would allow the County to maximize the amount of funds held within its custody and minimize the amount of any future borrowing, while maintaining the authority to retroactively review reimbursement requests for consistency with authorized expenditures.

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• County Government Center
70 West Hedding Street, 11th Floor
San Jose, California 95110
Phone: 408.299.5179
Fax: 408.293.6185

Measure B
Transportation Improvement Program
County of Santa Clara
County Executive Office

TO: Nicole Coburn
Harvey Rose
408-299-6434

FROM: Jeff Davis 
Administrator
408-299-5158, and
Tracey Loveridge 
Senior Fiscal Officer
408-299-5179

DATE: 08/22/2006

SUBJECT: Measure B Management Audit

Nicole,

On behalf of the Measure B Team, we would like to extend our thanks to you and your auditing staff for their professionalism. As you know, the Measure B Program is already in the closeout mode and we have appreciated your understanding during this time.

Attached please find the written response from the Measure B Transportation Improvement Program related to the revised draft management audit report, dated 08/01/2006.

Please contact Tracey Loveridge, at 408-299-5179, with any questions.

attachment: Written Response from the Measure B Transportation Improvement Program

cc: Sonia Sharifi

Topics Requiring Additional Review

General Sales Tax Management (page 22)

Measure B Response: Agree

The management structure and implementation methods established for Measure B worked well. Should the County consider a future sales tax measure for general purposes, the County would need to consider the appropriate oversight, management, staffing and implementation for that particular tax and purpose(s), which could vary from the Measure B model.

Asset Amortization and Allocation (page 23)

Measure B Response: Agree

Using only annual expenditure levels can disproportionately allocate the cost of significant assets across County departments. Measure B has significant annual expenditure levels. However, within its oversight function Measure B has processed a low volume of transactions for high dollar amounts. Even with the tremendously low usage of the SAP system, the Measure B Program has borne a significant cost for the County-wide implementation of this system based on the County Cost Plan and the amortization and allocation methods selected by the County. We agree that the County should use a more equitable method, using at least two factors (i.e. expenditure level, number of transactions, number of users, number of FTE, etc.), for allocation of such future costs.

**Written Response from the Measure B Transportation Improvement Program
to the 08/01/2006 Revised Draft of the Management Audit Report**

Section 1: Ending Balance

The Santa Clara County Board of Supervisors should direct the Measure B Program to:

- 1.1 Increase the Measure B ending balance by as much as \$1.3 million to reflect new information, including recent receipts of sales tax revenue, the availability of funds set aside in contingency, advancement of a deferred project and revised projections of administrative and oversight costs. (Priority 1)

Measure B Response: Partially Agree

The Measure B Program has historically included new information in regular reports to the Board of Supervisors every six months, within the Semi-up Annual Report (December) and the Revenue and Expenditure Plan (June). There are many factors that contribute to updating the ending balance and this report identifies only a few items that staff will be considering in order to compile the next report to be issued in December, 2006.

The Measure B Program already plans to include the first three factors indicated within this audit report, itemized in Table 1.2 (page 29), which results in a net increase to the ending balance of \$658,000. This includes a) an increase in sales tax revenue receipts, b) a release of contingency, and c) the approval of the combined San Martin projects to be moved from deferred projects into construction.

The remaining two items, related to a potential decrease to administrative costs and a potential increase to oversight costs will be considered, along with a host of other potential savings and costs, within the December 2006 Program report.

- 1.2 At the time that the first payment is due to the Valley Transportation Authority (VTA) for the reimbursement of landscaping costs, estimate whether enough residual sales tax revenue will be collected to fully reimburse VTA and whether any surplus revenue will remain following the reimbursement. If the Measure B Program expects to have excess residual sales tax revenue, these funds should be included in the Measure B ending balance. (Priority 1)

Measure B Response: Partially Agree

Measure B staff will estimate the potential to fund the landscaping costs per the agreement referred to above. However, the Program's commitment is to fund this particular expense only if sufficient residuals become available. There is an element of uncertainty related to the level of residual sales tax revenues that will be realized by the Program, thus the reason for the agreement related to the landscaping being contingent on the actual level of receipts the Program receives.

**Written Response from the Measure B Transportation Improvement Program
to the 08/01/2006 Revised Draft of the Management Audit Report**

The Program does have a few options that are being considered related to excess residual revenues and potentially excess regular revenues. A closeout agreement is in the process of being negotiated with both VTA and County Roads and Airports (the implementing agencies). These agreements could outline, for consideration by the Board of Supervisors, the proposed use of any and all excess funds.

