A Financing and Funding Framework for the Financial Information System for California (FI$Cal)

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FI$Cal FINANCING AND FUNDING
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Introduction

The purpose of this paper is to describe a financing and funding framework for the Financial Information System for California (FI$Cal) Project (the Project). For the purposes of this paper:

"Financing" means the method of paying for the *one-time developmental costs* of the Project, whether on a cash (pay-as-you-go) basis, or through a financial structure that allows developmental costs to be spread out and paid over a period of time.

"Funding" refers to *annual costs of the Project* including yearly operations and maintenance costs, as well as developmental costs, whether through pay-as-you-go or annual debt service payments associated with spreading out the developmental costs over time.

Background on the FI$Cal Project

FI$Cal is an information technology project that will enable the state to integrate into a single system its accounting, budgeting, cash management and procurement operations. It will enable the state to eliminate hundreds of independent legacy systems and department-specific applications that now support these internal business operations of the state. These multiple legacy systems generally are already well past their expected useful life. It is increasingly difficult for the state to find trained personnel and contractors to maintain these systems.

In addition, these systems do not "talk" to each other and maintain separate data bases that often contain duplicated or inconsistent data among them. Because of the decentralized and aged nature of the state's business operating systems, managing the state's financial operations is challenging and highly inefficient. In order for policy makers and managers to obtain information providing a statewide perspective on the state's fiscal and procurement activities, a significant manual effort must be undertaken. Such efforts are frequently confronted with data that is dissimilar in nature and challenging to compare and compile in a meaningful way. Because of the way they manage data, these decentralized and antiquated systems cannot provide real time information on the current state of affairs.

FI$Cal will provide the state with a centralized, integrated system for fiscal information that employs standardized data definitions and modernized data management processes. By standardizing business processes, FI$Cal will eliminate or minimize the need for redundant manual input, time-consuming reconciliations, and auxiliary systems and spreadsheets, thus enabling the state to realize ongoing operational savings. These changes will also increase the timeliness and flexibility of data reporting, improve financial management and enhance transparency. In addition, FI$Cal will replace hundreds of legacy systems, technologies, and applications, which are expensive to maintain, and thus enable the state to avoid the multi-billion dollar expense of replacing multiple antiquated fiscal systems in numerous state departments.

One of the less obvious benefits that will result from this standardized approach to the state's common business practices is greater efficiency in the state's workforce planning and training. Standardization of operations across organizations will reduce the state's overall costs of

training and improve productivity, since as persons move from one organization to another in the course of their careers, they do not incur down time and lost productivity to be trained on department-specific procedures and systems.

FI$Cal will use a commercial-off-the-shelf (COTS) enterprise resource planning (ERP) tool to achieve this upgrade of the state's fiscal systems. These COTS products have been widely and successfully deployed for years in both the private and public sectors. They are sophisticated and complex systems built around a standard, general way of doing business that will work for most organizations. However, even the best of these COTS systems will not provide a perfect fit to the way organizations operate their business practices. Consequently, organizations implementing COTS solutions will need to modify business practices to leverage value from replacing their old technology systems with current and modern COTS solutions. If an organization instead tries to customize and modify "out-of-the-box" COTS software to simply mimic the way it handles business processes currently, it will undercut many of the benefits of implementing a COTS solution, reduce the financial benefits, drive up costs of the project and also run the risk of errors and unintended consequences resulting from the customization effort. Nevertheless, a COTS product may not in fact meet all of the business needs of an organization without some modifications, customization or interfaces. Therefore, the goal in deploying one of these products is to minimize risk and cost by limiting modifications to only those that are absolutely essential to meeting the user's business requirements or where modifying business practices is not feasible. Achieving this goal requires the deploying organization to thoroughly evaluate its current business processes to determine whether and how those processes can be changed to meet business needs within the standard features offered in the COTS product. Because of this, COTS ERP projects are often referred to as business transformation, or business re-engineering projects.

California state government will be undergoing this kind of business transformation. Every organization in the Executive Branch will be affected by FI$Cal and will be changing the way it does business related to the financial operations of the state. For organizations that have implemented COTS ERP systems, the usual byproduct of this re-engineering effort is greater operational efficiency solely from identifying ways to eliminate unnecessary steps or instituting different, more effective practices and procedures—whether or not they are directly related to the use of a new system. Presented with the opportunity and challenge to completely rethink their data management needs and operational requirements in the context of converting to a substantially pre-defined system structure, has commonly led implementing organizations to identify and implement more efficient processes.

The FI$Cal Project has adopted a two-stage procurement strategy that has only one precedent in state procurements, but is widely regarded as the best approach for complex information technology projects. Under this approach, in June 2010, FI$Cal let "Stage 1" contracts for all system integrators (SI) of COTS ERP products who met specified minimum qualifications. The role of the SI is to work with the client in implementing a software solution (an ERP product). In the Stage 1 bidding, three firms successfully met the qualifications test and each was awarded a contract. The three firms each propose the use of a different ERP product and those three products represent the major ERP solutions for the public sector. The successful contractors are Accenture, which will use PeopleSoft; CGI, which will use its own ERP product; and IBM, which will use SAP.

The purpose of the Stage 1 contract is to conduct a "Fit Gap" analysis. During this process, the state will work separately with each vendor to identify in some detail the state's business needs and requirements, and the proposed product's capacity to meet those needs—the extent of the "fit" and the "gap" between the two. This stage is highly beneficial to both the

state and the contractors, since it allows each to develop a deep understanding of the state's business needs and the product capacity to meet those needs before a formal bid from the vendors is submitted. The objective of this knowledge transfer is better quality and more accurate costing in the final contractor proposals, thus enhancing the likelihood of a final contract that does not result in extensive change orders and disputes caused by a lack of understanding on the part of the state and the winning bidder. After completion of the Fit Gap process, vendors will submit final proposals compete in separate negotiations to offer the most responsive system at the lowest cost (Stage 2). The Project's timeline currently anticipates initiating Stage 2 in May 2011 with bids due back to the state in June 2011. Thereafter, extensive negotiations will be pursued with each of the bidders separately. Award of this Stage 2 contract is anticipated in April 2012, following a legislative review period of up to 90 days.

Financing Options

There are two fundamental categories of cost associated with the Project:

- The *one-time cost* of developing the system (developmental cost).
- The *ongoing cost* of operations and maintenance (O&M).

In this section, options for paying for the one-time, developmental costs will be discussed.

There are two basic approaches to paying for developmental costs:

- Pay-As-You-Go (Cash)
- Financing

Pay-As-You-Go

Paying developmental costs of an asset as they arise with cash is generally the least expensive approach over the long term, because it avoids the interest expense inherent in a financing. However, the pay-as-you-go approach requires disproportionately large payments in the early years of the useful life of the asset, thus paying for the long-term, annual benefits of the asset only during its developmental period, rather than allocating payment over the period during which the benefits occur. In addition, the interest rate cost of financing is frequently overstated, because the effect of inflation is not taken into account. Depending upon the interest rate structure and other terms of a financing instrument, after taking into account the impact of inflation on the value of money over time, the additional "net present value" expense of financing an asset is significantly less than the nominal value of the accrued interest cost.

Financing

There are two financing avenues available to spread out the developmental costs of FI$Cal over time. One is the issuance of bonds through the California Infrastructure and Economic Development Bank (I-Bank). The other is vendor financing.

