

CITY OF FRESNO

Audit Report

SPECIAL GAS TAX STREET IMPROVEMENT FUND

July 1, 2005, through June 30, 2013

TRAFFIC CONGESTION RELIEF FUND

July 1, 2005, through June 30, 2013

PROPOSITION 1B FUND

July 1, 2008, through June 30, 2013



BETTY T. YEE
California State Controller

January 2016



BETTY T. YEE
California State Controller

January 5, 2016

The Honorable Ashley Swearengin
Mayor of the City of Fresno
2600 Fresno Street, Room 2075
Fresno, CA 93721

Dear Mayor Swearengin:

The State Controller's Office audited the City of Fresno's Special Gas Tax Street Improvement Fund for the period of July 1, 2005, through June 30, 2013. We also audited the Traffic Congestion Relief Fund (TCRF) allocations recorded in the TCRF Fund for the period of July 1, 2005, through June 30, 2013, as well as reviewed the Proposition 1B funds recorded in the Proposition 1B Fund for the period of July 1, 2008, through June 30, 2013.

Our audit found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with requirements, except the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$10,811,519 as of June 30, 2013. The city understated the fund balance because it charged ineligible debt service payments of \$10,783,977 for its Certificate of Participation and negative interest of \$27,542 to the Special Gas Tax Street Improvement Fund as of June 30, 2013.

In addition, our audit found that the city overstated the fund balance in the Traffic Congestion Relief Fund by \$6,711 as of June 30, 2013. The city overstated the fund balance because it did not meet the two-year spending requirement.

Additionally, the city understated the fund balance in the Proposition 1B Fund by \$7,189 as of June 30, 2013, because it charged program expenses in excess of available funds.

If you have any questions, please contact Mike Spalj, Chief, Local Government Audits Bureau by telephone at (916) 324-6984.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/as

cc: Michael Lima, Finance Director
City of Fresno

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Audit Report

Summary

The State Controller's Office (SCO) audited the City of Fresno's:

- Special Gas Tax Street Improvement Fund for the period of July 1, 2005, through June 30, 2013;
- Traffic Congestion Relief Fund (TCRF) for the period of July 1, 2005, through June 30, 2013; and
- Proposition 1B Fund for the period of July 1, 2008, through June 30, 2013.

Our audit found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with requirements, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$10,811,519 as of June 30, 2013. The city understated the fund balance because it charged ineligible debt service payments of \$10,783,977 for its Certificate of Participation and negative interest of \$27,542 to the Special Gas Tax Street Improvement Fund as of June 30, 2013.

Our audit also found that the city overstated the fund balance in the Traffic Congestion Relief Fund by \$6,711 as of June 30, 2013. The city overstated the fund balance because it did not meet the two-year spending requirement.

Additionally, the city understated the fund balance in the Proposition 1B Fund by \$7,189 as of June 30, 2013, because it charged program expenditures in excess of available funds.

Background

The State apportions funds monthly from the Highway Users Tax Account in the Transportation Tax Fund to cities and counties for the construction, maintenance, and operation of local streets and roads. The highway users taxes derive from state taxes on the sale of motor vehicle fuels. In accordance with Article XIX of the California Constitution and Streets and Highways Code section 2101, a city must deposit all apportionments of highway users taxes in its Special Gas Tax Street Improvement Fund. A city must expend gas tax funds only for street-related purposes. We conducted our audit of the city's Special Gas Tax Street Improvement Fund under the authority of Government Code section 12410.

Government Code section 14556.5 created a Traffic Congestion Relief Fund in the State Treasury for allocating funds quarterly to cities and counties for street or road maintenance, reconstruction, and storm damage repair. Cities must deposit funds received into the city account designated for the receipt of state funds allocated for transportation purposes. The city recorded its TCRF allocations in the Traffic Congestion Relief Fund. We conducted our audit of the city's TCRF allocations under the authority of Revenue and Taxation Code section 7104.

Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, was introduced as Proposition 1B and approved by the voters on November 7, 2006, for a variety of transportation priorities, including the maintenance and improvement of local transportation facilities. Proposition 1B funds transferred to cities and counties shall be deposited into an account that is designated for the receipt of State funds allocated for streets and roads. The city recorded its Proposition 1B allocations in the Proposition 1B Fund. A city also is required to expend its allocations within four years following the end of the fiscal year in which the allocation was made and to expend the allocation in compliance with Government Code section 8879.23. We conducted our review of the city's Proposition 1B Fund under the authority of Government Code section 12410.

Objective, Scope, and Methodology

Our audit objective was to determine whether the city accounted for and expended its Special Gas Tax Street Improvement Fund, TCRF, and Proposition 1B Fund in compliance with Article XIX of the California Constitution, the Streets and Highways Code, Revenue and Taxation Code section 7104, and Government Code section 8879.23.

