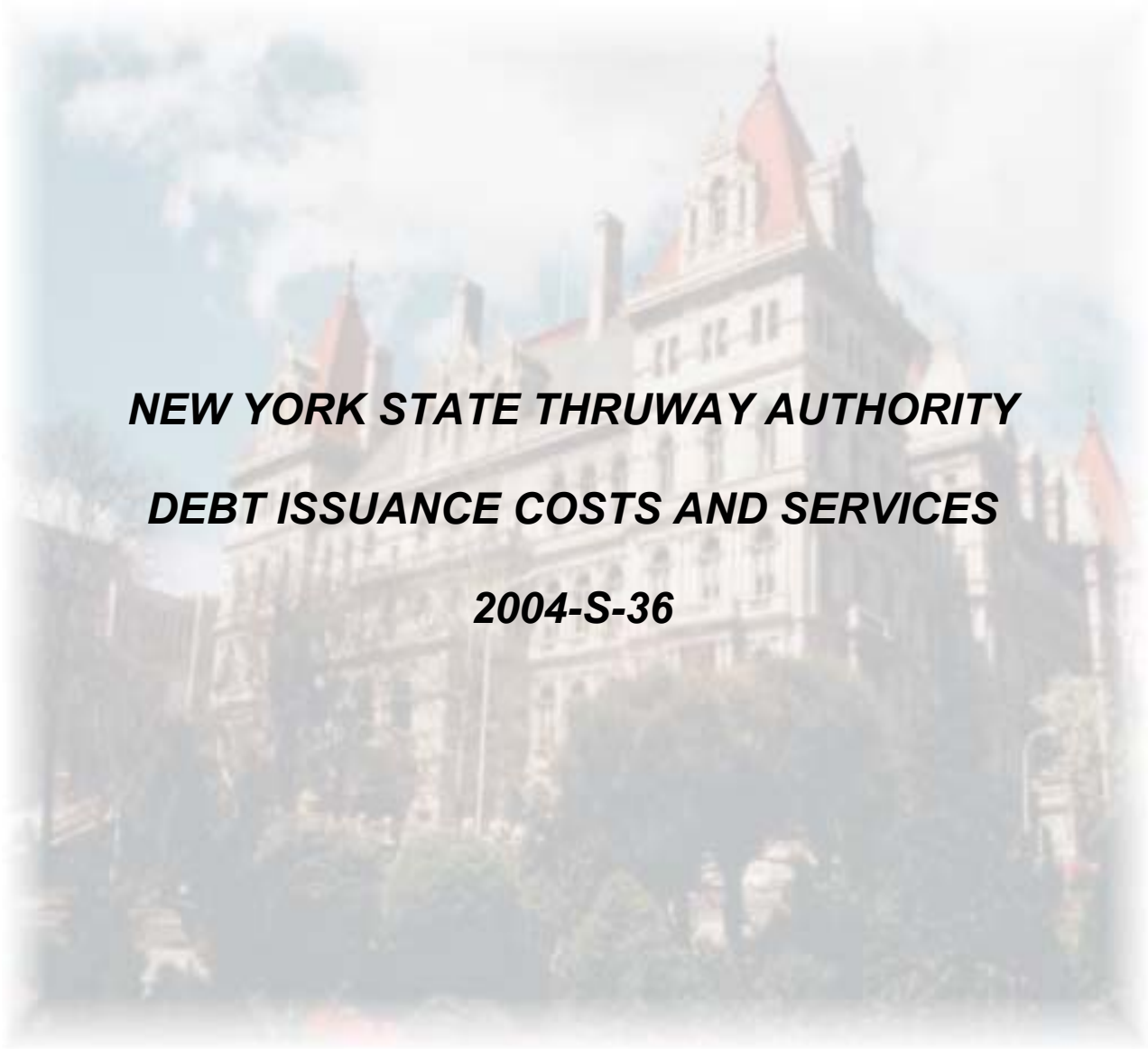
# *A REPORT BY THE NEW YORK STATE OFFICE OF THE STATE COMPTROLLER*

**Alan G. Hevesi**
**COMPTROLLER**



# *NEW YORK STATE THRUWAY AUTHORITY*

# *DEBT ISSUANCE COSTS AND SERVICES*

***2004-S-36***

**DIVISION OF STATE SERVICES**

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**Report 2004-S-36**

John L. Buono
Chairman
New York State Thruway Authority and Canal Corporation
200 Southern Blvd.
Albany, NY 12209

Dear Mr. Buono:

The following is our report on the New York State Thruway Authority's debt issuance costs and services.

We performed this audit pursuant to the State Comptroller's authority as set forth in Article X, Section 5 of the State Constitution. Major contributors to this audit report are listed in Appendix A.

*Office of the State Comptroller*
*Division of State Services*

August 24, 2005

# EXECUTIVE SUMMARY

# NEW YORK STATE THRUWAY AUTHORITY DEBT ISSUANCE COSTS AND SERVICES

## SCOPE OF AUDIT

The New York State Thruway Authority (Authority) was established in 1950 by the Public Authorities Law to construct and operate the State's Thruway system. The Authority, which is managed by an Executive Director and governed by a three-member Board of Trustees (Board), is authorized to issue negotiable debt to finance Authority capital projects and other State transportation projects. Debt sales require certain professional services, including those of underwriters, who purchase the debt and re-sell it in the market for a commission. The Authority can use either the competitive or the negotiated method to sell its debt. In a competitive sale, the Office of the State Comptroller would conduct the sale and award the debt to the underwriter who submits the lowest bid; in a negotiated sale, the Authority contracts with underwriters, pre-qualified through the Authority's Request for Proposal (RFP) process, and negotiates the terms of the debt and the underwriters' commission.

From January 1, 2002 through March 31, 2004, the Authority issued 15 series of debt in 12 debt sales, for a total principal amount of almost $5.8 billion. In issuing this debt, the Authority incurred costs of $82.4 million, comprising the following: $30.6 million for a mandatory State Bond Issuance Fee; $25.2 million for underwriters' commission; $23.3 million for bond insurance; and $3.3 million for costs of issuance. Costs of issuance, which the Authority receives from debt proceeds, cover Authority costs for various services, including bond counsel, financial advisor services and Authority staff time.

For the period January 1, 2002 through July 31, 2004, our audit addressed the following questions about the Authority's debt issuance costs and services:

- Does the Authority follow prescribed policies and procedures in obtaining underwriting and other necessary services, and ensure it obtains these services at the most reasonable cost?

- Has the Authority properly documented and accounted for the actual costs it incurred for debt sale transactions?

- Does the Authority document the basis for its choice of a method (negotiated or competitive) to use for debt sales?

## *AUDIT OBSERVATIONS AND CONCLUSIONS*

The Authority has guidelines for selecting pools of pre-qualified firms for services related to debt issuance, and generally complies with them. However, a few firms managed more of the Authority debt sales and earned a larger portion of the fees than the other firms. Because the Authority did not document how it selected firms from within the pools, Authority officials cannot demonstrate that the selection process is objective and achieves the most reasonable cost. We determined that the Authority properly documented and accounted for the costs of issuance related to a sampled series of debt, but that it did not document its basis for consistently choosing the negotiated sale method for all 12 sales during the audit period.