Regardless of the process used to secure financing for the Project (I-Bank or vendor), not all developmental costs will be eligible for financing (i.e., capitalizable). What is capitalizable is for all practical purposes determined by the rules issued by the Governmental Accounting Standards Board (GASB). Even though these standards do not constitute legal requirements or limitations, they have essentially the same effect for two reasons. First, to the extent federal

programs will share in paying the costs of FI$Cal, those payments will be limited to what is allowable under GASB rules. Secondly, the bond market will tend to view negatively any bonds for costs not meeting GASB standards, likely resulting in higher interest rates than would otherwise be the case.

Statement No. 51 of the Governmental Accounting Standards Board (GASB 51) recognizes the legitimacy of financing intangible assets—such as information technology projects like FI$Cal—and sets out standards for what costs are capitalizable. (Appendix B) In very general terms, capitalizable costs are those directly related to the design, coding, hardware and potentially some of the data conversion efforts necessary to make an information technology software project operational. However, a portion of the costs for state staff that will work on data collection, aggregation and cleansing, as well as other data management tasks and user training may not be capitalized. Consequently, some portion of the developmental costs will have to be covered on a pay-as-you-go basis. In addition, no costs incurred prior to award of the Stage 2 contract will be able to be debt financed.

GASB 51 also addresses what methodology should be applied when determining the "useful life" of an intangible asset (Appendix C). The useful life of the asset establishes the outside limit on the number of years over which debt service payments may be spread.

I-Bank. The I-Bank has broad authority to issue tax-exempt and taxable revenue bonds on behalf of private enterprise and local public agencies. However, legislation will be required to authorize I-Bank to issue bonds for a state project (Appendix D). FI$Cal staff and I-Bank staff have collaborated to explore the type of bond issuance that would be most feasible for financing the capital asset of the Project and there appear to be no serious impediments to doing so with appropriate legislative authorization. Such a financing will be complex, but not unprecedented or extraordinary.

Vendor Financing. Each of the three vendors involved in the Stage 1 contract have indicated the capacity and willingness to provide some form of vendor financing. On a confidential, proprietary basis, they have provided the Project with general information on the likely terms and structure of a vendor-financed option. While providing the Project with useful insights to the potential for this approach, none of the vendors offered any specific terms or conditions, indicating that such specifics would have to be negotiated and could be affected by various factors in place at that time (Appendix E).

Funding

Regardless of whether or not developmental costs are financed, there will be annual expenses associated with the Project throughout its life, including cash or debt service payments for developmental costs and ongoing operations and maintenance costs once the Project is operational.

Existing law requires all organizational entities within the Executive Branch (hereinafter collectively referred to as "departments") to use FI$Cal unless specifically exempted. Existing law also authorizes departments to be charged rates that cover the costs of the development and ongoing operation and maintenance costs of the system, including any debt service expenses.

While the general concept that the FI$Cal will be paid through charges to departments is already in place, several related specific issues and questions remain to be resolved before a permanent charging system can be implemented:

- What methodology should be applied to allocate these charges? Should it be based on some volumetric measure, such as number of transactions or number of records? Should it be based on a department's proportionate share of the state budget? Should some other methodology be applied?

- The federal government limits what expenses of the system it will pay for and when. With respect to developmental costs, for example, the federal government will not authorize payment of its programs' proportionate share until after the system is operational. Consequently, a methodology will need to be devised to allocate out the non-paid federal share to state funds until such time as federal payments are forthcoming. After federal payments begin, a method will need to be devised for reimbursing the funds that covered the federal share during the non-payment period (Appendix F).

- Are there special funds whose governing statutory or constitutional authority will limit the fair share distribution of FI$Cal's costs to them similar to limitations attendant to federal funds?

- Should charges be billed to departmental appropriations, or should they be assigned to departments' supporting funds and the funds charged directly?

These and other issues will require further study and decisions before a permanent system is put in place for funding FI$Cal. Currently, the Project anticipates providing a specific proposed charging system in time for implementation with the 2012-13 state budget.

In the meantime, and purely for the illustrative purposes of this paper, it is assumed that charges will be allocated directly to the funds that support departments' state operations. The amount of the charge to each fund will be in proportion to the amount of appropriation from each fund as a percentage of total state operations appropriations for the fiscal year of the charge. Based on this assumed methodology and applying it to appropriations for the 2011-12 fiscal year, a computation was made to determine how much of the total annual cost of the Project will be allocated to the General Fund, state special funds, non-governmental cost funds and federal funds. For the purposes of this document, a fund split of 70 percent General Fund and 30 percent other funds is assumed for the allocation of charges to support both the development and O&M costs of the Project (Appendix G).

Comparison Of Financing Options and State Costs

Generally, vendor financing would be less complicated than the I-Bank approach, since it would not involve many of the legal complexities of a public bond offering. However, vendor financing likely would be for a shorter term than an I-Bank bond issuance, thus spreading the financeable costs over fewer years. It also appears that vendors would not be willing to finance as many of the capitalizable costs as could be financed I-Bank bonds. Whether or not there would be a significant difference in interest rates between vendor financing and I-Bank financing is not discernible at this point, and will depend greatly on market conditions and other factors at the time financing is negotiated in detail. One cost advantage to vendor financing over I-Bank financing is the absence of any expense related to bond issuance costs and underwriters' fees. Pay-as-you-go is the least expensive option over the long term, but it requires larger appropriations in the early years.

Currently, the only "official" estimate of Project cost is the one provided in SPR #2, which was prepared in 2007 and estimated a twelve-year cost of $1.6 billion. However, in 2009 SPR #3 revised the procurement and implementation approach for the Project in a way that likely will reduce the development cost of the Project significantly. While final bids are due from vendors in June of 2011, the actual developmental cost of the Project will not be known until the Stage 2 contract is awarded in April of 2012. Since there are multiple variables (such as interest rates and terms) involved in a financing that are dependent upon market conditions at the time of financing and the outcome of vendor negotiations, it is necessary to make assumptions about these variables when comparing the fiscal aspects of the financing options.

Multiple scenarios with differing interest rates and terms were run for the I-Bank and vendor financing options, and a scenario was also prepared for the pay-as-you-go option. Those scenarios are included in Appendix I. For illustrative purposes, one scenario was chosen to be summarized in Tables 1 and 2, below. The purpose of these two tables is to illustrate in abbreviated fashion two aspects of fiscal differences between the financing options. Table 1 illustrates the amount of annual appropriation that will be required during the developmental stage of the Project under each option. These appropriations would cover debt service on financed costs, expenses for non-financeable one-time costs and O&M expenses. Table 2 illustrates the difference in total one-time development cost (not including O&M), after accounting for interest and debt issuance expenses. Graph 1 illustrates a graphical depiction of Table 1. The following assumptions (which are elaborated upon in Appendix H) were made for the purpose of illustrating the fiscal differences of the three financing options:

- The one-time development cost of the Project is assumed to be $1 billion (not including financing expenses). This hypothetical cost should *not* be construed as a new estimated cost of the Project. Rather, it is an arbitrary amount selected to illustrate financing and funding options.

- Implementation of the Project will occur in functional and departmental waves such that while developmental activities are still occurring, some system functionality will be deployed in some departments. Consequently, during the developmental time frame, some operations and maintenance (O&M) costs will also be incurred.

- Since there is currently no basis upon which to assume there would be a difference in interest rate between I-Bank and vendor financing, the same interest rate is applied to both.

- Capitalizable and non-capitalizable expenses and "useful life" are based on current understanding of existing guidance from GASB 51.

- Based upon information provided by vendors, less of the capitalizable costs are included under vendor financing than under I-Bank financing.