- 1.3 Request that the Valley Transportation Authority examine the remaining funding requirements of projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that is available to support the deferred projects. (Priority 1)

Measure B Response: Disagree

Pursuant to the implementation executed by Measure B and VTA, the use of the swap funds that are available through these agreements are at VTA's discretion within specified parameters. It was not intended for deferred projects to potentially be funded through swap funding.

- 1.4 Negotiate final payments with implementing agencies for each project that will remain open after June 30, 2007. The payment agreements should specify that any surplus funds that exist, once the projects have been fully closed out, should be re-appropriated by the Board of Supervisors. (Priority 1)

Measure B Response: Partially Agree

The Measure B Program had already planned and is in the process of negotiating draft closeout agreements with both implementing agencies for Board of Supervisors consideration. We believe that there is a more streamlined approach and intend to designate the use of surplus funds, should any remain, within these closeout agreements in a manner that will be acceptable to the Board of Supervisors.

Written Response from the Measure B Transportation Improvement Program to the 08/01/2006 Revised Draft of the Management Audit Report

Section 2: County Overhead Charges

The Santa Clara County Board of Supervisors should direct the Measure B Program or County Executive to:

- 2.1 Budget an estimate of overhead costs that will be charged in FY 2008-09 and FY 2009-10, and replace those estimates with the exact amount of costs proposed in the State approved Cost Allocation Plan. (Priority 1)

Measure B Response: Partially Agree

Prior to this management audit, Measure B staff had already sought to learn from OBA and the Controller-Treasurer's Office if a determination had been made as to whether or not the County intended to continue to charge the Measure B Program in FY 2009 and FY 2010 for overhead costs. We understood that no such determination had been made by the County related to FY 2009 and FY 2010.

With the Program being predominately closed-out in FY 2007, it is the Measure B staff's recommendation to implement the following steps:

- a) that only the carryover, whether in the Program's favor or the County's favor, be charged or credited to Measure B in FY 2009 and in FY 2010;*
- b) that a firm cap (not-to-exceed) amount of overhead costs be established for each such fiscal year;*
- c) with Program closeout eminent, the County provide the cap or not-to-exceed amount within the next 45 days to enable the Program to reserve such funds.*

The Santa Clara County Board of Supervisors should:

- 2.2 Consider using excess regular or residual sales tax revenue to (a) reimburse the General Fund up to \$645,642 for overhead costs incurred on behalf of the Measure B program; and/or, (b) support County programs and activities related to transportation improvements. (Priority 1)

Measure B Response: Partially Agree

The amount suggested is itemized within Table 2.1 (page 39) of this report, and is comprised of the following amounts:

<i>FY 2003-04</i>	<i>(\$340,306)</i>
<i>FY 2004-05</i>	<i>\$ 1,996</i>
<i>FY 2005-06</i>	<i>(\$307,339)</i>
<i>FY 2006-07</i>	<i>\$ 7</i>
<i>TOTAL</i>	<i>(\$645,642)</i>

**Written Response from the Measure B Transportation Improvement Program
to the 08/01/2006 Revised Draft of the Management Audit Report**

It was determined by County policy, not the Measure B Program, that FY 2004-05 would be the first such year that county overhead costs would be charged to the Program.

For FY 2004-05, per the State approved cost plan, the Measure B Program was over-charged by \$1,996. These funds should be transferred from the County back to the Measure B Program.

For FY 2005-06, the originally budgeted amount of \$1.22 million was not charged by the County, instead \$912 thousand was charged to the Measure B Program. It was understood that this was the final amount as determined by the County for FY 2005-06. During FY 2005-06, the decrease in the amount charged was initiated by the County, not the Measure B Program. Measure B staff would need to learn more for the basis of the management audit recommending the County retroactively charge the Program an additional \$307,339.

For FY 2006-07, unless determined to be inappropriate by OBA or the Controller-Treasurer's Office, Measure B staff would recommend that the Program be charged the amount that is included within the final state approved county cost plan. We understand that plan should be approved in the Fall of 2006.