While the Board has approved, and the Authority follows, guidelines for using an RFP process to identify qualified firms for underwriter, bond counsel and financial advisor services, these guidelines do not describe how the Authority should assign specific debt sale work to firms within the pools, or identify documentation the Authority should keep to support selection decisions. Although Authority officials said they rotate work among firms in the pool, we found a relatively small number of firms manages the majority of Authority debt sales and earns the largest share of the fees. For example, one underwriter served as the "book-runner" (the underwriter responsible for coordinating the sale) on debt sales representing 39 percent and 78 percent, respectively, of the face amount of the bonds and notes sold during our audit period. We recommend the Authority document how it assigns firms to debt sales, both to demonstrate it obtained services at the most reasonable cost, and to avoid the appearance of favoritism in its hiring decisions. We also found the Board has authorized the Executive Director to execute personal service contracts for more than one year for amounts up to $150,000, and has also authorized the Executive Director to approve very significant increases in this amount. While the Board approves such contracts collectively by resolution once a year, we recommend the Board pre-approve such contracts, where feasible, and ratify contracts quarterly so it can exert more control over the costs of personal service contracts. (See pp. 18-23)

Our review of five series of debt sales determined the Authority had properly accounted for and documented the $10.5 million it received to cover issuance costs, including almost $9.5 million the Authority paid in State Bond Issuance Fees for this debt, and about $1 million for issuance costs (e.g., bond counsel and financial advisor services), which we verified to invoices or the Authority's accounting system. Estimated costs of $47,500 for Authority employee time could not be verified since this cost is not tracked per sale. We believe the Authority should measure this in-house cost per sale to determine whether its

estimate is reasonable. We also determined that the Authority's total costs of issuance, as a percentage of principal, were lower than those of two other entities for comparable debt sales. (See pp. 25-28)

Although the Authority used the negotiated sale method for all 12 debt sales, we found that officials do not evaluate the overall costs of using the competitive and negotiated methods, or maintain documentation to support the choice of the negotiated method. To help ensure the lowest costs for every debt sale, we recommend that Authority officials evaluate market conditions and other variables for each issuance to determine the most appropriate sale method. (See pp. 29 - 32)

## *COMMENTS OF AUTHORITY OFFICIALS*

A draft copy of this report was provided to Authority officials for their review and comment. We have considered their comments in preparing this final report.

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# INTRODUCTION

## Background

The New York State Thruway Authority (Authority) is a public benefit corporation established in 1950 by Article 2, Title 9, Section 352 of the Public Authorities Law (Law) to finance, construct, reconstruct, improve, develop, maintain or operate a thruway system, together with incidental facilities for the public. The Authority is managed by an Executive Director who reports to a three-member Board of Trustees (Board). The Authority is responsible for operating the State's 641-mile Thruway system, the longest toll highway system in the United States. The New York State Canal Corporation, a subsidiary public corporation of the Authority, was created by the Legislature in August 1992 to accept jurisdiction and control over the State Canal System from the State.

The Authority's authorizing legislation provides for the ability to issue negotiable debt to finance capital projects for the Thruway and Canal Systems which are secured by tolls, revenues and other Authority earned income. The Authority is also authorized to undertake financing activities for non-Authority transportation projects in the State. These financing activities include authorization to issue the types of debt listed below.

CHIPs Bonds: CHIPs Bonds are Local Highway and Bridge Service Contract Bonds that fund expenditures under these programs: the Consolidated Local Street and Highway Improvement Program (CHIPs); the Municipal Streets and Highway Program; the Suburban Highway Improvement Program; and the Multi-Modal Program. These programs provide funds to municipalities and other project sponsors throughout the State for qualifying capital expenditures for highway, bridge and multi-modal projects.

PIT Bonds: State Personal Income Tax Revenue Bonds (PIT Bonds) provide funding for the programs previously funded by the CHIPs Bonds.

Trust Fund Bonds: Highway and Bridge Trust Fund Bonds (Trust Fund Bonds) are issued to reimburse the State for expenditures that were (or will be) made by the State

Department of Transportation in conjunction with the State's multi-year highway and bridge capital program.

CHIPs, PIT and Trust Fund Bonds are payable solely from payments received by the Authority under contractual agreements with the State, and are issued only at the request and direction of the State Division of the Budget (DOB). When it conducts sales of CHIPs, PIT and Trust Fund bonds on behalf of the State, the Authority receives amounts from the debt proceeds to pay for the costs of issuing the debt.

During the audit period, the Authority performed three to four debt sales per calendar year. The following table (Table 1) summarizes information about the various types of debt issued by the Authority, the Authority's outstanding debt as of December 31, 2003, and debt issuance activity during the period January 2002 to March 2004.

**Table 1: Authority Bond Data**

| Type | Agency Determining Issuance | Statutory Authorized Amount (in millions) | Outstanding Debt As of 12/31/03 (Note 1) (in millions) | ISSUED 1/1/02-3/31/04 | |
|---|---|---|---|---|---|
| | | | | # Of Series | Amount (in millions) |
| General Revenue Bonds | Thruway | No Limit | $1,046.8 | 0 | $0 |
| General Revenue Notes | Thruway | No Limit | 650.0 | 3 | 925.0 |
| CHIPs Bonds | DOB | $3,870.2* | 2,166.8 | 4 | 1,404.0 |
| PIT Bonds | | | 593.6 | 2 | 598.8 |
| Trust Fund Bonds | DOB | $10,250 | 5,459.7 | 6 | 2,839.9 |
| **Total** | | | **$9,916.9** | **15** | **$5,767.7** |

**Note 1**: The source of the data is the Authority's audited financial statements for the year ended 12/31/03.

* The $3.87 billion noted here is the combined authorized amount for both CHIPs and PIT Bonds.

To issue bonds and notes, the Authority contracts with outside professional firms for a variety of services, including underwriter, bond counsel, and financial advisory services; trustee and bond rating services; insurance; and printing. The Authority can use two different methods - competitive or negotiated - to sell debt. Under the competitive sale method, the Office of the State Comptroller (OSC) must ready the debt for issuance and conduct the sale. After underwriters submit their sealed bids to OSC, the lowest bidder is awarded the debt and proceeds to

sell it in the markets. Under the negotiated method, the Authority contracts with underwriters (pre-qualified through an Authority Request for Proposal process) and negotiates the terms of the debt and the underwriters' commission, and the results of both are approved by OSC before the sale is conducted. Underwriters perform many of the administrative tasks needed to ready the debt for sale using the negotiated method. From January 1, 2002 through March 31, 2004, the Authority issued 15 series of debt in 12 debt sales for a total principal amount of almost $5.8 billion. All 12 debt issuances used the negotiated sale method.

The Authority incurred costs of $82.4 million in issuing the above debt, as shown in Table 2.

**Table 2: Authority Debt Issuance Costs**

| Cost Type | Amount (millions) | How Determined |
|---|---|---|
| State Bond Issuance Fee | $30.6 | Bond face value multiplied by the applicable State-approved rate |
| Underwriters' Costs | 25.2 | Various methods |
| Bond Insurance | 23.3 | Underwriter obtains quotes |
| Costs of Issuance | 3.3 | Hourly rates are subject to a cap, or set by contract terms |
| **Total** | **$82.4** | |

Section 2976 of the Law requires public benefit corporations to pay a State Bond Issuance Fee on most bonds, notes or other obligations. During our audit scope, the Authority issued 11 debt obligations, totaling $4.4 billion, which were subject to this fee, and paid related State Bond Issuance Fees totaling $30.6 million.