Table 1

COMPARISON OF ANNUAL APPROPRIATIONS DURING FI$Cal PROJECT DEVELOPMENT STAGE FOR $1 BILLION SCENARIO

(Operations and maintenance (O&M) costs during the development stage as implementation is rolled out in waves are included, and totals $23m in each option through 2016-17)

(dollars in millions, rounded)

Fiscal Year	No Financing (Pay-As-You-Go)			I-Bank 10 Yr @ 5.75%			Vendor 5 Yr @ 5.75%		
	Total	GF	OF	Total	GF	OF	Total	GF	OF
2005-06 through 2011-12	$150	$105	$45	$150	$105	$45	$150	$105	$45
2012-13	147	103	44	21	15	6	98	69	29
2013-14	194	136	58	41	29	12	118	83	35
2014-15	187	131	56	65	46	19	144	101	43
2015-16	173	121	52	90	63	27	167	117	50
2016-17	172	120	52	114	80	34	188	132	56
Project cost at the end of the development period	$1,023	$716	$307	$481	$338	$143	$865	$607	$258

Table 2

COMPARISON OF FI$Cal PROJECT DEVELOPMENT COST ONLY FOR $1 BILLION SCENARIO

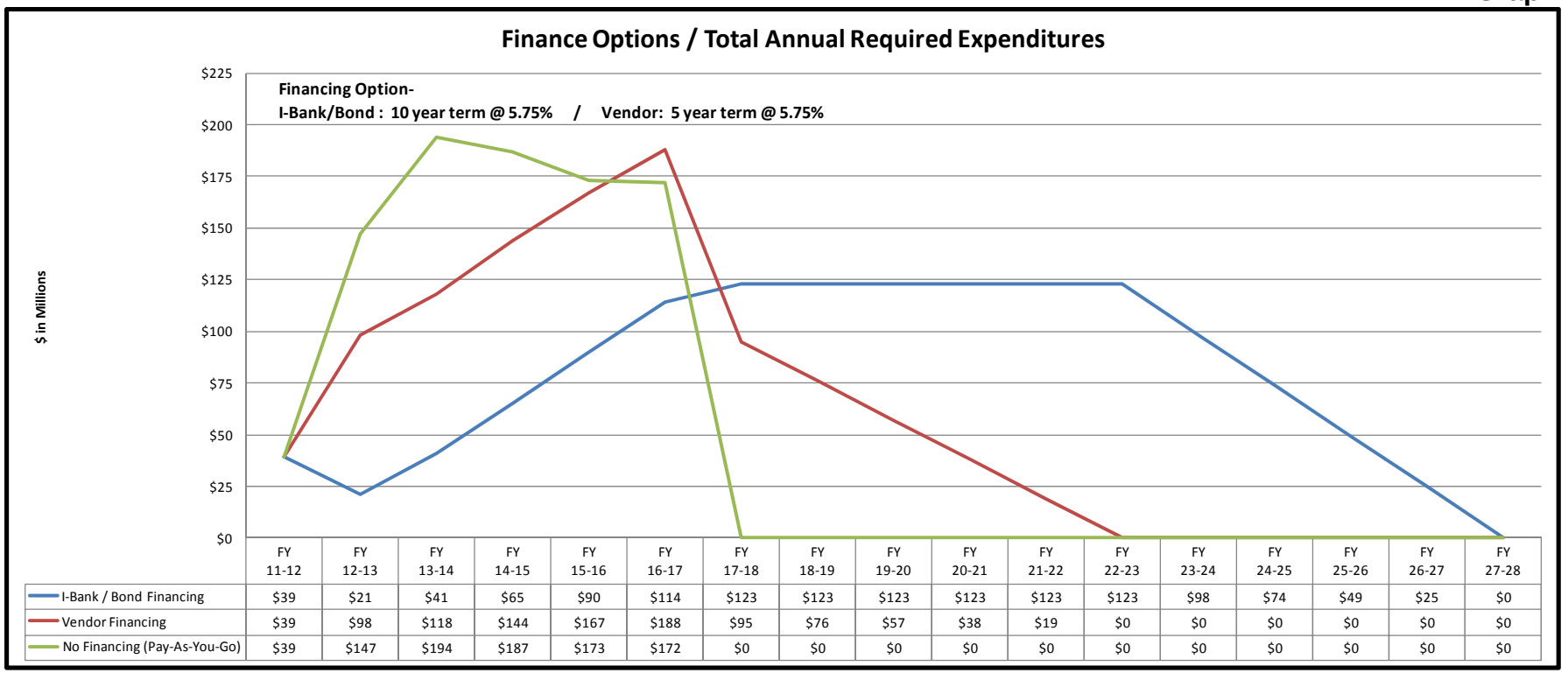
(O&M costs NOT included for any years. Costs represent only total developmental expenses spread over the noted time periods.)

(dollars in millions, rounded)

Funding Option	Debt Service for Capitalizable Development Expenses	Cash Costs For Non-Financed Development Expenses	Total Development Costs
No Financing (Pay-As-You-Go) (Through 2017-18)	$0	$1,000	$1,000
I-Bank (Ten year financing through 2026-27)*	$1,256	$186	$1,442
Vendor (Five year financing though 2021-22)*	$485	$642	$1,127

* Financed amounts are issued in multiple, staggered values over time as capitalizable expenses are incurred. Outstanding debt period reflects the final payment of the last issued financing.

Graph 1



	FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18	FY 18-19	FY 19-20	FY 20-21	FY 21-22	FY 22-23	FY 23-24	FY 24-25	FY 25-26	FY 26-27	FY 27-28
I-Bank / Bond Financing	$39	$21	$41	$65	$90	$114	$123	$123	$123	$123	$123	$123	$98	$74	$49	$25	$0
Vendor Financing	$39	$98	$118	$144	$167	$188	$95	$76	$57	$38	$19	$0	$0	$0	$0	$0	$0
No Financing (Pay-As-You-Go)	$39	$147	$194	$187	$173	$172	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0

Other States' Approaches to Financing ERP Projects

Other ERP projects have been financed using either a combination of pay-as-you-go, notes, and bonds; or using only pay-as-you-go funds. Financing options were discussed with two states, and the three fit-gap vendors provided brief presentations on how projects were financed in other states. In addition, assessment studies completed for other states' ERP projects presented financing models for up to 16 other states.

A majority of states have opted to use pay-as-you-go as the primary means of financing ERP systems. However, bonds or other debt instruments were used by some states as the primary means of financing one-time implementation costs. Several states used a combination of pay-as-you-go and financing to for the developmental costs of their ERP systems.

For example:

Louisiana's financing model for its ERP system used a central appropriation of state general funds to cover the implementation and on-going costs.

Montana issued bonds to amortize the one-time implementation costs of the ERP system over a ten-year period.

Ohio appropriated general revenue funding along with financing (certificate of participation) to fund the costs of its ERP project.

South Carolina funded 25% of the implementation costs centrally, with 75% funded by user agencies. Agencies established restricted accounts to reserve funds for their share of the project implementation costs. These accounts had full carry-forward authority and were protected from mid-year budget reductions.

Massachusetts sold commercial paper during the preliminary phase and the development and implementation phase to cover project costs. Ultimately, costs were partially funded from the proceeds of five-to-seven year general obligation bonds.

