January 2003

LAO 60 YEARS OF SERVICE

Get $mart: Reforming the State's Equipment Financing Program

ELIZABETH G. HILL • LEGISLATIVE ANALYST

Over the last seven years, the Department of General Services (DGS) has operated the GS $Mart Program, which has been used to finance $521 million in state equipment purchases. In this report, we review the program for its statutory authority, fiscal controls, financing practices, and overall program operation. We found that DGS demonstrated initiative in developing an innovative program to finance state equipment purchases. Our review, however, also found significant deficiencies in the GS $Mart Program—including the lack of statutory authority to operate the program. We make several recommendations aimed at addressing the deficiencies and restructuring the program. ■

Acknowledgments

This report was prepared by Anna Brannen, and reviewed by Michael Cohen. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

LAO Publications

To request publications call (916) 445-4656.

This report and others, as well as an E-mail subscription service, are available on the LAO's Internet site at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.

BACKGROUND

On an annual basis, government agencies acquire, replace, or upgrade equipment. Every year the State of California purchases hundreds of millions of dollars in equipment. The state either makes these purchases out-right, or through some type of financing program. Considering the amount of equipment that the state purchases every year, the current and future budgetary impacts can be significant.

Some equipment purchases—such as a $10 million printing press or a $5 million airplane—tend to be too costly for individual departments to purchase in a single budget year and, therefore, financing such purchases becomes necessary. Financing large equipment purchases is a fiscal strategy that reduces costs in one budget year and extends the costs over multiple years. In some circumstances, financing may be the only method available for acquiring equipment when fund reserves are inadequate to accommodate the total purchase price. Financing, however, increases the overall purchase price of equipment because of interest costs.

Prior to 1996, most state equipment purchases were financed through the equipment supplier. Since financing was included in the overall purchase proposal, the state had little flexibility in negotiating favorable interest rates on such procurements. For this reason, the Department of General Services (DGS) made a policy decision to allow financing to be procured separately from the equipment procurement. The DGS then established the GS $Mart (pronounced "GS Smart") Program that the state could use to finance equipment purchases. As with other DGS programs, the GS $Mart Program is also available for use by local governments. Our review focuses on the state's use of the program.

In this report, we describe the GS $Mart Program, evaluate the program's effectiveness, and make recommendations to improve its operation.

OPERATION OF GS $MART PROGRAM

The GS $Mart Program is administered and operated within DGS' Procurement Division and has been in operation since 1996. Figure 1 (see page 4) summarizes the program, which we discuss in more detail below.

DGS Prequalifies Lenders

To participate in the GS $Mart program, lenders must agree to (1) update their interest rates every 30 days, (2) complete a loan in 30 days, and (3) use a standard financing contract. In addition, GS $Mart lenders are required to post their interest rates on the GS $Mart Web site. The Web site then presents the interest rates from lowest to highest for various loan amounts. For example, in November 2002, the interest rates for a 48 month $250,000 loan ranged from 3.4 percent to 6.25 percent.

DGS Assists Departments in Processing Loans

After procuring equipment through standard state procedures, a department may begin the process of securing financing. Using the DGS Web site, the department selects at least three different lenders for interest rate quotes. Based on this financial information, the department selects a GS $Mart lender. Then, the department asks DGS to prepare a GS $Mart loan. Current DGS policy recommends that the financed amount be for a minimum of $100,000. Upon completion of its legal review of the procurement, DGS completes the loan package and forwards it to the department and lender. At that point, the lender provides payment to the equipment vendor.

Figure 1

Components of DGS' GS $Mart Loan Program

- ✓ DGS prequalifies lenders.
- ✓ DGS assists in loan preparation.
- ✓ Lenders and state use standard financing contract.
- ✓ Lenders post broad range of interest rates on Web site every 30 days.
- ✓ Departments receive a minimum of three interest rate quotes.
- ✓ Lenders complete loans in 30 days.