Underwriters' Costs include components for management fees, underwriting expenses and "takedown." Takedown, the underwriters' commission, is a percentage of the face value for each bond the underwriter commits to sell. Of the $25.2 million the Authority paid for Underwriters' Costs, $21.6 million (86 percent) was attributable to takedown, while $2.4 million and $1.2 million related to underwriting expenses and management fees, respectively. The single largest share of a debt sale's takedown is earned by one underwriter, who is selected from among the group of underwriters selling the bond or note (the underwriting syndicate) to be the "book-runner." The book-runner is the underwriter responsible for the overall structuring

and marketing of the debt issuance and for coordinating the work of the underwriting syndicate.

Bond Insurance guarantees payment of principal and interest on a debt issue if the issuer defaults. Bond insurance may result in a significant interest cost savings depending on the issuer's underlying credit and the market conditions at the time of the sale. The Costs of Issuance, which are estimated at the time of the sale, include the Authority's costs for bond counsel; a financial advisor; bond rating agencies; printing; trustee fees; and Authority staff time.

## *Audit Scope, Objectives and Methodology*

We audited the Authority's debt issuance costs and services for the period January 1, 2002 through July 31, 2004. The objectives of our audit were to determine whether the Authority:

- follows prescribed policies and procedures in obtaining underwriting and other services needed for debt transactions;
- ensures these services are obtained at the most reasonable cost;
- has properly documented and accounted for the actual costs it incurred for debt sale transactions; and
- documents the basis for its choice of a method (negotiated or competitive) to use for debt sales.

To accomplish our objectives, we interviewed Authority officials and reviewed laws, rules and regulations, Authority Board minutes, Authority Board resolutions and the Authority's procurement policies and procedures. We also interviewed officials from the OSC Debt Management Unit, OSC Contracts Unit, and DOB. Further, we interviewed officials from the Public Resources Advisory Group (PRAG), a leading national financial advisory firm. PRAG serves as one of the financial advisors to New York State government entities, including OSC and several of the State's public authorities. We also examined various official statements and other documents related to the approval and sale of the debt, and reviewed Authority procurement records related to obtaining underwriters, bond counsel and financial advisors. We verified that the Authority properly calculated and paid the State Bond Issuance Fee on their debt issuances during the audit period. We also reviewed Cost of Issuance folders maintained by the Authority and reviewed invoices related to the issuance costs and traced invoice

amounts to the Authority's accounting records for a sample of five debt sales. Documentation supporting internal charges applied to the debt issuance costs, such as staff salaries and benefits were also reviewed. In addition, we compared and contrasted the costs of issuance related to two of these sampled debt sales to the issuance costs incurred by two other entities (The Dormitory Authority of the State of New York and the Empire State Development Corporation/Urban Development Corporation) issuing the same type of debt. We also reviewed several publications from financial experts, professional organizations and academic researchers. In addition, we reviewed audit reports prepared by other states' audit groups related to government debt sales.

We conducted our audit in accordance with Generally Accepted Government Auditing Standards. Such standards require that we plan and perform our audit to adequately assess those operations of the Authority that are within our audit scope. Further, these standards require that we understand the Authority's internal control structure and its compliance with those laws, rules and regulations that are relevant to the operations included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. The Office of the State Comptroller also has a role in the oversight of bond sales. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under Generally Accepted Government Auditing Standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

## *Response of Authority Officials to Audit*

A draft copy of this report was provided to Authority officials for their review and formal comment. Their comments have been considered in preparing this final report, and are included as Appendix B. In addition, the State Comptroller's Notes to the Authority's response are included as Appendix C.

Authority officials replied they would consider implementing several of the recommendations and agreed to implement a few recommendations which were process-oriented. They disagreed with the recommendations directed towards improving accountability and documentation of decisions for final selection of a firm and the use of the negotiated method for each debt sale. As indicated in our report, it is important to record these decisions as a means of demonstrating that the actions were in the best interest of the Authority and the public.

Within 90 days of the final release of this report, as required by Section 170 of the Executive Law, the Chairman of the New York State Thruway Authority and Canal Corporation shall report to the Governor, the State Comptroller and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

# PROCUREMENT OF DEBT ISSUANCE SERVICES

Section 2879(1) of the Law requires each public authority to promulgate procurement guidelines, as approved by its Board, which detail the operative policy and instructions for using, awarding, monitoring and reporting of procurement contracts. We found that the Authority has promulgated internal procurement guidelines, and that the Board has approved the guidelines, as required. We determined the Authority generally complies with these guidelines by using a Request for Proposal process to obtain a pool of pre-qualified underwriters, bond counsel and financial advisors.

However, these guidelines do not describe the process the Authority should use to select and hire specific underwriters and bond counsel from the pre-qualified pools to market individual debt sales, or identify the documentation the Authority should keep to support these selection decisions. We found that a relatively small number of firms manages more of the Authority debt sales than the others and, therefore, earns larger fees. For example, one underwriter served as the book-runner on bond and note sales representing 39 percent and 78 percent, respectively, of the face amount of the bonds and notes sold during our audit period. The Authority should document how it selects the firms it hires to sell debt, both to demonstrate that it obtained debt sale services at the most reasonable cost, and to avoid the appearance of favoritism in its hiring decisions.

Further, we found that the Board has passed resolutions that authorize the Executive Director to execute personal service contracts for more than one year for amounts up to $150,000, and contract increases up to $150,000 for any previously approved contract without Board approval. While the Board approves such contracts collectively when it ratifies the Annual Contract Procurement Report, we believe the Board should pre-approve these service contracts, where feasible, and formally ratify contracts quarterly to exert more control over the costs of personal service contracts.

## *The Request for Proposal Process*

The Authority is required to follow Board-approved guidelines in obtaining qualified professional services for debt issuance at the most reasonable cost. To accomplish this goal, the Authority issues a Request for Proposal (RFP) for underwriting, bond counsel and financial advisory services to establish pre-qualified pools of firms that can provide the services when needed. For bond rating services, the Authority negotiates with two of the three rating agencies, and then pays the fees established by those agencies. The book-runner collects bond insurance quotes when structuring the bond transaction, and does a cost-benefit analysis to help the Authority determine, prior to the sale, whether bond insurance should be purchased.

Underwriting, bond counsel and financial advisor firms all submit proposals in response to the Authority's RFP for services. An in-house Evaluation Committee reviews and scores these submissions based on established criteria (e.g., the firm's experience, financial strength, and past performance on Authority debt issuance), and firms are selected based on their evaluations. The Executive Director approves the firms recommended for selection, and the Board approves the selections by resolution.

For underwriters, the RFP process results in three pre-qualified pools of firms: the senior pool (from which the book-runner is selected), the co-senior pool and the co-manager pool. As noted earlier, the book-runner structures the debt sale, coordinates marketing efforts and earns most of the takedown. The co-senior and co-manager underwriters market the debt to ensure a broad distribution of the bonds or notes in the debt market. The book-runner, co-senior and co-manager underwriters, as well as any other underwriting firms used to sell the debt, together comprise the underwriting syndicate for the sale. When the Authority plans a sale, it hires underwriters to serve in the above capacities from the pre-qualified pools. For the period January 1, 2003 to December 31, 2006, the Authority has assigned six firms to the senior pool, four firms to the co-senior pool and 17 firms to the co-manager pool. Although each sale has only one book-runner, it usually has two or three co-seniors, and six or seven co-manager underwriters. The Authority negotiates underwriters' fees with the contracted firms.

For bond counsel, the Authority issues one RFP for general bond counsel to provide legal services related to all Authority

debt sales, and another RFP for special bond counsel to provide legal services for State debt sales. For the period January 1, 2000 to December 31, 2004, six firms were selected for the pre-qualified pool of special bond counsel, and one of these six firms was selected to serve as general bond counsel during the same period. Both types of bond counsel are paid a fixed hourly rate up to a fee cap.