Governmental Accounting Standards Board Statement No. 51
Accounting and Financial Reporting for Intangible Assets

GASB 51, issued in July 2007, provides guidance of what should be considered an intangible asset and includes specific guidance on the proper accounting treatment for internally generated computer software, such as an ERP system. GASB 51 establishes requirements for state and local governments reporting on intangible assets and requires all intangible assets not specifically excluded by its provisions be classified as capital assets. Intangible assets are identified as possessing the following characteristics:

- Lack of physical substance (e.g., computer software)
- Nonfinancial nature (e.g. not in a monetary form)
- Initial useful life extending beyond a single reporting period

Intangible assets are considered internally generated if they are created or produced by the government or an entity contracted by the government, or if they are acquired from a third party but require more than minimal incremental effort to begin to achieve their expected level of service capacity. The FI$Cal System is identified as meeting the definition of an internally generated intangible asset: acquired from a third party, but requiring more than a minimal incremental effort on the part of FI$Cal to begin to achieve the expected level or service capacity.

Outlays related to the development of an internally generated intangible asset can only be capitalized upon the occurrence of *all* of the following:

a. Determination of the specific objective of the project and the nature of the service capacity that is expected to be provided by the intangible asset upon the completion of the project
b. Demonstration of the technical or technological feasibility for completing the project so that the intangible asset will provide its expected service capacity
c. Demonstration of the current intention, ability, and presence of effort to complete or, in the case of a multi-year project, continue development of the intangible asset.

Only outlays incurred subsequent to meeting the above criteria can be capitalized. Outlays prior to meeting those criteria should be expensed as incurred.

The criteria immediately above are deemed to be met only when *both* of the following occur:

- Preliminary project stage activities are completed (see below for definition).
- Management implicitly or explicitly authorizes and commits to funding, at least currently in the case of a multi-year project, the software project.

Per GASB 51 there are three stages of activities involved in developing and installing internally generated computer software:

1. Preliminary Project Stage *(these activities are expensed)*: conceptual formulation and evaluation of alternatives, determination of the existence of needed technology, final selection of alternatives for development of the software.

2. Application Development Stage *(most of these activities are capitalized)*: design of the chosen path, software configuration, software interfaces, coding, installation to hardware, and testing.
3. Post-Implementation/Operation Stage *these activities are expensed)*: application training and ongoing software maintenance

Only outlays during the application development stage can be capitalized; all preliminary and post-implementation expenditures need to be expensed as incurred.

It is important to note that the recognition guidance for outlays associated with the development of internally generated computer software should be applied based on the nature of the activity, not the timing of its occurrence. For example, in a case of multiple modules, each module will have its own development cycle, particularly as it relates to application development-stage and post-implementation/operation-stage activities. Therefore GASB 51 guidance should be applied for each individual module of the system rather than the system as a whole.

What this means for FI$Cal is that as individual modules are implemented, subsequent modules could be in the planning phase, while prior modules could be in the maintenance phase. At any one time, FI$Cal would be tracking planning, application development, and operation costs.

GASB 51 guidance was used for the FI$Cal financing and funding plan to identify the FI$Cal application development costs that can be capitalized. The Department of Finance (Finance) audit unit, Office of State Audits and Evaluations, is also assisting the Project staff in this effort.

Examples of capitalized costs are:

- Design of the chosen path, including software configuration and software interfaces
- Coding
- Installation of hardware, and testing, including the parallel processing phase
- Data conversion only to the extent it is determined to be necessary to make the computer software operational, that is, in condition for use.

Examples of costs that cannot be capitalized are:

- Training
- Business Process Reengineering activities
- Software maintenance

The financing scenarios in Appendix H apply the above guidance to determine the Project's capitalizable versus non-capitalizable costs.

Useful Life Considerations

Guidance in GASB 51 was considered when determining the life of the FI$Cal ERP system, although no definitive rule for determining the expected life is provided. GASB 51 states that the length of the useful life of an intangible asset is not limited by physical condition, and the deterioration thereof, as with tangible capital assets.

For purposes of the financing models, the Project is estimating an expected useful life of 10 to 15 years. This is based on guidance in GASB 51, proven record of accomplishment of ERP commercial off-the-shelf systems, the age of existing California legacy systems, and the tradition of the State of California to not perform major upgrades to existing legacy systems.

The term of the bond financing through the I-Bank scenario, for tax purposes, cannot exceed the expected life of the System. For that reason, we have presented scenarios with 10 years and 15-year terms.

It is important to note that the recognition guidance for outlays associated with the development of internally generated computer software should be applied based on the nature of the activity, not the timing of its occurrence. For example, in the case of multiple modules, each module will have its own development cycle, particularly as it relates to application development-stage and post-implementation/operation-stage activities. Therefore GASB 51 guidance should be applied for each individual module of the system rather than the system as a whole. This means at any one time, FI$Cal could be tracking multiple modules either in the planning, application development, or operation phase.

I-Bank (Bond) Financing

If capital asset costs of the Project are to be financed by I-Bank bonds, legislation will be necessary to:

- Authorize the I-Bank to issue bonds from time-to-time to finance Project capital asset costs, upon the determination by a state entity (the ”Bond Administrator”) of the amount of bond proceeds necessary for the payment of capital assets costs during the next succeeding Project development period.

- Direct the deposit of the net proceeds of the I-Bank bonds into a fund which costs of the capital assets of the Project are to be paid at the direction of the Project or the Bond Administrator.

- Invest the Bond Administrator with the authority to establish a fee for each participating department which, when aggregated, will equal the debt service on the I-Bank bonds.

- Authorize the Bond Administrator to implement the collection of the System Cost Fee over the term of the I-Bank bonds, and to reallocation System Cost Fees among participating departments from time-to-time during the term of the bonds as necessary to permit the aggregated System Cost Fees to equal the debt service payments on the I-Bank bonds.

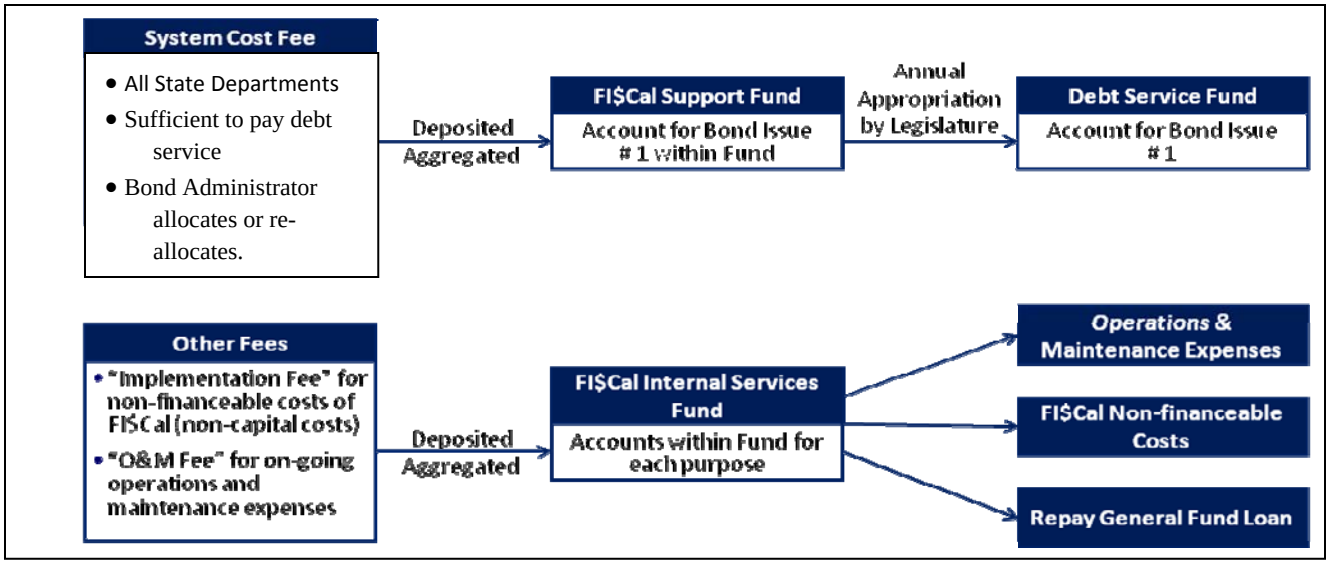
- Authorize the aggregation of the System Cost Fees in a centralized account (the FI$Cal Support Fund), to be disbursed only upon an annual appropriation by the Legislature for purposes of facilitating the payment of debt service on the I-Bank bonds.