Should the County elect to implement any of the items within Recommendation 2.2, the Measure B Program staff would urge the Board of Supervisors to fund Program expenditures in this order of priority:

- a) the existing commitments of the Program, as approved with the adoption of the FY 2007, June 2, 2006 Revenue and Expenditure Plan;*
- b) the deferred project funded by the Board of Supervisors on June 20, 2006;*
- c) additional potential closeout costs being identified by the Program;*
- d) remaining deferred projects;*
- e) commitments on residual revenues;*
- f) other Program costs, if appropriate (as proposed by this management audit, and if approved by the Board of Supervisors); and:*
- g) appropriate, Board approved, transportation needs, if excess funds exist after all other Program needs are met.*

Section 3: Cash Management

The Santa Clara County Board of Supervisors should direct the County Executive to:

- 3.1 Discontinue the practice of advancing funds to implementing agencies based upon an estimate of monthly project cash flow requirements in future agreements with implementing agencies. (Priority 1)

Measure B Response: Partially Agree

Depending upon the magnitude of the projects or programs involved, the extent to which the implementing agencies can finance significant capital projects and the extent of obligations assumed by the implementing agencies this could prove difficult for the County. However, on a case by case basis every effort should be made to secure the services or collaboration by implementing agencies without advancing funds.

- 3.2 Require implementing agencies selected for future periods to (a) batch charges for labor, design consultants, non-technical services, professional consultants, real estate services, property costs, construction, field operations and other activities at bi-weekly intervals; and, (b) notify the County of the total amount of charges in the batch with detailed information on the charges and a request to wire funds within two to three business days. (Priority 1)

Measure B Response: Partially Agree

In an ideal textbook case this approach could be feasible. However, at the time the Master Agreement was negotiated, VTA was unable to agree to finance the Program, or to directly secure the services of dozens of consultants, designers and contractors without the ability to pay for such services and materials. Several approaches were considered and while the batching process was not selected for Measure B, perhaps it could be successful in a future program.

- 3.3 Establish procedures that will ensure the monthly reconciliation of reimbursement claims to authorized expenditures, as defined by Board approved plans, for future projects. (Priority 2)

**Written Response from the Measure B Transportation Improvement Program
to the 08/01/2006 Revised Draft of the Management Audit Report**

Measure B Response: Partially Agree

There have been timely reconciliation performed throughout the Program within each invoice provided by VTA to the Measure B Program. Per the Master Agreement, with the advance processes established, 45 days was allowed for this reconciliation.

With the data provided with this report on the average daily cash balance that VTA had on hand over the last three years, Measure B staff would recommend instead that future programs, when applicable, include a maximum cash on hand allowed by such future implementing agencies.

It is important to note that the Master Agreement required interest earned by VTA from cash balances on hand from the Program, to be credited to the Measure B program. This was adhered to throughout the life of the Program, to the benefit of Measure B.

While not stated within any of the recommendations of this report, but within the body of the report, the auditors conclude that "...an estimated \$1.4 million in net interest expense could have been saved over the life of the Program..." Staff does not agree with this conclusion as there were several additional factors that were involved in the decisions that led to the execution of the Master Agreement not included within this report. If an additional response was deemed to be appropriate by the Board of Supervisors, staff would need to learn additional information related to the assumptions behind this claim.



August 18, 2006

Nicole Coburn
Board of Supervisors Management Audit Division
County Government Center, East Wing
70 West Hedding Street
San Jose, CA 95110

Subject: Comments on the Revised Management Audit Report on Measure B
Transportation Improvement Program (MBTIP) by the County Board of
Supervisors Management Audit Division

Dear Ms. Coburn:

Santa Clara Valley Transportation Authority (VTA) would like to thank the Management Audit Team for the opportunity to comment on the revised draft *Management Audit Report of the MBTIP* dated August 1, 2006. We have attached our comments on the management audit report. Please note that since the recommendations were not addressed to VTA, VTA provided comments, and not responses. VTA believes that of the nine recommendations, three are relevant to VTA and therefore, appropriate comments indicating VTA's position were provided. These comments are summarized as follows:

1) SWAP Funds

The draft report suggests that the undisbursed balance of Measure B Swap Funds be examined to determine the amount, if any, that is available to support funding deferred Measure B projects. VTA takes strong exception to the recommendation based on the following:

- The VTA Board of Directors approved programming actions committing the Swap Funds to the projects listed in Table 1.3 of the draft report.
- VTA has executed contracts for majority of these projects and/or is incurring other project expenses that are to be paid from the Swap funds.
- In some instances, the Swap Funds are leveraging other project funding sources, such as Federal grants.
- Three of the projects listed totaling \$6.7 million are highway planting construction contracts that have been executed or shortly will be, with

expenditures to be paid by Swap Funds in anticipation that future sales tax residuals will partially or fully replenish Local Program Reserve.