Program Experience to Date

Funding for the GS $Mart Program. The GS $Mart Program's annual budget is $298,000 and three positions. The program administration costs are recovered through fees paid by departments procuring equipment (DGS' acquisition fee currently is 2 percent of acquisition purchases).

GS $Mart Has Processed $521 Million in Loans. Since 1996, DGS has completed

Figure 2

GS $Mart Loans Completed Since 1996

By Equipment Category

Equipment Category	Total Number of Loans	Total Amount of Loans (In Millions)
Information Technology (IT):		
IT equipment	217	$240.4
Software development projects	5	100.7
Software licenses	14	74.0
Telecommunications	26	50.7
Subtotals	(262)	($465.8)
Non IT Equipment:		
Airplane	1	$5.0
Copiers	13	2.0
Furniture	5	2.7
Generators	2	12.4
Mailroom equipment	9	3.7
Miscellaneous[a]	22	4.9
Printing & publishing equipment	12	13.1
Vehicles	7	11.3
Subtotals	(71)	($55.1)
Totals	**333**	**$520.9**

[a] Includes medical and specialized equipment, video conferencing, and various building-related equipment.

333 GS $Mart state loans for a total of $445 million (all fund sources) in purchases. The loan costs increase to $521 million after accounting for $75 million in interest costs. Over the last seven years, the GS $Mart interest rates have averaged 5 percent. On an annual basis, the program has averaged 47 loans worth $74 million.

Figure 2 summarizes the completed GS $Mart loans since 1996 by equipment category, and Figure 3 summarizes by state agency the total amount financed. The most common equipment purchased with GS $Mart loans is information technology (IT) and telecommunications equipment. The departments in the Health and Human Services Agency are the most frequent users of the program—accounting for more than one-third of loans completed and dollars financed.

Figure 3

State GS $Mart Loans Completed Since 1996

By Agency

Agency	Total Number of Loans	Total Amount of Loans (In Millions)
Attorney General	12	$74.4
Board of Equalization	3	3.0
Business, Transportation and Housing Agency	65	47.2
Department of Education	9	1.1
Environmental Protection Agency	7	1.9
General government departments	18	4.7
Health and Human Services Agency	130	172.3
Higher education	3	1.5
Insurance Commissioner	2	1.2
Judicial Council	1	0.7
Lottery Commission	1	34.4
Resources Agency	4	9.3
Secretary of State	1	0.5
State and Consumer Services Agency	52	132.1
State Controller	7	4.2
Youth and Adult Correctional Agency	18	32.4
Totals	**333**	**$520.9**

COMPONENTS OF A PUBLIC FINANCING PROGRAM

In our view, a sound public financing program should include several components designed to manage the financial risk posed by governmental financing:

- *Statutory authority* that designates legal authority and defines the roles and responsibilities to administer and operate the program.
- *Fiscal controls* consistent with state law and government budgetary practices.
- *Financing practices* that minimize the risk of governmental debt.
- *Program operation* that enforces compliance with laws and regulations while meeting program objectives within allocated resources.

SIGNIFICANT DEFICIENCIES FOUND IN GS $MART PROGRAM

We used the components discussed above to assess the GS $Mart Program's ability to properly operate, administer, and obligate state funds. In our review, we found that DGS demonstrated initiative in developing an innovative program for financing state equipment purchases. We found that the greatest benefits of the GS $Mart Program are its standardization of financing documents and its streamlined approach to loan preparation. In addition, we found that the GS $Mart Program enjoys good working relationships with departments, local governments, and the financing industry.

The GS $Mart Program, however, suffers from significant deficiencies. Specifically, as we discuss below, the program lacks statutory authority, operates without proper fiscal controls, fails to include some advised financing practices, and does not enforce its own policies.

Statutory Authority

No Explicit Authority to Operate Program. DGS states that it has statutory authority to operate the GS $Mart Program due to Public Contract Code Sections 12120 and 12101.5. These sections, however, only authorize DGS to conduct IT equipment procurements and create master award schedules. In our review, we were unable to find any statute which specifically creates the GS $Mart Program or authorizes DGS to operate a financing program for equipment purchases.