The Authority also uses the RFP process to select a financial advisor, who serves for a three-year period. A financial advisor provides numerous services, including monitoring bond-related data (such as credit ratings and proposed interest rates). The Authority established a pre-qualified pool of three financial advisory firms for the period January 1, 2000 to December 31, 2002. However, for the current three-year period (January 1, 2003 to December 31, 2005), Authority officials said they selected a single financial advisor to work on all bond sales for the period to provide for better continuity between the various bond issues.

In 2001, the Authority's Internal Audit unit reviewed the procurement of underwriters and found that it was in compliance with Authority guidelines. Our own review of procurement files for underwriting, bond counsel and financial advisor services also shows the Authority generally complies with its procurement guidelines by using the RFP process to select firms.

We found that two firms selected for the co-senior underwriter pool had lower scores than another two firms that were not selected for the co-senior pool. The two firms selected were a local firm and the top-scoring minority firm. Authority officials explained they selected these firms for the co-senior pool to allow these firms to obtain more experience, and to expand the pool of firms from which future selections could be made. However, the Authority did not document its reasons for choosing lower-scoring firms over higher-scoring firms in this instance. Further, while the Board had properly approved (by resolution) underwriter selections for the senior and co-senior pools, there was no evidence the Board had approved the selection of firms for the co-manager pool. Authority officials should fully document the reasons for exceptions to the procurement guidelines for the RFP process so they can support the basis for such decisions. The Board should also approve all the firms recommended for pre-qualified pools.

## *Assignment of Firms to Debt Sales*

When a debt sale is planned, the Executive Director forwards selections made from the pools of pre-qualified underwriters and counsel to the Board Chairman for approval. Subsequently, the Board approves, by resolution, the sale of the debt to selected underwriters, the selection of bond counsel, and the form of other documents needed to complete the sale. The Authority contracts with underwriters to buy the debt, and with special bond counsel (as necessary) to perform bond-related legal services. Authority officials stated their objective in assigning underwriters and special bond counsel (as well as financial advisors prior to January 2003) is to rotate the work among pool members. Officials said assignments of underwriters are also intended to ensure the syndicate has the mix of underwriters needed to broadly distribute the debt in the institutional market (e.g., mutual funds and pension funds) and the retail market (individual investors). However, the Authority does not have written procedures for assigning firms from the pre-qualified pools to each debt sale. Further, officials said they have no documentation of why particular underwriters and special bond counsel were assigned to individual sales. When we analyzed assignments during our audit period, we found that certain firms received more assignments than others. We also found discrepancies in allotment tables officials can use to confirm a broad distribution of bonds within the syndicate.

To perform our analyses, we examined the nine bond transactions (12 series of bonds) and three note transactions that occurred between January 1, 2002 and March 31, 2004 to determine whether the Authority effectively rotated its selections. During calendar 2002, (the only year in our scope period when more than one financial advisor firm could be selected), we concluded that the Authority distributed financial advisor work evenly among the three pre-qualified firms. Authority officials stated that the work of special bond counsel was also rotated among all the pre-qualified firms. (There were initially six firms in the special bond counsel pool, but one firm withdrew from the pool.) However, we noted that one firm, which also serves as general bond counsel and worked on all three note sales, was assigned special counsel work on 3 of the 9 bond issuances, representing 33 percent of the total number of bond issuances, and 34 percent of the face amount of the bond issuances. Since the Authority did not evenly rotate its special bond counsel assignments, or document the basis for its

assignment decisions, these decisions risk the appearance of favoritism.

(Responding to our draft report, Authority officials claimed that two of the three bond issuances that this firm was selected for were very complex and the firm was found to be the most capable.) However, there was no contemporaneous documentation to support the decisions when they were made. As a result, it is not possible to determine what factors actually entered into the selection.

We also examined the distribution of underwriter assignments among members of the three pre-qualified pools. We found that co-senior and the co-manager underwriter work was evenly rotated among the firms. However, one firm received more work as book-runner - the most lucrative position in the syndicate - than other firms in the senior pool during our audit period. This firm was book-runner on sales representing 39 percent of the face amount of the bonds issued, and 78 percent of the face amount of the notes issued. Specifically, this firm:

- was book-runner for three of the nine bond sales and all note transactions that occurred during our audit period;
- served as co-senior on two other bond issuances and as co-manager on one bond issuance that occurred between January 1, 2002 and March 31, 2004; and
- was paid $403,500 (35 percent) of the $1,148,500 in management fees related to debt sales for the audit period.

Of the remaining five underwriters in the senior pool, three firms were each assigned book-runner responsibilities for one sale, and the other two firms received no book-runner assignments. Therefore, the Authority did not meet its objective of evenly distributing the book-runner work for the sales in our audit period. To meet this objective, the Authority needs to develop guidelines requiring the selection of firms in the pre-qualified pools of underwriters, and to document how assignment decisions are made.

Another stated Authority objective of the assignment process is to achieve the broadest possible distribution of the debt in the market. Our review of underwriter assignments for sales during our audit period found that the selection of syndicates appeared to provide for an underwriter mix to cover both institutional and retail markets. However, when we examined data in Final

Pricing Books, which the Authority uses to determine if its debt is broadly distributed to underwriters, we found this data contained discrepancies. The Authority receives a Final Pricing Book for each debt issuance. These Final Pricing Books, which are prepared by the Authority's financial advisor, contain pricing and marketing information, as well as allotment tables that show the total number of bonds allotted to underwriters in the syndicate. Tables show allotments of bond shares to the book-runner, co-seniors, co-managers, and other underwriting firms in the syndicate. Share allotment information is presented in a summary table (which shows each underwriter's total allotment of bond shares over the bond's life) and also in a maturity table (which shows each underwriter's allotment of bond shares on a year-by-year basis over the bond's life).

Since takedown is a percentage of the bond's face value earned by each firm in the syndicate, Final Pricing Book data, if accurate, could be used to calculate the total takedown (commission) earned by each underwriter. Thus, we should have been able to use the allotment information to determine takedown amounts. However, we could not calculate takedown per firm because there were discrepancies between allotment numbers in the summary table and maturity table data, whose totals should agree. Examples of the discrepancies in two bond sales are shown in Table 3.

**Table 3: Review of Allotment Tables**

| | | Allotments | | | |
|---|---|---|---|---|---|
| **Total Bond Share Allotment** | **Total Takedown (millions)** | **Level** | **Bond Shares Per Summary Table** | **Bond Shares Per Maturity Table** | **Difference** |
| **2002 CHIPs Bonds - $650 million** | | | | | |
| 650,000 | $3.074 | Book-runner | 162,170 | 155,582 | 6,588 |
| | | Total | 650,000 | 625,660 | 24,340 |
| **2002A PIT Bonds $250.9 million** | | | | | |
| 250,915 | $1.2 | Book-runner | 104,298 | 307,893 | (203,595) |
| | | Total | 250,915 | 758,275 | (507,360) |

Authority officials told us they do not need to calculate takedown amounts for their purposes. However, officials maintain that they do use the allotment tables to ensure a broad distribution of the bonds among the syndicate. Given that share allotment data is not reliable, we do not believe officials can use this data to determine how many shares individual underwriters were

actually allotted. Without such data, the Authority cannot demonstrate it is meeting its objective of broad distribution of debt within the syndicate. The Authority should work with its financial advisor to verify the accuracy of Final Pricing Book information.