2) Measure B Closeout

VTA and the County Measure B Administrative staff are developing a closeout agreement that would establish a mutually agreed upon firm fixed price to complete the remaining active contracts and Caltrain deferred projects, subject to the approval of both the VTA Board of Directors and the County Board of Supervisors. VTA recommends that the Board of Supervisors should not implement Recommendation 1.4 until such time as it is determined what the terms and conditions of a potential closeout agreement would be.

3) Overhead costs relating to the highway projects

Similar to the County's method of calculating its indirect cost allocation plan, VTA's indirect cost rate is also based on prior two-year's actual costs. This means that there is also a two-year delay between when actual overhead costs are incurred and when they are fully allocated. As a result, VTA also has unreimbursed indirect costs relating to the highway projects, and therefore requests that this be considered in the closeout agreement.

Should you have questions, please call Grace Salandanan at (408)321-7019, or myself at (408)321-5630.

Sincerely,



Roger Contreras
Chief Financial Officer

Enclosures: VTA comments

C: Jack Collins, Chief Construction Officer
Jeff Funk, Deputy Director, Construction
Carolyn Gonot, Chief Development Officer
John Ristow, Deputy Director, Planning and Programming Development
Susan Stark, Controller
Grace Salandanan, Manager, Fiscal Resources
Tracey Loveridge, Measure B, Fiscal Officer

VTA COMMENTS ON “PURPOSE AND SCOPE”

UNCOMMITTED SWAP FUNDING

Page 2, Item 1

The report suggests that VTA consider funding a portion of the remaining MBTIP projects using uncommitted swap derived funding. Prior and upcoming actions by the VTA Board of Directors will have committed all of the swap funding to projects; nothing is anticipated to be available for deferred Measure B projects. VTA is working with Caltrain and the County of Santa Clara Measure B staff to identify a funding plan for the deferred projects comprised of a combination of MBTIP, Caltrain and VTA transit capital funding sources.

OVERHEAD COSTS

Page 2, Item 2

Similar to the County’s method of calculating its indirect cost allocation plan, VTA’s indirect cost rate is also based on prior two-year’s actual costs. This means that there is also a two-year delay between when actual overhead costs are incurred and when they are fully allocated. As a result, VTA also has unreimbursed indirect costs relating to the highway projects, and therefore requests that this be considered in the closeout agreement.

ADVANCES

Page 2 Item 3

It was never intended that VTA finance the Measure B Program, hence the monthly advances in accordance with the Master Agreement. Despite VTA being somewhat conservative on cash flow projections, the calculation of an additional \$1.4 million in interest should be compared to the benefit realized by the County of not having to cut 40 to 60 individual checks a month during the peak period of activity. VTA’s emphasis on prompt vendor payment within 15 days of approved invoices, creates a contracting environment that encourages more competitive bid prices. We believe that other tangible and intangible benefits similar to the ones just described were not factored into the \$1.4 million calculation.

VTA COMMENTS ON SECTION 1: ENDING BALANCE

Page 31, 4th paragraph under “Local Program Reserve”

The VTA Board of Directors has already approved programming actions committing the Swap Funds listed in Table 1.3 of the draft report to projects and are not available for reprogramming due to the following:

- VTA has executed contracts for majority of these projects and/or is incurring other project expenses that are to be paid from the Swap Funds.
- In some instances, the Swap funds are leveraging other project funding sources, such as Federal grants.
- Three of the projects listed totaling \$6.7 million are highway planting construction contracts that have been executed or shortly will be with expenditures to be paid by Swap Funds in anticipation that future sales tax residuals will partially or fully replenish Local Program Reserve.

Page 33, 3rd paragraph under “Final Payments”

VTA and the County Measure B Administrative staff are developing a closeout agreement that would establish a mutually agreed upon firm fixed price to complete the remaining active contracts and Caltrain deferred projects, subject to the approval of both the VTA Board of Directors and the County Board of Supervisors. The concepts presented in the revised draft Management Audit Report are being considered in the development of the potential closeout agreement. VTA recommends that the Board of Supervisors not implement any audit recommendation on Final Payments until such time as it is determined what the terms and conditions of a potential closeout agreement would be.