Unclear Roles and Responsibilities. Since there is no statutory authority for the GS $Mart Program, the program lacks well-defined roles and responsibilities. For example, the State Treasurer's Office (STO) in its role as the state's public financing authority is required by Government Code Section 5700 to conduct lease-purchase agreements over $10 million. The DGS has completed 12 loans over $10 million for a total of $250 million. The department informally notifies STO of the loans only *after* they have been completed. This section is, however, somewhat unclear whether it pertains to equipment lease purchases or other types of government leases.

Fiscal Controls

No Oversight Provided by Department of Finance, STO, or Legislature. The Department of Finance (DOF) is responsible for establishing budgetary controls and developing the state budget. The STO is responsible for public financing and reviewing the state's indebtedness. Yet during our review, we could not find any program requirement that GS $Mart loans be reviewed or approved by DOF or STO. In addition, DGS does not notify the Legislature of GS $Mart loans.

Since no budgetary oversight is provided for the GS $Mart Program by DOF, it is unclear if departments have baseline budget capacity to meet the future financial obligations imposed by these loans. For example, the Stephen P. Teale Data Center (TDC) entered into four GS $Mart loans during 2001-02 totaling $1.2 million for IT equipment and software to support the California Home Page. These loans were not authorized by DOF or the Legislature, and the loans contributed to a deficiency in the year after the purchase.

Legislature May Not Know When GS $Mart Financing Is Used. In our review of completed GS $Mart loans, we found that some of the loans were related to budget requests approved by the Legislature. In reviewing those budget requests, we found that departments did not always clearly identify proposed financing. For example, in the *2002-03 Budget Act*, the Legislature approved a $878,000 request by Franchise Tax Broad (FTB) to replace obsolete computer equipment. According to FTB, the request included funding for a GS $Mart loan to purchase the equipment over two years. The request, however, did not provide information on the proposed financing nor did it clearly state that the total estimated equipment cost was $1.2 million. The Legislature, therefore, was not fully informed about what FTB was proposing.

In addition, most GS $Mart loans have been finalized without prior legislative knowledge or review. Because financing can have some effect on the state's credit rating, the Legislature should have a role in monitoring the loans. For example, the administration, without prior legislative review, entered into a $52 million GS $Mart loan to finance the Oracle Enterprise License Agreement (ELA). Several months after the loan was completed, the Legislature directed the administration to terminate the ELA. To accomplish this, however, the state also had to terminate the loan. The termination had to be completed prior to the first loan payment to avoid the loan going into default and potentially affecting the state's credit rating.

Financing Practices

Financing Software Development Jeopardizes Contractual Protections. Most state IT contracts contain a number of contractual provisions designed to protect the state in the event of nonperformance by the contractor. When financing is used to fund state IT contracts, the loan provisions may override some provisions in the state IT contract. For example, the Oracle ELA contract included a "term of convenience" provision that would have allowed the state to terminate the ELA at any time. This provision, however, was nullified because a GS $Mart loan was used to finance the ELA and loan agreements cannot be terminated for convenience.

State Finances Nontangible Assets. Lenders provide their best interest rates on tangible assets because the asset can be easily repossessed in the event of a nonpayment. For nontangible assets (such as software licenses and software development projects), lenders may (1) require changes to the standard financing contract and (2) increase interest rates and costs in order to protect their financial investment. The GS $Mart Program does not restrict the types of assets that the state finances. For example, the GS $Mart Program has completed 21 loans for a total of $192.5 million for nontangible assets. In our view, financing nontangible assets through the GS $Mart Program is not advisable because (1) the standard financing documents must be modified, and (2) the state could lose some contractual protections.

No Requirement to Select Loan With Lowest Interest Rate. When selecting loans, it is generally best to select the loan that has the lowest interest rate. There are occasions, however, when selecting the lowest interest rate is not the best loan alternative. For example, some lenders offer special GS $Mart contract riders for replacing obsolete equipment. If these contract riders are beneficial to the state, the department may select these lenders even though they may not offer the lowest interest rates.