## *Board Approval of Service Contracts*

According to Section 2879 (3)(b)(ii) of the Law, any contract requiring services rendered for more than one year must be approved by the authority's governing board. Each year at a public meeting, the Authority Board issues a formal ratification that technically approves all service contracts in excess of one year. Authority officials maintain that the annual ratification by the Board meets the requirements of the Law. In our opinion, the Authority's process satisfies the minimum standards in the Law, but it needs improvement to help the Authority achieve fuller compliance with the statute's intent.

In examining the Authority's process for the authorization of contracts, we found that a Board resolution:

- authorizes the Executive Director to execute any personal service contract up to $150,000 that is negotiated in conformance with the Authority's policies;
- authorizes the Executive Director to approve an increase of expenditures (up to $150,000) for any contract or agreement previously approved by the Board; and
- requires that the Executive Director report the executed contracts to the Board quarterly. At an annual meeting, the Board passes a resolution to approve the executed contracts, as listed in the Authority's Annual Contract Procurement Report (Report).

Since Board approval of these contracts is by resolution at the Board's annual meeting, individual contracts may be in effect for nearly a year prior to being ratified by the Board. Further, the Board is simply ratifying contracts management has already executed. In our opinion, the Board should pre-approve the contracts, where feasible; ratification after the fact should be the exception rather than the rule. By pre-approving personal service contracts, the Board can exert control over contracting practices, and improve Authority accountability for contractor selections.

We also found that the language of the Board resolution itself is problematic. The resolution states the Board will approve the Report, rather than specific contracts. However, there are two statutory requirements: the Board must approve the annual procurement contracts report (Section 2879 (6)); and the Board must also approve, by resolution, individual service contracts in effect longer than one year (Section 2879 (3)(b)(ii)). To better meet these two distinct requirements, the Board should approve the annual report, and also pre-approve individual contracts in effect for more than one year.

We reviewed contracts for various bond-issuance services, and found that the current Board authorization process is a pro forma exercise that appears to have little effect on personal service contract decisions or costs. In our review of contracts for special bond counsel services, the Board passed by resolution, the selection of six firms and authorized the Executive Director to execute contracts for these services. However, the resolution did not specify contract amounts. The following examples illustrate the lack of approval of several personal service contract increases by the Board:

- The Board approved, by resolution, the selection of a financial advisor, and authorized the Executive Director to execute an agreement with this firm without specifying a contract amount. According to the Report, as of December 31, 2003, the value of this contract is $1.18 million. However, we found no Board resolution authorizing the Executive Director to increase the value of this contract by more than an additional $150,000.

- In January 2000, the Board passed, by resolution, the selection of special bond counsel firms and authorized the Executive Director to execute contracts with the firms. Again, the resolution did not specify a contract amount. According to the Report as of December 31, 2003, the Authority still has five contracts with four of these firms (one firm is also general bond counsel). For one contract, we noted that the Board properly passed a subsequent resolution authorizing the Executive Director to increase the amount of the contract to $375,000. However, we found no Board resolutions authorizing the Executive Director to increase the value of the remaining four contracts by more than an additional $150,000.

We requested a legal opinion from Authority officials as to how their policies and procedures were in compliance with the Law. However, we have not received a legal opinion in support of the Authority's current practices related to approval of service contracts exceeding one year in duration in the amount of $150,000 and less. In a subsequent meeting with Authority officials, they stated their processes are in compliance with the Law.

## Recommendations

1. Develop written procedures that outline the criteria to be used when assigning underwriters and bond counsel to each debt issuance. Similar written procedures should be developed in the event that more than one financial advisor is used in the future.

2. Document the reasons why particular firms were assigned to work on each debt issuance.

3. Periodically verify the accuracy of the Final Pricing Book allotment tables.

4. Revise current procedures for obtaining Board approval of service contracts that exceed one year and are valued at $150,000 or less. Ensure the Executive Director obtains Board approval for increasing contracts by amounts greater than $150,000.

   (In response to the draft report Authority officials indicate that their legal staff has worked with OSC legal staff in an attempt to resolve differences in interpretation of the relevant laws. However, a resolution had not been reached at the time this report was issued.)

5. Improve Authority accountability for contractor selections, by obtaining Board pre-approval of contracts whenever feasible, and ratify contracts by formal resolution at least quarterly rather than annually.

# COSTS OF DEBT ISSUANCE

We judgmentally selected a sample of five series of debt sales for which the Authority had received $10,523,836 to pay the costs of issuance, including $9,496,945 (which totals $21, 206 more than was required) to pay the mandatory State Bond Issuance Fee and $1,026,891 to pay the remaining costs of issuance. We verified that the Authority correctly calculated and paid the State Bond Issuance Fee related to all debt issued during our audit period, including the above five sales, and that the Authority used cost of issuance proceeds for only appropriate costs. We also found the Authority's total costs of issuance, as a percentage of principal, were lower than those of two other entities for comparable debt sales. We were able to verify virtually all the Authority's actual costs of issuance to invoices or the Authority's accounting system. However, we found the Authority could improve oversight of certain bond-related services to better ensure it receives the services specified in contracts at agreed upon hourly rates. In addition, the Authority should track the time employees spend on individual debt sales to help ensure it correctly estimates issuer costs.

## *State Bond Issuance Fees and Contract Services Costs*

The costs associated with the sale of debt include fees for: underwriter services, financial advisory services; bond counsel; trustee services and trustee counsel; financial printing; bookbinding; bond rating services; issuer expenses; and a mandatory State Bond Issuance Fee on certain debt sales. Some costs are deducted directly out of the debt sale proceeds, such as underwriters' costs (management fees, takedown and expenses) and bond insurance, while other costs are paid by the Authority.

At the time of each debt sale, the Authority receives a cost of issuance amount from the bond proceeds to pay costs related to the Authority expenses other than underwriters' costs and bond insurance costs. This cost of issuance amount is an estimated amount, which is deposited into an administrative account set up for each debt program. According to provisions in the Internal Revenue Code, any funds that remain in the

administrative account after issuance costs are paid can be used by the Authority to pay the ongoing costs of administering the related debt program (e.g., PIT bonds), or to offset amounts requested from the State to make debt service payments.

The Authority sets up a cost of issuance folder for each debt sale, which includes a schedule of the estimated costs received from the debt proceeds, the actual costs paid and copies of invoices. We judgmentally selected a sample of 5 (four bonds and one note) of the 15 series of debt issued during our audit period. We selected our sample to include a mix of debt issued under different bond programs and with similar principal amounts.

We reviewed the Authority's cost of issuance folders (folders) for which the Authority's estimated costs of issuance totaled $10,523,836. We verified that the Authority paid the required State Bond Issuance Fee charges of $9,475,739, for the five sample debt sales as well as the amounts due on the remaining six debt series subject to the fee during our audit period.

In verifying payment of the remaining $1,026,891 in estimated costs of issuance, we found that, as of September 24, 2004, the Authority had paid only $833,681 of this amount, with a number of charges still outstanding. We verified essentially all the $833,681 in actual costs, per the folders, to either the Authority's accounting system or invoices. We verified $778,128 (93.3 percent) to both invoices and the Authority's accounting system, and another $54,556 (6.5 percent) to unpaid invoices. We could not verify $997 (0.2 percent) because adjustments were made to the two invoices in question.