Costs and obligations of the Project over and above the capital asset costs would be paid for through the aggregation of fees paid by participating departments other than the System Cost Fee, For example, the following fees are anticipated:

- An “Implementation Fee” imposed on participating departments to pay for any development costs that are not financed (this would include those costs not deemed capital asset costs pursuant to GASB 51); and

- An “O & M Fee” to pay for the ongoing operation and maintenance expenses for the system.

The figure below presents a graphical depiction of the funds for the “System Cost”, “Implementation”, and O&M” fees.


System Cost Fee
All State Departments
Sufficient to pay debt service
Bond Administrator allocates or re-allocates.
Deposited Aggregated
FI$Cal Support Fund
Account for Bond Issue # 1 within Fund
Annual Appropriation by Legislature
Debt Service Fund
Account for Bond Issue # 1
Other Fees
"Implementation Fee" for non-financeable costs of FI$Cal (non-capital costs)
"O&M Fee" for on-going operations and maintenance expenses
Deposited Aggregated
FI$Cal Internal Services Fund
Accounts within Fund for each purpose
Operations & Maintenance Expenses
FI$Cal Non-financeable Costs
Repay General Fund Loan

Vendor Financing

Each of the three fit-gap vendors did a white paper presentation on financing options with their companies. The presentations also included other options for financing, such as business models and benefits funding. At this time the Project is only looking into direct vendor financing, without consideration for business models or benefits funding.

The vendors indicated that vendor financing would only cover the costs of their contracts (hardware, software, system integrator), not all capitalizable costs. Therefore, the financeable amount would be less, and out-of-pocket costs would be more. However, the vendors also said they would be able to work with the state for possible financing of other capitalizable costs, such as state staff, and work with the state on payment terms to minimize the costs to the General Fund in the early years of the Project.

Vendor financing would be available only from the vendor awarded the system integrator contract. However, all three vendors indicated payment schedules could be customized to meet the cash flow needs of the Project.

The funding mechanism to pay for vendor financing would be similar to that in the graphical depiction in Appendix D for bond financing. A System Cost Fee would be imposed on departments in the amount needed for the annual payments for the vendor financing. The System Cost Fee would continue to be imposed over the payment term. These fees would be aggregated in a centralized account (the FI$Cal Support Fund) and would be used for vendor financing payments.

As with the bond financing structure, the vendor financing structure also contemplates that other costs and obligations of the Project would be paid for by fees other than the System Cost Fee. As such, a fee referred to as an “Implementation Fee” would also be imposed on state departments in order to pay for any application development costs that are not financed. In addition, an “O&M Fee” (user fee) would be imposed on state departments as they become users of the system, in order to pay for the ongoing system operation and maintenance expenses.

Federal Government Considerations

Office of Management and Budget (OMB) Circular A-87 on Cost Principles for State, Local, and Indian Tribal Governments.

On September 13, 2007, the federal Division of Cost Allocation (DCA) issued a letter of guidance to states implementing ERP systems. The letter specifically referenced GASB 51 and stated that ERP projects "…should be amortized over their estimated useful lives. Federal programs only benefit and should only be charged for amortization of the capitalized costs once the software programs are implemented and in use by Federal programs."

This means the state is required to carry (or finance) the federal share of costs until the state can demonstrate the success of the System. So although federal programs can be charged for development costs of the System, these costs can only be charged after implementation. Due to the lengthy term of FI$Cal and the benefit received by departments as releases occur, a wave-by-wave (or release by release) capitalization strategy may be acceptable to DCA. This would enable the departments using the System to benefit from federal cost reimbursement as they are implemented. The Project staff will engage the DCA regarding the preferred funding and allocation plan and federal reimbursement.

Interest Costs

Another consideration for financing and federal participation is that interest costs incurred by a state for financing computer software development is classified as unallowable for federal participation under OMB A-87. The Department of Finance has requested an interpretation from the OMB on the permissibility of interest cost reimbursement for the Project. Requests were submitted on October 31, 2007, December 30, 2009, and again on March 15, 2010. In addition, in February 2009, the Association of Government Accountants (AGA) wrote an issue paper urging the federal government to clarify whether financing costs for software development projects are allowable or unallowable. To date there has been no federal progress in this area. Since this is a nationwide issue and states have seen no progress, the Project will continue to monitor the interest cost issue.

Fund Split Analysis

Included in the FI$Cal Financing and Funding document are various schedules which use a funding split of 70 percent General Fund and 30 percent special funds.

This funding split was calculated based on the expenditure detail provided in the Governor's Budget, Schedule 9 (Comparative Statement of Expenditures), Budget Act Totals, State Operations lines for fiscal years 2007-08 through 2011-12. Comparing these five years of expenditures from the actual past years, the estimated current years, and the proposed budget years for state operations from each category of funding to the totals for State Operations, the overall average percentages were 60 percent General Fund, 10 percent federal funds, and 30 percent special funds.

As mentioned in Appendix F, federal programs only benefit and can only be charged for amortization of the capitalized costs once the software programs are implemented and in use by federal programs. This requires the state to carry (or finance) the federal share of costs until the state can demonstrate the success of the System.

Because of the federal program requirement, the funding scenarios include a funding split where the federal share has been included in the General Fund total, thereby assuming the General Fund will provide the upfront cash during the development stage of the FI$Cal Project, pending future federal reimbursement.

The resulting scenario funding split is 70 percent General Fund and 30 percent special funds. Information extracted from the Governor's Budget is presented on the next page.

GOVERNOR'S BUDGET SCHEDULE 9, ACTUAL PY, BUDGET ACT TOTALS, STATE OPERATIONS								
	2005-06	2006-07	2007-08	2008-09	2009-10	TOTAL	AVERAGE	% OF TOTAL
G.F.	18,686	21,389	22,797	20,979	18,467	102,318	20,463.60	60.9%
O.F.	9,586	9,216	10,277	9,574	8,972	47,625	9,525.00	28.3%
F.F	2,893	2,958	3,148	4,281	4,869	18,149	3,629.80	10.8%
TOTAL	31,165	33,563	36,222	34,834	32,308		33,618.40	

GOVERNOR'S BUDGET SCHEDULE 9, ESTIMATED PY, BUDGET ACT TOTALS, STATE OPERATIONS								
	2006-07	2007-08	2008-09	2008-10	2010-11	TOTAL	AVERAGE	% OF TOTAL
G.F.	21,541	22,972	22,924	18,362	21,707	107,506	21,501.20	60.2%
O.F.	9,699	10,878	10,512	9,720	10,523	51,332	10,266.40	28.7%
F.F	3,409	3,532	3,591	5,444	3,872	19,848	3,969.60	11.1%
TOTAL	36,649	37,382	37,027	33,526	36,102		35,737.20	

GOVERNOR'S BUDGET SCHEDULE 9, PROPOSED BY, BUDGET ACT TOTALS, STATE OPERATIONS								
	2007-08	2008-09	2009-10	2010-11	2011-12	TOTAL	AVERAGE	% OF TOTAL
G.F.	22,965	24,665	21,755	19,802	21,340	110,527	22,105.40	60.3%
O.F.	10,522	10,935	10,706	11,096	10,823	54,082	10,816.40	29.5%
F.F	3,383	3,401	3,528	4,512	3,928	18,752	3,750.40	10.2%
TOTAL	36,870	39,001	35,989	35,410	36,091		36,672.20	

Financing Scenarios

1. Financing Options

   The Project is presenting three different financing scenarios: I-Bank (bond) financing, vendor financing, and no financing (pay-as-you-go).