State policy, however, does not require departments to select the lender that best meets the state's needs *and* offers the lowest interest rate. For example, TDC and the Health and Human Services Agency Data Center have on occasion selected lenders with which they have an established relationship or appear to provide better customer service but who have offered higher interest rates. We believe these are not legitimate reasons to select lenders with higher interest rates since any lender approved by the GS $Mart Program should be providing a similar quality of service.

Restriction on Equipment Replacement May Be Unenforceable. The GS $Mart loans include a provision which restricts the state from replacing equipment for one year in any case where the Legislature does not appropriate funds to continue the contract. Courts in other states have found this provision in similar government contracts to be unenforceable because it restricts the ability of state legislatures to make such decisions. Even if the language were found to be enforceable, this contract language limits the Legislature's flexibility in future budget actions.

Program Operation

Departments and Lenders Are Not Required to Sign Financing Contract. To establish legal and fiscal accountability, it is good practice for the state and its contractors to sign the financing contract. Without a signed contract, the state is at risk because there is no signed loan agreement to which the state and lender can refer during disputes. In order to streamline the GS $Mart loan process, DGS does not require departments and lenders to sign a financing contract. Instead, DGS allows the equipment supplier to reference the loan in the equipment purchase order.

DGS Does Not Review Performance of Financing Institutions. On a periodic basis, government procurement programs should review the performance of its contractors to gain customer satisfaction information. Without a formalized contractor evaluation program, it is unclear if the state is receiving quality services from its contractors. The DGS has never reviewed the performance of the GS $Mart lenders and, therefore, it is unknown if problems exist. In addition, DGS states that it does not have the authority to sanction poor performing lenders if problems were uncovered.

DGS Does Not Enforce Current GS $Mart Policies. A public financing program should enforce its policies to ensure compliance with good fiscal practices and state laws and regulations. Without enforcement, policies become meaningless and sound fiscal practices may not be maintained. The DGS has issued a number of policies on the GS $Mart Program, but it seldom enforces its policies in some areas. For example, state policy specifies that departments should not finance equipment under $100,000. We believe this is a reasonable policy because it eliminates financing costs for small purchases. Despite the policy, DGS has completed 46 loans under $100,000 for a total of $2.6 million.

GS $MART PROGRAM NEEDS RESTRUCTURING

We believe that the GS $Mart Program should be maintained because it has (1) reduced interest rates paid on equipment financing, (2) standardized loan processing, and (3) provided equipment-financing options unavailable from other government programs. We believe, however, that the program would benefit from some structural changes aimed at correcting certain deficiencies. For these reasons, we recommend one approach that the Legislature could use to create a statutory framework that restructures the GS $Mart Program. In restructuring the program, our approach reallocates existing resources to accommodate the proposed changes. Figure 4 summarizes our recommendations, which are discussed in more detail below.

Statutory Authority and Fiscal Controls

Designate STO as Lead Agency. Since STO is the state's public financing authority, we recommend that the Legislature provide STO with the legal authority to operate the program. This role is consistent with STO's role for maintaining the state's credit rating, interacting with the financing industry, and reviewing the state's indebtedness. In addition, we recommend that STO be responsible for (1) establishing the lender requirements and (2) reviewing and finalizing the GS $Mart loans after DOF's approval of the loan.

Figure 4

Correcting GS $Mart Deficiencies
LAO Recommendations

State Authority and Fiscal Controls
✓ Designate STO as lead agency.
✓ Define roles and responsibilities of DGS and DOF.
✓ Require budget requests to clearly identify financing.
✓ Require legislative notification for loans over $5 million.
✓ Require annual reporting.
Financing Practices
✓ Restrict GS $Mart loans to equipment purchases.
✓ Require departments to select loan with lowest interest rate.
✓ Eliminate restrictions on equipment replacement.
Program Operation
✓ Require DGS to conduct annual performance reviews.
✓ Direct DGS, DOF, and STO to issue and enforce policies.