During our review of invoices, we noted that some bond counsel and financial advisor contracts specify the individuals and/or employee titles that are to work on the contract. However, for two invoices (one from the financial advisor and the other from bond counsel), the personnel working on the debt issuance were not the personnel that were specified in the contracts. Authority officials explained this occurrence by stating that firm personnel changes may require substitutions. However, since the Authority apparently believed it was important enough to specify the services of certain individuals in its contract, Authority officials should make sure the contractor complies with these terms. We also found that another invoice from the financial advisor billed an hourly rate for two employees that exceeded the rate specified in the contract, resulting in a

relatively small overpayment ($463). The Authority should periodically monitor invoices to verify that services are reimbursed at the contracted hourly rate. Authority officials told us that in the future they will ensure that they document personnel or title changes from those in the contract.

## *Issuer Expenses*

One of the components of the Authority's cost of issuance is issuer expense. Issuer expense includes the time Authority employees spend on debt issuances, plus an applicable amount for benefits and overhead. The Authority's Accounting Department periodically calculates the amount needed to reimburse the Authority from the administrative account for each bond program. For the five series of debt sales we reviewed, the Authority estimated its costs to be $47,500.

When we attempted to verify these in-house expenses, however, we found the Authority does not record the amount of time Authority employees spend on each sale in the folders. Instead, Authority employees record the actual time they spend on debt sales on behalf of the State on their time sheet. Since time sheets break down employees' time by debt program rather than by specific debt sale, it is not possible to determine the Authority's actual issuer expense per debt sale. Authority officials agreed that it would be useful to determine the reasonableness of the issuer expenses but have not done so due to work load issues. They add that they are in the process of adding a position which should allow them to perform this function.

## *Comparison of Authority Issuance Costs to Those of Other Authorities*

To determine how the Authority's cost of issuance compared to those of other entities, we compared Authority debt to the debt issued under the same program with similar principal amounts by the Dormitory Authority of the State of New York (DASNY) and Empire State Development Corporation/Urban Development Corporation (ESDC/UDC). We used the estimated costs of issuance that authorities must provide to OSC on debt issuance approval request forms. Table 4 shows two comparisons of debt issuances, including respective principal amounts, combined underwriters' costs and costs of issuance, and what these costs represent as a percentage of

the principal amount. Bond insurance was excluded because it was not obtained for all sales. In addition, we compared the amount of the underwriters' costs per bond or note, and the reported true interest cost for each debt. True interest cost is the interest rate that equates the present value of debt proceeds and interest and principal payments on the debt. According to municipal finance literature, true interest cost is a widely used means of measuring the effective cost of a bond issue.

**Table 4: Comparative Costs of Issuance**

| Authority | Principal Amount (millions) | Combined Underwriters' Costs/Costs of Issuance | | Underwriters' Costs per $1,000 of Debt | True Interest Cost as a Percentage |
|---|---|---|---|---|---|
| | | Total | As a Percentage of Principal | | |
| **Comparison 1** | | | | | |
| Thruway | $250.9 | $3.32 | 1.32% | $5.46 | 4.53% |
| DASNY | $102.3 | $1.46 | 1.43% | $6.06 | 4.04% |
| | | | | | |
| **Comparison 2** | | | | | |
| Thruway | $347.9 | $4.45 | 1.28% | $5.21 | 4.13% |
| ESDC/UDC | $491.0 | $8.58 | 1.75% | $5.06 | 4.53% |

As shown in Table 4, the Authority's cost of issuance/underwriters' costs as a percentage of principal, were lower than those of DASNY and ESDC/UDC in these comparisons. In comparison 2, the underwriters' costs for ESDC/UDC were lower per $1,000 of debt, even though its combined costs were higher than those of the Authority. Moreover, even though an entity paid more in combined costs, it may have obtained a lower interest cost over the life of the debt. In comparing true interest costs, which takes cash inflows and outflows into consideration, we found the true interest costs were relatively consistent for all three entities.

## Recommendations

6. Determine an actual issuer expense amount for each debt sale to evaluate whether estimated expenses are reasonable or should be increased during future debt sales.

7. Verify that personnel listed in the contract actually work on the contract or document approval of changes to personnel listed in the contract.

# NEGOTIATED VERSUS COMPETITIVE ISSUANCE PROCESS

Article 2, Title 9, Section 365(2) of the Law authorizes the Authority to choose the method used to sell its debt instruments, and to make pricing decisions. However, the issuer's goal should be achieving the proper administration of the debt instrument at the lowest possible issuance cost. Although governmental entities can issue debt using either the competitive or the negotiated sale method, we found the Authority used the negotiated sale method for all 12 of its debt issuances during our audit period. While there is no consensus among experts in the field as to which method results in the lowest overall debt issuance costs, there are widely recognized guidelines that list conditions that might favor using one method over the other. However, the Authority lacks policies and procedures requiring an evaluation of conditions for each debt issuance to determine the most appropriate method to use. Thus, the Authority does not have assurance that its debt is consistently issued at the lowest possible cost.

According to academic research and industry sources, competitive and negotiated sale methods differ in a number of ways. In a competitive sale, the issuer conducts all of the tasks necessary to offer the debt for sale. In the case of Authority debt, these tasks would fall to OSC, since Section 365(2) of the Law requires OSC to issue Authority bonds sold at a competitive sale. Issuer tasks include structuring the maturity schedule; preparing the official statement; verifying legal documents; obtaining debt ratings; securing credit enhancement, if advantageous; and timing the sale. These tasks are done with the assistance of a financial advisor. Underwriting syndicates submit closed bids to the issuer, and the debt is awarded to the syndicate with the best bid, as measured by the lowest true interest cost. The winning underwriting syndicate then markets the debt. No structural aspects of the debt are changed, regardless of the success or failure of the syndicate sales efforts, and any unsold debt remains the responsibility of the syndicate. The competitive method allows the issuer to avoid allegations of preferential

treatment; have the market set bid prices; and get broad exposure to underwriters across the market.

A negotiated sale differs from the competitive sale method in the way the underwriter is selected and paid, the way the debt is marketed, and the process for determining interest rates. According to officials from OSC's Debt Management Unit, negotiated sales are the primary method the State's public authorities use to sell debt. In a negotiated sale, the underwriters are selected first, and then the issuer and the underwriters negotiate the interest costs and other terms of the debt instrument, including underwriter compensation. The underwriters perform most of the administrative activities of the sale and often engage in pre-sale marketing activities. With the negotiated method, the issuer can benefit from significant pre-sale marketing and can restructure aspects of the debt once the contract with the underwriter is signed.

Although both the competitive and negotiated sale methods are used in bringing municipal bonds to market, there is currently disagreement in the industry regarding which types of sale results in the lowest costs. Proponents of the competitive method argue that it results in lower interest costs, since underwriters have an incentive to offer lower interest rates so they can win the contract to sell the debt. Competitive sales may also result in lower issuance costs. Proponents of negotiated sales argue that negotiated sales may result in lower interest costs and issuance costs because the syndicate often engages in significant pre-marketing efforts. They also argue that using a competitive underwriter selection process (such as the Authority's RFP process for obtaining pre-qualified pools) can also result in lower issuance costs. The Government Finance Officers Association (GFOA) recommends that issuers using the negotiated sale method strive for the best balance between the yield for each maturity and the takedown to achieve the lowest overall cost of financing.

The GFOA also recommends that the competitive method be chosen when the issuance environment includes a number of conditions, including all those listed below.

- The market is familiar with the issuer, and the issuer is a stable and regular borrower in the public market.
- The debt has a credit rating of "A" or above, or bond insurance can enhance credit prior to the sale.