2. Estimated Useful Life of the System

   The Project is estimating a 10 to 15 year useful life for the FI$Cal System. This is based on guidance in GASB 51, proven record of accomplishment of ERP COTS systems, the age of existing California legacy systems, and the history of the state in utilizing current administration systems for the maximum length of time possible prior to replacement.

3. Total Capitalizable Costs of the System

   With guidance in GASB 51, the Project has estimated the following types of costs can be capitalized:

   - All staff on the technical team, business team, and PMO team (81 percent of total staff)
   - All system integrator costs
   - All hardware and software costs
   - 89 percent of telecommunications (percent of capitalized project and SI staff)
   - All supporting contracts
   - All data center services
   - 89 percent of agency facilities

   The outcome of the Project's financing model assumptions is:

   - Approximately 90 percent of application development costs can be capitalized
   - Application Development costs are approximately 60 percent of total project costs
   - Approximately 50 percent of total project costs (through the first year of O&M) can be capitalized

4. Length of the Application Development Period

   For the purposes of the financing models, a five-year application development period was used (2012-13 through 2016-17). This is consistent with previous estimated timelines for Project implementation.

5. The Interest Rate

The anticipated interest rate the state would be able to obtain through I-Bank issued bonds is based on the credit worthiness of the state, the assumed rating, and bond term. The Project received financing scenarios from the I-Bank's financial advisor in the range of 5.75 percent (highest bond rating; shortest term), 6 percent, 6.5 percent, and 7 percent. For the purposes of the financing models, 5.75 and 6.5 percent interest rates were used. Slightly lower interest rates were received from the Fit Gap vendors, but vendors stated that their estimates were not firm and may change based on the state's credit rating. The Project took a conservative position and assumed the same percent interest for the vendor financing model also.

Appendix J presents an analysis of the required annual and total outlay for the three financing scenarios based on a total project development cost of $1Billion, and the following assumptions:

I-Bank
- Financing of all capitalizable costs (per GASB 51)
- Five annual bond sales (first bond sale in FY 2012-13)
- Terms: 6.5% interest, bi-annual payments, over 15 years
- Terms: 5.75% interest, bi-annual payments, over 10 years
- Requires 1 percent issuance cost
- Requires debt service reserve fund

Vendor financing
- Finance only vendor costs (hardware, software, system integrator)
- Five annual disbursements (first disbursement in FY 2012-13)
- Terms: 6.5% interest, bi-annual payments, over 7 years
- Terms: 5.75% interest, bi-annual payments, over 5 years
- Does not require an issuance cost
- Does not require a debt service reserve fund

No Financing
- pay as you go

It is important to note that the amounts displayed in the scenarios are estimates only developed for this paper. Actual Project costs, and therefore, capitalizable or financeable costs, will not be available until vendor proposals are received and SPR 4 is developed.

COMPARISON OF ANNUAL APPROPRIATIONS DURING FI$Cal PROJECT DEVELOPMENT STAGE FOR $1 BILLION SCENARIO

(Operations and maintenance (O&M) costs during the development stage as implementation is rolled out in waves are included, and totals $23m in each option through 2016-17)

(dollars in millions, rounded)

Fiscal Year	No Financing (Pay-As-You-Go)			I-Bank 10 Yr @ 5.75%			Vendor 5 Yr @ 5.75%		
	Total	GF	OF	Total	GF	OF	Total	GF	OF
2005-06 through 2011-12	$150	$105	$45	$150	$105	$45	$150	$105	$45
2012-13	147	103	44	21	15	6	98	69	29
2013-14	194	136	58	41	29	12	118	83	35
2014-15	187	131	56	65	46	19	144	101	43
2015-16	173	121	52	90	63	27	167	117	50
2016-17	172	120	52	114	80	34	188	132	56
Project cost at the end of the development period	$1,023	$716	$307	$481	$338	$143	$865	$607	$258

COMPARISON OF FI$Cal PROJECT DEVELOPMENT COST ONLY FOR $1 BILLION SCENARIO

(O&M costs NOT included for any years. Costs represent only total developmental expenses spread over the noted time periods.)

(dollars in millions, rounded)

Funding Option	Debt Service for Capitalizable Development Expenses	Cash Costs For Non-Financed Development Expenses	Total Development Costs
No Financing (Pay-As-You-Go) (Through 2017-18)	$0	$1,000	$1,000
I-Bank (Ten year financing through 2026-27)*	$1,256	$186	$1,442
Vendor (Five year financing though 2021-22)*	$485	$642	$1,127

* Financed amounts are issued in multiple, staggered values over time as capitalizable expenses are incurred. Outstanding debt period reflects the final payment of the last issued financing.

FI$Cal Project Cost Summary
Project Period: FY 2005-06 through FY 2016-17
Total Project Development Cost Scenario: $1 Billion
($ in Millions)

Funding Option	Debt Service: Cost for Capitalizable Development Expenses	Cash Costs for Non-Financed Development Expenses	Operations & Maintenance Cost	Total Project Cost
No Financing (Pay-As -You -Go)	$0	$1,000	$23	$1,023
Vendor Financing 5 Year Term @ 5.75 % (Debt Service: FY 2012-13 through FY 2021-22)	$485	$642	$23	$1,150
Vendor Financing 7 Year Term @ 6.5 % (Debt Service: FY 2012-13 through FY 2023-24)	$526	$642	$23	$1,191
I-Bank / Bond Financing 10 Year Term @ 5.75 % (Debt Service: FY 2012-13 through FY 2026-27)	$1,256	$186	$23	$1,465
I-Bank / Bond Financing 15 Year Term @ 6.5% (Debt Service: FY 2012-13 through FY 2031-32)	$1,485	$186	$23	$1,694

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.

No Financing
Total Project Development Cost Scenario: $1 Billion, (Pay-as-you-go)
($ in Mililions)

Fiscal Year	Debt Service for Development Expenses	Cash Costs for Development Expenses	Operations & Maintenance Cost	Total Annual Cost	GF (70 %)	SF (30%)
2005-06 thru 2011-12	0	150	0	150	105	45
2012-13	0	147	0	147	103	44
2013-14	0	191	3	194	136	58
2014-15	0	182	5	187	131	56
2015-16	0	166	7	173	121	52
2016-17	0	164	8	172	120	52
Sub Total:	0	1,000	23	1,023	716	307
2017-18						
2018-19						
2019-20						
2020-21						
2021-22						
2022-23						
2023-24						
2024-25						
2025-26						
2026-27						
2027-28						
2028-29						
2029-30						
2030-31						
2031-32						
Total Project Cost through 2031-32:	0	1,000	23	1,023	716	307

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.