RECOMMENDATIONS

The Santa Clara County Board of Supervisors should direct the Measure B Program to:

- 1.1 Increase the Measure B ending balance by as much as \$1.3 million to reflect new information, including recent receipts of sales tax revenue, the availability of funds set aside in contingency, advancement of a deferred project and revised projections of administrative and oversight costs. (Priority 1)

VTA's Comment: None

- 1.2 At the time that the first payment is due to the Valley Transportation Authority (VTA) for the reimbursement of landscaping costs, estimate whether enough residual sales tax revenue will be collected to fully reimburse VTA and whether any surplus revenue will remain following the reimbursement. If the Measure B Program expects to have excess residual sales tax revenue, these funds should be included in the Measure B fund balance. (Priority 1)

VTA's Comment: None

- 1.3 Request that the Valley Transportation Authority examine the remaining funding requirements of projects for which swapped Measure B funds have been allocated from the Local Program Reserve but not yet disbursed for expenditure, and report on the amount of funding that is available to support the deferred projects. (Priority 1)

VTA's Comment: The VTA Board of Directors has already approved programming actions committing the Swap Funds listed in Table 1.3 of the draft report to those projects and the funding is not available for reprogramming.

- 1.4 Negotiate final payments with implementing agencies for each project that will remain open after June 30, 2007. The payment agreements should specify that any surplus funds that exist, once the projects have been fully closed out, should be re-appropriated by the Board of Supervisors. (Priority 1)

VTA's Comment: VTA recommends that this recommendation not be implemented because:

VTA and the County Measure B Administrative staff are developing a closeout agreement that would establish a mutually agreed upon firm fixed price to complete the remaining active contracts and Caltrain deferred projects, subject to the approval of both the VTA Board of Directors and the County Board of Supervisors. Until the terms and conditions of the potential closeout agreement are determined, this recommendation is premature.

VTA COMMENTS ON SECTION 2: COUNTY OVERHEAD COSTS

RECOMMENDATIONS

The Santa Clara County Board of Supervisors should direct the Measure B Program or County Executive to:

21. Budget an estimate of overhead costs that will be charged in FY 2008-09 and FY 2009-10, and replace those estimates with the exact amount of costs proposed in the State approved Cost Allocation Plan. (Priority 1)

VTA's Comment: None

The Santa Clara County Board of Supervisors should:

- 2.2 Consider using excess regular or residual sales tax revenue to (a) reimburse the General Fund up to \$645,642 for overhead costs incurred on behalf of the Measure B program; and/or, (b) support County programs and activities related to transportation improvements. (Priority 1)

VTA's Comment: Similar to the County's method of calculating its indirect cost allocation plan, VTA's indirect cost rate is also based on prior two-year's actual costs. This means that there is also a two-year delay between when actual overhead costs are incurred and when they are fully allocated. As a result, VTA also has unreimbursed indirect costs relating to the highway projects, and therefore requests that this be considered in the closeout agreement.

VTA COMMENTS ON SECTION 3: CASH MANAGEMENT

The Santa Clara County Board of Supervisors should direct the County Executive to:

- 3.1 Discontinue the practice of advancing funds to implementing agencies based upon an estimate of monthly project cash flow requirements in future agreements with implementing agencies. (Priority 1)

VTA's Comment: None

- 3.2 Require implementing agencies selected for future periods to (a) batch charges for labor, design consultants, non-technical services, professional consultants, real estate services, property costs, construction, field operations and other activities at bi-weekly intervals; and, (b) notify the County of the total amount of charges in the batch with detailed information on the charges and a request to wire funds within two to three business days. (Priority 1)

VTA's Comment: None

- 3.3 Establish procedures that will ensure the monthly reconciliation of reimbursement claims to authorized expenditures, as defined by Board approved plans, for future projects. (Priority 2)

VTA's Comment: None

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County of Santa Clara

Finance Agency
Controller-Treasurer Department
County Government Center
70 West Hedding Street, East Wing, 2nd Floor
San Jose, California 95110-1705
(408) 299-5200 FAX (408) 289-8629



August 23, 2006

To: Management Audit Division
of the Board of Supervisors

From: Dave Elledge
Controller-Treasurer

A handwritten signature in black ink, appearing to be "DE", written over the printed name "Dave Elledge".