- The sale is appropriately sized to be easily absorbed by the market.
- Interest rates are stable, market demand is strong, and the market is able to absorb a reasonable amount of buying or selling at reasonable price changes.

Officials from the Public Resources Advisory Group (PRAG), a leading financial advisory firm that serves the State and several public authorities, stated that a negotiated sale may be preferable if even one of a number of factors exists. Some of these factors that favor the negotiated sale method include:

- The credit for the debt is complex and requires an explanation of the debt issue's structure.
- The issuer wants to reward firms whose innovative ideas result in a lower borrowing costs.
- The capital markets are volatile with wide shifts in interest rates and investor demand.
- Retail is an important factor in the market. (Retail investors are generally willing to buy lower-yield bonds because they want tax exempt investments.)

Officials from PRAG and from OSC's Debt Management Unit state that some of these factors currently exist, such as a volatile capital market and an important retail market.

The GFOA has also developed a set of recommended best practices related to municipal debt issuance. It recognizes there are divergent views about the relative merits of the competitive and negotiated methods due to the lack of comprehensive, empirical evidence that would favor one method over the other. Therefore, the GFOA recommends that governments adopt policies "to ensure that the most appropriate method of sale is selected in light of financial, market, and transaction-specific and issuer-related conditions; the method of sale is evaluated for each bond issue, including an assessment of the different risks associated with each method; and thorough records are kept about the process to demonstrate that it was equitable and defensible."

All 12 Authority debt issuances sold between January 1, 2002 and March 31, 2004 were sold using the negotiated sale method. However, the Authority lacks policies and procedures that require an evaluation of debt issuance costs, and does not maintain documentation to show that the negotiated method

was the appropriate choice. Authority officials believe that negotiated method results in the lowest cost of capital for a number of reasons such as: it provides greater flexibility in reacting to current market conditions, allows for retail participation which is important to the pricing process, fosters minority firm participation, and its sales are usually very large for the market to absorb which is suited to the negotiated method. The Authority believes it is not appropriate to require a formal determination for each sale because they stated that the aforementioned conditions do not change. However, such reasons should be documented and provided to the Board for review for each sale to create a record of the conditions at that time as noted by the GFOA best practices.

## Recommendations

8. Develop written policies and procedures for the Board's approval that require the method of sale be evaluated for each debt issuance transaction to determine the most appropriate method.

9. Document and quantify the financial, market and transaction-specific and issuer-related conditions that support management's choice of sales method and document the assessment of risks associated with each method. This document should be submitted to the Board for review and approval by resolution.

   (In response to our draft report, Authority officials disagreed with Recommendations 8 and 9 because they have determined that negotiated sales are in the best interest of the Authority and results in the lowest cost of capital for several reasons. They added that these reasons do not change from one bond issuance to another, and therefore, they will not take any action.)

   Auditor's Comments: Regardless of the method used for a sale, Authority officials need to document the reasons for each bond sale in official records for purposes of public accountability and disclosure of the use of public monies. In addition, officials should not conclude that there is no opportunity for another method to yield better results because the reasons could change over the long term.

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January 26, 2005

Ms. Carmen Maldonado
Audit Director
Office of the State Comptroller
Division of State Services
State Audit Bureau
123 William Street – 21st Floor
New York, NY 10038

Re: A Report by the New York State Office of the State Comptroller, "New York State Thruway Authority, Debt Issuance Costs and Services, 2004-S-36."

Dear Ms. Maldonado:

On behalf of Chairman Buono, the Thruway Authority ("Authority") submits the following response with respect to the recommendations made as part of the Office of State Comptroller's ("OSC") review of the Authority's debt issuance practices.

The Authority is pleased that OSC has found that our debt issuance practices comply with both the Authority's guidelines and controlling statutory requirements, that the total costs of issuance were lower than other entities in the OSC control group, and that there is proper accounting for debt issuance expenditures. While the audit does include a few valuable recommendations relating to documentation and internal procedures, your overall findings add confirmation that the Authority's current debt issuance policies and procedures are sound.

Your recommendations and the Authority's response are as follows:

1. **Develop written procedures that outline the criteria to be used when assigning underwriters and bond counsel to each debt issuance. Similar written procedures should be developed in the event that more than one financial advisor is used in the future.**

The Authority is willing to consider whether the development of written criteria will assist in the designation of firms for certain debt issues. However, any written criteria established by the Authority would need to be broadly written to give the Authority flexibility and discretion in making its designations. Otherwise, reducing the designation to a mathematical calculation would not assure a balanced team was available to make sales successful and to minimize issuance costs.

**Department of Finance and Accounts**
**John M. Bryan**
**Chief Financial Officer** **Phone: (518) 436-2820** **Fax: (518) 471-5974**

As with all public authority bond issuances, the Thruway Authority utilizes the services of various professional firms to assist in the marketing of its debt. In order to market the Authority's General Revenue Debt and State Supported Debt[1], underwriters, bond counsel and financial advisor services are required. The firms selected to provide these services are selected through a competitive process undertaken in accordance with guidelines adopted pursuant to the provisions of Section 2879 of the Public Authorities Law and all resulting contracts with selected firms are approved by OSC. Furthermore, the RFP's clearly state that selection does not guarantee that services will be required.

Based on the need for services, the Authority, through a competitive process, has selected a bond counsel and a financial advisor for issuances of its General Revenue debt. These singular designations ensure that the Authority works with one team of professionals to structure Authority debt and provide consistency with its overall financial strategy. As a result, establishing written selection criteria for selecting a bond counsel and financial advisor does not make sense for the issuance of General Revenue Debt.

For State Supported Debt, the Authority has selected, again through a competitive process, a number of bond counsels qualified to provide required services. Contracts, approved by OSC, are executed with each firm following selection. One firm is designated for each transaction from the pool of firms. Since the schedule for the more complex State Supported Debt issuances are set by the Division of the Budget with relatively short notice and narrow time frame in which to go to market, selecting from this pool is necessary to ensure that bond counsel will be available within the required time frame. Since the designations for the State Supported Debt transactions are made from a pool of firms, the Authority will consider establishing written criteria that ensures fairness yet will not hamper the flexibility required to select a bond counsel expeditiously to meet the needs of the State.

The audit also suggests that the lack of written selection criteria in bond counsel selection results in "favoritism." In the audit, OSC reports that one firm was assigned to be special bond counsel on State Supported Debt on three occasions during the audit period, which was 33 percent of the total number of issuances. The audit neglects to state that the remaining transactions were almost evenly spread amongst the other firms in the pool. Authority staff advised OSC that two of the three transactions to which OSC makes reference involved very complex issues concerning: a) the closing of the First General Trust Fund resolution and the

* Note 1

[1] The Authority issues debt on its own behalf in accordance with the General Revenue Bond Resolution adopted by the Authority in August 1992. This "General Revenue Debt" is secured by a pledge of revenues of the Authority, primarily from tolls collected along the Thruway system.

The Authority also issues on behalf of the State of New York, pursuant to various statutory authorizations. These "State Supported Debt" obligations, such as Personal Income Tax (PIT) and Dedicated Highway and Bridge Trust Fund (Trust Fund) Bonds, are secured by a pledge of State revenues.



* See State Comptroller's Notes, page 41

drafting of the Second General Trust Fund resolution to comport with the current debt practices of the State; and b) the issuance of taxable and tax-exempt debt coincident with the execution of the Authority's first interest rate exchange agreement. Both of these transactions were very complex and the firm in question was found to be the most capable at handling these complicated transactions in the aforementioned narrow time frame.