Vendor Financing
Total Project Development Cost Scenario: $1 Billion, 5 Year Term; 5.75 % Interest
($ in Mililions)

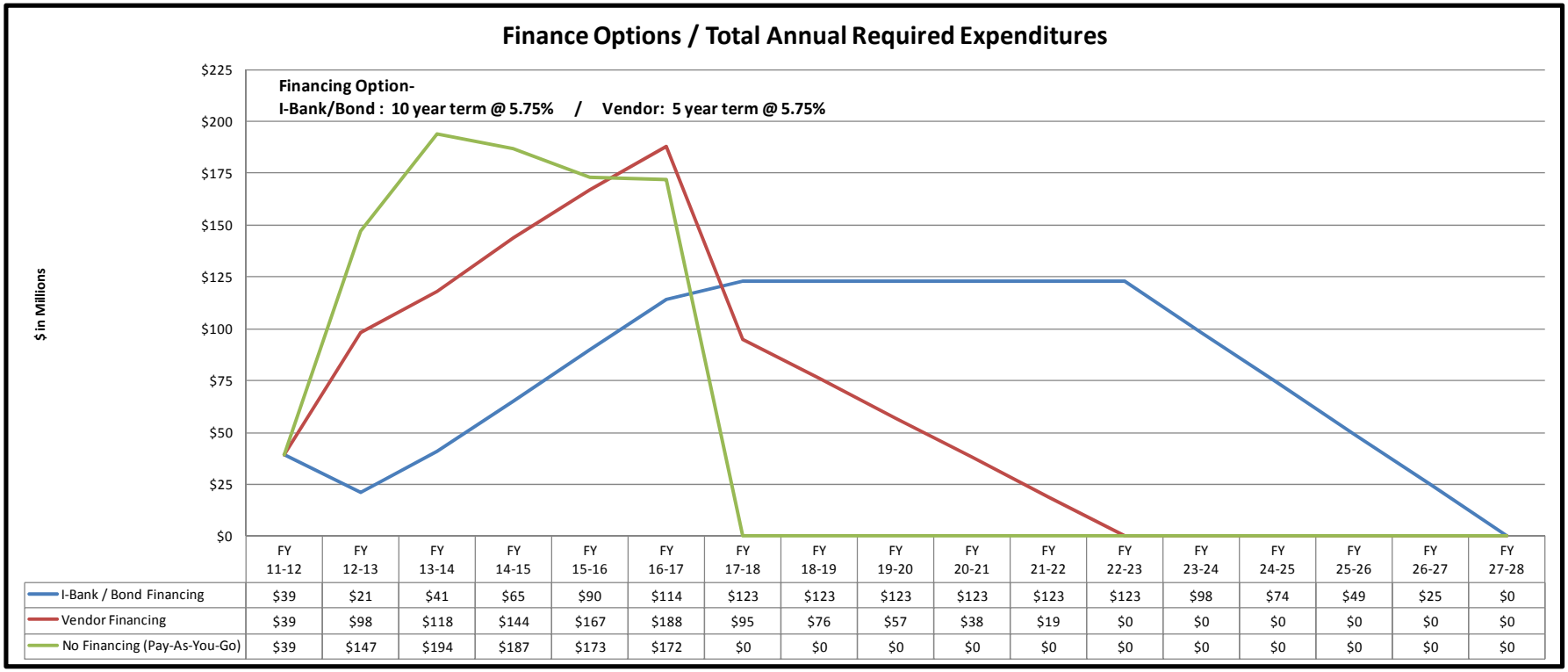
Fiscal Year	Debt Service: Cost for Capitalizable Development Expenses	Cash Costs for Non-Financed Development Expenses	Operations & Maintenance Cost	Total Annual Cost	GF (70 %)	OF (30%)
2005-06 thru 2011-12	0	150	0	150	105	45
2012-13	2	96	0	98	69	29
2013-14	21	94	3	118	83	35
2014-15	40	99	5	144	101	43
2015-16	59	101	7	167	117	50
2016-17	78	102	8	188	132	56
Sub Total:	200	642	23	865	607	258
2017-18	95			95		
2018-19	76			76		
2019-20	57			57		
2020-21	38			38		
2021-22	19			19		
2022-23						
2023-24						
2024-25						
2025-26						
2026-27						
2027-28						
2028-29						
2029-30						
2030-31						
2031-32						
Total Project Cost through 2021-22:	485	642	23	1,150	607	258

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.

I-Bank / Bond Financing
Total Project Development Cost Scenario: $1 Billion, 10 Year Term; 5.75 % Interest
($ in Mililions)

Fiscal Year	Debt Service: Cost for Capitalizable Development Expenses	Cash Costs for Non-Financed Development Expenses	Operations & Maintenance Cost	Total Annual Cost	GF (70 %)	OF (30%)
2005-06 thru 2011-12	0	150	0	150	105	45
2012-13	5	16	0	21	15	6
2013-14	30	8	3	41	29	12
2014-15	54	6	5	65	46	19
2015-16	79	4	7	90	63	27
2016-17	104	2	8	114	80	34
Sub Total:	272	186	23	481	338	143
2017-18	123			123		
2018-19	123			123		
2019-20	123			123		
2020-21	123			123		
2021-22	123			123		
2022-23	123			123		
2023-24	98			98		
2024-25	74			74		
2025-26	49			49		
2026-27	25			25		
2027-28						
2028-29						
2029-30						
2030-31						
2031-32						
Total Project Cost through 2026-27:	1,256	186	23	1,465	338	143

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.



	FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18	FY 18-19	FY 19-20	FY 20-21	FY 21-22	FY 22-23	FY 23-24	FY 24-25	FY 25-26	FY 26-27	FY 27-28
I-Bank / Bond Financing	$39	$21	$41	$65	$90	$114	$123	$123	$123	$123	$123	$123	$98	$74	$49	$25	$0
Vendor Financing	$39	$98	$118	$144	$167	$188	$95	$76	$57	$38	$19	$0	$0	$0	$0	$0	$0
No Financing (Pay-As-You-Go)	$39	$147	$194	$187	$173	$172	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0

COMPARISON OF ANNUAL APPROPRIATIONS DURING FI$Cal PROJECT DEVELOPMENT STAGE FOR $1 BILLION SCENARIO

(Operations and maintenance (O&M) costs during the development stage as implementation is rolled out in waves are included, and totals $23m in each option through 2016-17)

(dollars in millions, rounded)

Fiscal Year	No Financing (Pay-As-You-Go)			I-Bank 15 Yr @ 6.5%			Vendor 7 Yr @ 6.5%		
	Total	GF	OF	Total	GF	OF	Total	GF	OF
2005-06 through 2011-12	$150	$105	$45	$150	$105	$45	$150	$105	$45
2012-13	147	103	44	22	15	7	99	69	30
2013-14	194	136	58	36	25	11	114	80	34
2014-15	187	131	56	56	39	17	136	95	41
2015-16	173	121	52	75	53	22	155	109	46
2016-17	172	120	52	94	66	28	171	120	51
Project cost at the end of the development period	$1,023	$716	$307	$433	$303	$130	$825	$578	$247

COMPARISON OF FI$Cal PROJECT DEVELOPMENT COST ONLY FOR $1 BILLION SCENARIO

(No O&M costs are included for any years. Costs represent only total developmental expenses spread over the noted time periods.)