Regarding: Management Audit of the Measure B Transportation Improvement Program

We have reviewed the audit report of the Measure B Transportation Improvement Program, issued by the Management Audit Division on August 1, 2006. Though the report did not include any specific findings or make recommendations relating to the Controller-Treasurer Department (the Department), the section titled, "*Topic Requiring Additional Review*," included comments and suggestions on the Department's current practices relating to the amortization and allocation of costs for implementing the SAP financial accounting and reporting system. The report concluded this discussion by suggesting that the Director of Finance Agency fully explore the amortization and allocation methods used for SAP, and assess the broader impacts of extending the amortization period and changing the allocation basis for future costly asset acquisitions made by the County.

We do not agree with the comments and suggestions made by the management auditors.

Asset Amortization Period

The management audit report questioned the Department's use of a five-year period for amortizing the SAP costs as being too short. They have suggested that a longer period of time would be more fair to programs like Measure B, which are of a short duration. We do not agree with the auditors due to the following reasons:

- a. We have followed the County's fixed asset policy in capitalizing and amortizing the SAP costs. The policy states that all capitalized software costs should be amortized over a five-year period. The criteria for determining the useful economic life for an asset is based on the asset class to which it belongs. We do not select the useful life for an asset on the basis of any financial impact it may have on a specific program, such as Measure B. Further, the County's comprehensive annual financial report (CAFR) reflects the value of its fixed assets based on the guidelines set in the fixed asset policy. We have consistently followed the fixed asset policy in preparing the County's CAFR.

- b. The Office Management & Budget (OMB) Circular A-87 allows the governmental entities to consistently follow their accounting policies (including fixed asset policies) in preparing their local/State cost allocation plans. It states that classes of assets included in the cost allocation plan shall be determined on the same basis as used for preparing the CAFR. The County's cost allocation plan follows the guidelines set in OMB Circular A-87. The State Controller's Office routinely audits this plan, and have never questioned the County's fixed asset policy for depreciation.
- c. The County's fixed asset policy reflects the best business practices for public sector entities for capitalization of major software projects, such as the SAP system. The current business environment renders it uneconomical to maintain a major software system without upgrading it for over five years. Major enterprise resource planning (ERP) systems generally release minor software upgrade patches annually with a major system upgrade release every three to five years. These ERP vendors generally stop providing customer support for older releases. The County is currently planning a major upgrade to its four-year old SAP system. Extending the software life beyond five years will not allow us to amortize its full costs during its useful economic life.
- d. The management auditors suggestion to prolong the life of SAP and other software systems beyond five-years will result in a reduction of the General Fund revenues. The software costs are allocated to departments through the cost allocation plan, and some departments claim these cost plan charges to federal and state programs. Extending the life of software systems will reduce the cost plan charges and shift the revenues from current to future years. This will not be economically beneficial to the County.

Allocation Method

We do not agree with the management auditors' comment on the fairness of the allocation basis used by the Department in allocating the SAP costs to various programs or functions. We have allocated those costs based on the annual expenditures of various departments. The auditors suggested annual transactions, full-time equivalent (FTE) employee count, or number of SAP users as some other allocation basis that we could have used for this purpose. The State Controller's Office and the OMB look for reasonableness as the prime criteria for selecting the allocation basis. The State Controller's Office, which routinely reviews the County's annual cost allocation plan, has accepted the annual expenditures as a reasonable method for allocating the SAP and other software costs. In selecting an allocation method, we look at: a) its countywide application rather than its effect on one particular program, such as Measure B; b) the relationship of the allocation method to the costs distributed to other programs; and c) availability of information to be used as an allocation basis. The State Controller's Office also looks at the consistency of the County's use of an allocation method. For example, FTE count does not have any direct relationship with the SAP financial accounting and reporting system as the ratio of employees using the accounting software

varies a lot among departments. Therefore, the FTE count will not make a reasonable basis for allocating SAP costs. Similarly, the number of SAP users as an allocation basis may result in some smaller departments getting a disproportionately higher share of SAP costs because every department, irrespective of its size and complexity of financial transactions, must have a certain minimum number of SAP users. We believe, the total annual expenditures provide us a reasonable basis for allocating SAP costs to various departments.

If needed, we will be glad to discuss our response in more detail.

Cc: John Guthrie, Director of Finance Agency
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