The audit also suggests that the lack of written criteria results in "favoritism" in determining the underwriting team. As an example, the audit states that only one underwriting firm was selected for three of the nine bond deals progressed during the audit period. The Authority selects the book-running firm and co-senior managers from a Board-approved list developed through a competitive selection process that it feels can best handle the transaction at hand, which may involve selecting a firm more frequently than others. Our competitive RFP process made it very clear that no underwriting team is guaranteed equity in transaction involvement and our selection will be merit based. The Authority's current underwriter selection process, as mentioned in your audit, has resulted in the total costs of issuance for Authority transactions being lower than those of other entities you examined in your control group. Nonetheless, the Authority will consider establishing written criteria that will not hinder the flexibility required to select an underwriting team quickly and will ensure that the firm(s) selected meet the needs of the Authority's issuances.

2. **Document the reasons why particular firms were assigned to work on each debt issuance.**

In conjunction with the Authority's consideration of establishing written designation criteria, the Authority will consider taking steps to identify and document the basis behind each assignment.

3. **Periodically verify the accuracy of the Final Pricing Book allotment tables.**

The Authority will take steps to make certain that the Final Pricing Books accurately reflect this information.

4. **Revise current procedures for obtaining Board approval of service contracts that exceed one year and are valued at $150,000 or less. Ensure the Executive Director obtains Board approval for increasing contracts by amounts greater than $150,000.**

OSC requested a legal opinion from the Authority as to how its contracting policies and procedures related to approval of service contracts exceeding one year and amounts greater than $150,000 were in compliance with law. The Authority's General Counsel and Deputy Counsel met with OSC audit staff and the General Counsel had additional conversations with and provided additional information and documentation to OSC legal staff demonstrating that the Authority's practices are within the law. The audit makes no mention of these efforts to resolve

* Note 2

* See State Comptroller's Notes, page 41

the differences in legal interpretation and only states that the legal opinion was never provided. The law is clear that the Authority Board has the authority under the Public Authorities Law to delegate its powers and in this case it has done so. Furthermore the provisions of the Authority's enabling act indicate that the provisions of the enabling act are controlling when inconsistent with the provisions of any other act. The Authority does not believe that OSC has demonstrated that the current Authority policy is outside the bounds of existing law. Nevertheless, the Authority will continue to work with the appropriate staff at OSC to determine if the referenced policies and procedures can be improved.

**5. Improve Authority accountability for contractor selections, by obtaining Board pre-approval of contracts whenever feasible, and ratify contracts by formal resolution at least quarterly rather than annually.**

The Authority feels that the current contracting and contract reporting process ensures sufficient accountability. However, Authority staff will meet with appropriate staff from OSC to determine if these procedures can be improved.

**6. Determine an actual issuer expense amount for each debt sale to evaluate whether estimated expenses are reasonable or should be increased during future debt sales.**

The Authority agrees with this recommendation as it would be useful to determine the reasonableness of the Issuer Expense amounts included in the Cost of Issuance figures. We will make the necessary procedural changes to accomplish this.

**7. Verify that personnel listed in the contract actually work on the contract or document approval of changes to personnel listed in the contract.**

Each RFP for professional services requires that the proposing firm list the members of its staff that will be assigned to engagements pursuant to the contract. In as much as these are multi year contracts, those staff members may change from time to time. The Authority makes every effort to verify the members of the team assigned to the transaction at the earliest possible point in time. In all cases, the Authority does verify prior to payment that all personnel working on the transaction are qualified to work on the assignment and are approved pursuant to the contract.

**8. Develop written policies and procedures for the Board's approval that require the method of sale be evaluated for each debt issuance transaction to determine the most appropriate method.**

The Authority disagrees with this recommendation as it has determined that negotiated sales are in the best interest of the Authority and results in the lowest cost of capital for the following reasons:

* Note 3



* See State Comptroller's Notes, page 41

- Negotiated sales provide greater flexibility in reacting to current market conditions. In the past, the Authority has been able to enter the market earlier than originally planned, and on very short notice, to take advantage of favorable market conditions. This would not have been possible in a competitive transaction;

- Negotiated sales allow for retail participation, which has become an important part of the pricing process. By allowing "retail only" order periods, the Authority has been able to sell as much as 40% of an issue before taking orders from institutional firms. Since retail customers are not as rate sensitive as institutional investors, this has often allowed the Authority to maintain lower bond yields on certain maturities;

- Negotiated sales encourage and foster participation by minority firms. The Authority's syndicate rules allow firms in the selling group, which includes many minority firms, to submit orders without committing their firm's capital. Under a competitive sale, a minority firm would need to bid as part of a syndicate and thus would need to commit the firm's capital to the transaction. Many firms are reluctant to do this as the firm could suffer substantial losses in an adverse market;

- The Authority's bond sales are generally in the $300 to $500 million range, which is generally very large for the market to absorb. In accordance with the GFOA and PRAG information shown in the OSC report, large transactions are best issued on a negotiated basis; and

- New financing ideas sometimes result in a lower cost of capital to the Authority. Pursuant to a negotiated transaction, the Authority can recognize the contributions of firms presenting innovative financing ideas that result in reduced costs of capital. A competitive transaction does not encourage new ideas to be presented to the issuer, rather the competitive transaction focuses solely on the lowest cost at that time.

The above reasons do not change from bond issuance to bond issuance. Therefore, we do not consider it appropriate to require a determination of competitive versus negotiated for every transaction.

**9. Document and quantify the financial, market, and transaction-specific and issuer-related conditions that support management's choice of sales method and document the assessment of risks associated with each method. This document should be submitted to the Board for review and approval by resolution.**

Recommendation #9, in conjunction with Recommendation #8, suggests that a determination and analysis be performed and that it further be approved by the Authority's Board for each transaction. The Authority's reasons for choosing negotiated over competitive sales, as listed in the response to Recommendation #8, do not change from transaction to transaction.

*
*Note 3*

* See State Comptroller's Notes, page 41

Therefore, this Recommendation is neither necessary nor practical. The Board approves the pool of senior underwriting firms and the contracts for bond counsel and financial advisor. These approvals are made within the context of negotiated issuances for the Authority's debt obligation programs.

Thank you for the opportunity to comment on the recommendations contained within your audit. The Authority looks forward to continue working with you and your office and if you have any comments or questions, please feel free to call me at your convenience. I hope this letter finds you well.

Sincerely,

John M. Bryan
Chief Financial Officer

# State Comptroller's Notes

1. Authority officials have told us on several occasions that there are several reasons why some firms receive more business than others. As a result, it should be an easy task for them to document these reasons as a matter of public record regarding the use of public funds. We did not state that favoritism actually occurred in the selection of firms, but rather that the lack of both written criteria and documentation for the selection of firms could result in the appearance of favoritism.

2. We have revised the report to reflect information provided in the Authority's response.

3. Authority officials cite a number of reasons for choosing the negotiated sale method and state that they do not change from one bond sale to another, and therefore disagree with Recommendations 8 and 9. However, it is important to establish a public record of the reasons supporting the method of sale selected for each bond issuance even if, as Authority officials claim, the reasons do not routinely change between bond sales. We do not see this process as perfunctory because it ensures that the Board is kept apprised of the conditions at the time of the sale, creates a permanent record of the Authority's decisions regarding the use of public monies. Such documentation promotes disclosure and transparency of Authority business which helps to improve accountability.