(dollars in millions, rounded)

Funding Option	Debt Service for Capitalizable Development Expenses	Cash Costs For Non-Financed Development Expenses	Total Development Costs
No Financing (Pay-As-You-Go) (Through 2016-17)	$0	$1,000	$1,000
I-Bank (Fifteen year financing through 2031-32)*	$1,485	$186	$1,671
Vendor (Seven year financing though 2023-24)*	$526	$642	$1,168

* Financed amounts are issued in multiple, staggered values over time as capitalizable expenses are incurred. Outstanding debt period reflects the final payment of the last issued financing.

No Financing
Total Project Development Cost Scenario: $1 Billion, (Pay-as-you-go)
($ in Mililions)

Fiscal Year	Debt Service for Development Expenses	Cash Costs for Development Expenses	Operations & Maintenance Cost	Total Annual Cost	GF (70 %)	SF (30%)
2005-06 thru 2011-12	0	150	0	150	105	45
2012-13	0	147	0	147	103	44
2013-14	0	191	3	194	136	58
2014-15	0	182	5	187	131	56
2015-16	0	166	7	173	121	52
2016-17	0	164	8	172	120	52
Sub Total:	0	1,000	23	1,023	716	307
2017-18						
2018-19						
2019-20						
2020-21						
2021-22						
2022-23						
2023-24						
2024-25						
2025-26						
2026-27						
2027-28						
2028-29						
2029-30						
2030-31						
2031-32						
Total Project Cost through 2031-32:	0	1,000	23	1,023	716	307

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.

Vendor Financing
Total Project Development Cost Scenario: $1 Billion, 7 Year Term; 6.5 % Interest
($ in Mililions)

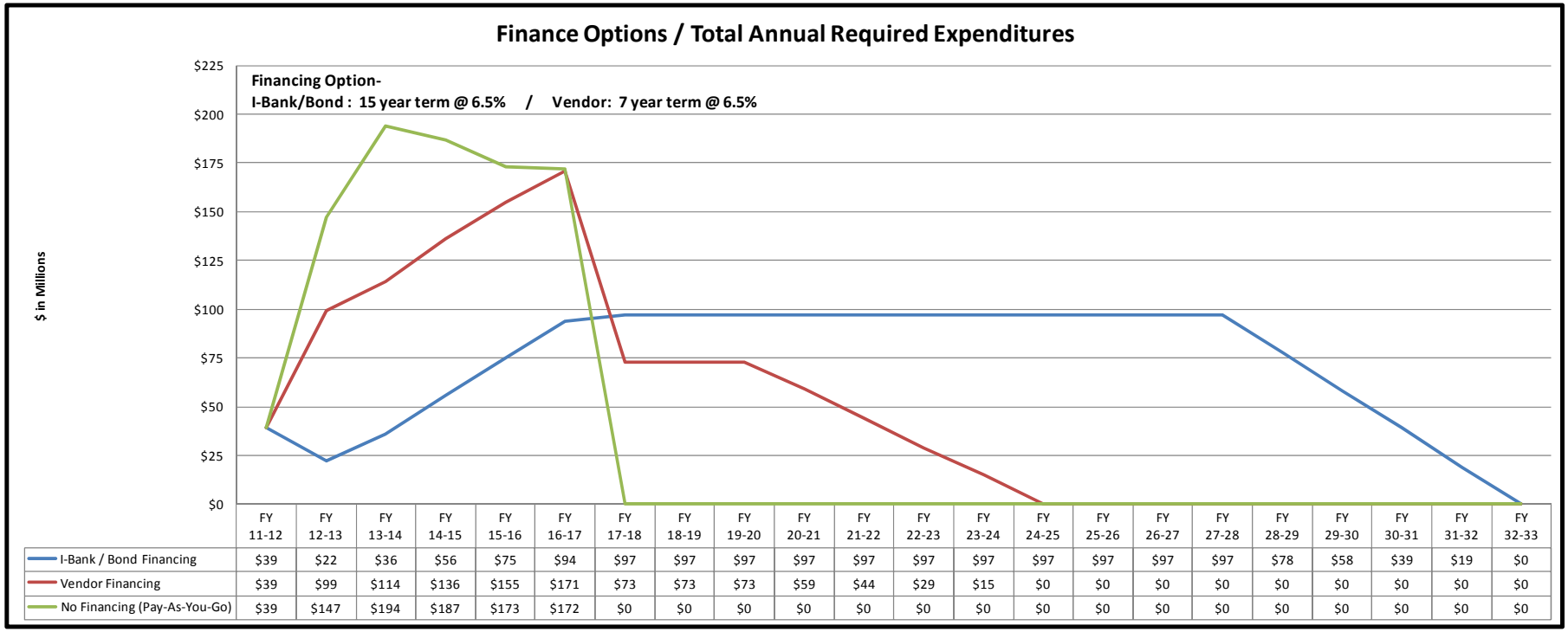
Fiscal Year	Debt Service: Cost for Capitalizable Development Expenses	Cash Costs for Non-Financed Development Expenses	Operations & Maintenance Cost	Total Annual Cost	GF (70 %)	OF (30%)
2005-06 thru 2011-12	0	150	0	150	105	45
2012-13	3	96	0	99	69	30
2013-14	17	94	3	114	80	34
2014-15	32	99	5	136	95	41
2015-16	47	101	7	155	109	46
2016-17	61	102	8	171	120	51
Sub Total:	160	642	23	825	578	247
2017-18	73			73		
2018-19	73			73		
2019-20	73			73		
2020-21	59			59		
2021-22	44			44		
2022-23	29			29		
2023-24	15			15		
2024-25						
2025-26						
2026-27						
2027-28						
2028-29						
2029-30						
2030-31						
2031-32						
Total Project Cost through 2023-24:	526	642	23	1,191	578	247

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.

I-Bank / Bond Financing
Total Project Development Cost Scenario: $1 Billion, 15 Year Term; 6.5 % Interest
($ in Mililions)

Fiscal Year	Debt Service: Cost for Capitalizable Development Expenses	Cash Costs for Non-Financed Development Expenses	Operations & Maintenance Cost	Total Annual Cost	GF (70 %)	OF (30%)
2005-06 thru 2011-12	0	150	0	150	105	45
2012-13	6	16	0	22	15	7
2013-14	25	8	3	36	25	11
2014-15	45	6	5	56	39	17
2015-16	64	4	7	75	53	22
2016-17	84	2	8	94	66	28
Sub Total:	224	186	23	433	303	130
2017-18	97			97		
2018-19	97			97		
2019-20	97			97		
2020-21	97			97		
2021-22	97			97		
2022-23	97			97		
2023-24	97			97		
2024-25	97			97		
2025-26	97			97		
2026-27	97			97		
2027-28	97			97		
2028-29	78			78		
2029-30	58			58		
2030-31	39			39		
2031-32	19			19		
Total Project Cost through 2031-32:	1,485	186	23	1,694	303	130

Project cost beyond 2016-17 for Operations and Maintenance is unknown and will be defined in Special Project Report #4.



	FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18	FY 18-19	FY 19-20	FY 20-21	FY 21-22	FY 22-23	FY 23-24	FY 24-25	FY 25-26	FY 26-27	FY 27-28	FY 28-29	FY 29-30	FY 30-31	FY 31-32	FY 32-33
I-Bank / Bond Financing	$39	$22	$36	$56	$75	$94	$97	$97	$97	$97	$97	$97	$97	$97	$97	$97	$97	$78	$58	$39	$19	$0
Vendor Financing	$39	$99	$114	$136	$155	$171	$73	$73	$73	$59	$44	$29	$15	$0	$0	$0	$0	$0	$0	$0	$0	$0
No Financing (Pay-As-You-Go)	$39	$147	$194	$187	$173	$172	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0

Current Project Timeline