Define Roles and Responsibilities of DGS and DOF. We recommend that the Legislature include roles for (1) DGS that use its procurement skills and (2) DOF that use its budget skills. In particular, we recommend that DGS continue its responsibilities for prequalifying lenders and maintaining the lender list and the GS $Mart Web site. We recommend that DOF have the primary responsibility for reviewing proposed loans for effects on the budget and fund reserves. Figure 5 summarizes the recommended roles and responsibilities. The figure shows activities by department for each loan and periodic activities. When appropriate, STO and DOF could delegate some loan activities to DGS and the departments.

Require Budget Requests to Clearly Identify Financing. We recommend that the Legislature require that department budget proposals clearly identify any financing included in the request. In addition, the budget request should include total financing costs with the estimated interest rates and payment schedules.

Require Legislative Notification for Loans Over $5 Million. We recommend that the Legislature require the administration to provide legislative notification prior to completing loans over $5 million. We believe this would provide additional oversight on large financing agreements.

Require Annual Reporting. In addition to clearly identifying financing in proposed budget augmentations, we recommend that the Legislature also direct STO, with assistance from DOF, to provide an annual report identifying all current GS $Mart loans. The report should provide information on each GS $Mart loan including (1) the department which has the loan, (2) the loan amount, (3) the interest rate, (4) the purpose of the loan, (5) the amount outstand-

Figure 5

**GS $Mart Program's Roles and Responsibilities
LAO Recommendations**

STO Financing Role	DGS Procurement Role	DOF Budget Oversight Role
Loan Specific Activities		
• Review pre-approved loans' impact on credit rating and financial activities. • Review selected interest rate and finance costs. • Review appropriateness of financing approach. • Finalize loan package.	• Perform legal review on equipment procurement.	• Review financing information included in budget requests. • Review proposed loans' effects on budget and fund sources.
Periodic Program Activities		
• Establish lender specifications. • Advise DOF and departments on financing options. • Report annually on outstanding loans. • Issue financing policies.	• Prequalify lenders. • Maintain lender list. • Conduct annual performance reviews of lenders. • Sanction poor performing lenders. • Issue procurement policies.	• Assist STO in annual reporting. • Issue budget policies.

ing, and (6) the last payment date. This information would allow the Legislature to know which departments have outstanding loans, the purpose of the loans, and the extent of the state's GS $Mart financing.

Financing Practices

Restrict GS $Mart Loans to Equipment Purchases. We recommend that the Legislature restrict the use of the GS $Mart Program solely to equipment. As discussed earlier, the GS $Mart Program is not well suited for the financing of nontangible assets such as software licenses and software development projects. Financing nontangible assets can be provided by other financing options available through DGS or STO.

Require Departments to Select Loan With Lowest Interest Rate. We recommend that the Legislature require departments to select the loan that meets their needs with the lowest interest rate.

Eliminate Restrictions on Equipment Replacement. We recommend that the Legislature direct DGS to eliminate any GS $Mart contract language that restricts actions of the Legislature when making budget decisions. In particular, the provision restricting the state from replacing equipment for one year should be eliminated.

Program Operation

Require DGS to Conduct Annual Performance Reviews. We recommend that the Legislature require DGS to conduct annual performance reviews of all GS $Mart lenders. In addition, DGS should be given authority to sanction poor performing lenders.

Direct DGS, DOF, and STO to Issue and Enforce Policies. We recommend that the Legislature direct DGS, DOF, and STO to issue and enforce policies for the revised GS $Mart Program. In particular, a policy should be issued requiring departments and lenders to sign the GS $Mart loan agreement. The DGS, DOF, and STO should be held accountable for nonenforcement of issued policies.

CONCLUSION

We found the GS $Mart Program to be an innovative government financing program that provides several benefits to the state. By providing a statutory framework, the Legislature can authorize the GS $Mart Program as an improved option for state agencies to use when financing equipment purchases. The recommended changes would minimize the risk to taxpayer funds used in financing government equipment acquisitions.