To meet the audit objective, we performed the following procedures:

Special Gas Tax Street Improvement Fund

- Reconciled the fund revenue recorded in the city ledger to the balance reported in the SCO's apportionment schedule to determine whether Highway Users Tax Account (HUTA) funds received by the city were completely accounted for.
- Judgmentally selected a sample of expenditure transactions and verified proper documentation and eligibility to determine whether HUTA funds were expended in accordance with the criteria above.
- Analyzed and tested sample transactions to determine whether recoveries of prior HUTA fund expenditures were identified and credited to the Special Gas Tax Street Improvement Fund.
- Reviewed the fund cash and liabilities accounts for unauthorized borrowing to determine whether unexpended HUTA funds were available for future street-related expenditures.
- Interviewed city employees and reviewed policies and procedures to gain an understanding of the city's internal controls and accounting systems related to this audit.

Traffic Congestion Relief Fund (TCRF)

- Reconciled the TCRF revenue recorded in the city ledger to confirm that the TCRF allocations received by the city agreed with the SCO's apportionment schedule.

- Judgmentally selected a sample of expenditure transactions and verified proper documentation and eligibility to determine the city's compliance with the criteria above.
- Reconciled the City's "Schedule of Expenditures as Reported in the Streets and Roads Annual Report" with the SCO's "Average Annual Expenditures Computation of Discretionary Funds" to determine compliance with the maintenance-of-effort (MOE) requirement.

Proposition 1B Fund

- Reconciled the Proposition 1B revenue recorded in the city ledger to confirm that the Proposition 1B Fund allocations received by the city agreed with the SCO's apportionment schedule.
- Judgmentally selected a sample of expenditure transactions and verified proper documentation and eligibility to determine the city's compliance with the criteria above.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We did not audit the city's financial statements. We limited our audit scope to planning and performing the audit procedures necessary to obtain reasonable assurance that the city accounted for and expended the Special Gas Tax Street Improvement Fund, the Traffic Congestion Relief Fund, and the Proposition 1B Fund in accordance with the requirements of the Streets and Highways Code, Revenue and Taxation Code section 7104, and Government Code section 8873.23. Accordingly, we examined transactions, on a test basis, to determine whether the city expended funds for street purposes. We considered the city's internal controls only to the extent necessary to plan the audit.

Conclusion

Our audit found that the City of Fresno accounted for and expended its:

- Special Gas Tax Street Improvement Fund in compliance with Article XIX of the California Constitution and the Streets and Highways Code for the period of July 1, 2005, through June 30, 2013, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The finding requires an adjustment of \$10,811,519 to the city's accounting records.
- Traffic Congestion Relief Fund in compliance with Article XIX of the California Constitution, the Streets and Highways Code, and Revenue and Taxation Code section 7104 for the period of July 1, 2005, through June 30, 2013, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The finding requires an adjustment of \$6,711 to the city's accounting records.

- Proposition 1B Fund in compliance with Government Code section 8879.23 for the period of July 1, 2008, through June 30, 2013, except as noted in Schedule 1 and described in the Finding and Recommendation section of this report. The finding requires an adjustment of \$7,189 to the city’s accounting records.

Follow-Up on Prior Audit Findings

The city satisfactorily resolved the findings noted in our prior audit report, issued on January 26, 2007.

Views of Responsible Official

We issued a draft audit report on December 19, 2014. Michael Lima, Finance Director, responded by letter dated January 6, 2015, agreeing with the audit results with the exception of Finding 1—Ineligible debt service payment. The city’s response is included in this final audit report as an attachment.

Restricted Use

This report is intended for the information and use of the City of Fresno’s management and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

January 5, 2016

**Schedule 1—
Reconciliation of Fund Balance
July 1, 2012, through June 30, 2013**

	Special Gas Tax Street Improvement Fund Highway Users Tax Allocations ¹	Proposition 1B Fund ²	Traffic Congestion Relief Fund ³
Beginning fund balance per city	\$ 3,308,837	\$ 2,574,262	\$ 6,711
Revenues	<u>11,530,542</u>	<u>141,643</u>	<u>—</u>
Total funds available	14,839,379	2,715,905	—
Expenditures	<u>(10,326,480)</u>	<u>(2,723,094)</u>	<u>—</u>
Ending fund balance per city	<u>4,512,899</u>	<u>(7,189)</u>	<u>6,711</u>
Timing adjustment:			
Accrual of June 2013 highway users tax apportionment (Governmental Accounting Standards Board Statement No. 34)	<u>(423,582)</u>	<u>—</u>	<u>—</u>
SCO adjustments: ⁴			
Finding 1—Ineligible COP debt payments	10,783,977	—	—
Finding 2—Negative interest charged	27,542	—	—
Finding 3—Negative fund balance	—	7,189	—
Finding 4—Unspent TCRF	<u>—</u>	<u>—</u>	<u>(6,711)</u>
Total SCO adjustments	<u>10,811,519</u>	<u>7,189</u>	<u>(6,711)</u>
Ending fund balance per audit	<u>\$ 14,900,836</u>	<u>\$ —</u>	<u>\$ —</u>

¹ The city receives apportionments from the State highway users tax account, pursuant to Streets and Highways Code sections 2103, 2105, 2106, 2107, and 2107.5. The basis of the apportionments varies, but the money may be used for any street purpose. Streets and Highways Code section 2107.5 restricts apportionments to administration and engineering expenditures, except for cities with populations of fewer than 10,000 inhabitants. Those cities may use the funds for rights-of-way and for the construction of street systems. The audit period was July 1, 2005, through June 30, 2013; however, this schedule includes only the period of July 1, 2012, through June 30, 2013.

² Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, introduced as Proposition 1B, provided funds for a variety of transportation priorities. The audit period was July 1, 2008, through June 30, 2013; however, this schedule includes only the period of July 1, 2012, through June 30, 2013.

³ Government Code section 14556.5 created a Traffic Congestion Relief Fund (TCRF) in the State Treasury for allocating funds quarterly to cities and counties for street and road maintenance, reconstruction, and storm damage repair. The TCRF allocations were recorded in the TCRF Fund. The audit period was July 1, 2005, through June 30, 2013; however, this schedule includes only the period of July 1, 2012, through June 30, 2013.

⁴ See the Findings and Recommendations section.

Findings and Recommendations

**FINDING 1—
Ineligible debt service
payments**

The city improperly charged the Special Gas Tax Street Improvement (Gas Tax) Fund \$10,783,977 for debt service payments (principal and interest) for the period from July 1, 2005, through June 30, 2013. The principal and interest was for the “Fresno COP 1991 Street Improvement Project, Trust No. 65141.” The proceeds were used to finance long-term capital improvements to the city’s streets and highways.

There is no provision in the Streets and Highways Code for debt service payments relating to the issuance of a Certificate of Participation (COP).

A COP is similar to a bond, and as such, principal and interest costs may be eligible for Gas Tax funding. The Streets and Highways Code allows for Gas Tax funding of principal and interest when the following three criteria are met:

1. Bonds are voter approved,
2. The terms of the bonds do not exceed 25 years, and
3. The bonds are limited to 25% of the annual Gas Tax allocations.

Street and Highways Code section 2107.4 states:

Not more than one-quarter of the funds allocated to a city or county from the Highway Users Tax Account in the Transportation Tax Fund for the construction of streets therein may be used to make principal and interest payments on bonds issued for such construction, if the issuance of such bonds is authorized by a proposition approved by a majority of the votes cast thereon. The term of any such bonds shall not exceed 25 years.

As a result, the following debt service charges to the Gas Tax Fund are unallowable:

<u>Debt service payments</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
FY 2012-13	\$ 867,149	\$ 202,175	\$ 1,069,324
FY 2011-12	849,612	218,034	1,067,646
FY 2010-11	839,102	233,176	1,072,278
FY 2009-10	1,136,895	581,557	1,718,452
FY 2008-09	1,637,808	309,926	1,947,734
FY 2007-08	1,526,924	391,366	1,918,290
FY 2006-07	767,000	326,753	1,093,753
FY 2005-06	586,000	310,500	896,500
Audit Adjustments	<u>\$ 8,210,490</u>	<u>\$ 2,573,487</u>	<u>\$ 10,783,977</u>

Recommendation

The city should reimburse the Gas Tax Fund for the ineligible debt service payments totaling \$10,783,977 from FY 2005-06 through FY 2012-13.

In the future, the city should ensure that all debt service payments charged to the Gas Tax Fund are for voter-approved bonds and not for COPs, and the term is not to exceed 25 years. In addition, the city should ensure that the proceeds from bonds are used for street activities and that the debt service payments do not exceed 25% of the annual Gas Tax Fund allocations.

City's Response

The Fresno COP 1991 Street Improvement Project, Trust No 65141 debt service was far less than stated, and therefore, the reimbursement should be less than stated (if all). Please see the schedule below for the correct principal and interest payments, which can be verified by page 9 of the Official Statement of said COP:

<u>Debt service payments</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
FY 2012-13	\$0	\$0	\$0
FY 2011-12	920,000	60,950	980,950
FY 2010-11	860,000	117,925	977,925
FY 2009-10	810,000	171,588	981,588
FY 2008-09	760,000	221,937	981,937
FY 2007-08	705,000	268,644	973,644
FY 2006-07	670,000	313,031	983,031
FY 2005-06	630,000	354,611	984,611
Audit Adjustment	\$ 5,355,000	\$ 1,508,686	\$ 6,863,686

In addition to the schedule above, the City however, did not pay the entire amount of debt service on these bonds as stated in the Official Statement from Gas Tax, but instead used other available funds as reflected below:

<u>Debt service payments</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>	<u>Source</u>
FY 2012-13	\$0	\$0	\$0	
FY 2011-12	0	0	0	Pd w/ Bond Reserve
FY 2010-11	0	0	0	Prepaid in 2010
FY 2009-10	1,670,000	54,720	1,724,720	Gas Tax Tfrs for DS
FY 2008-09	760,000	140,791	900,791	Gas Tax Tfrs for DS
FY 2007-08	705,000	189,258	894,258	Gas Tax Tfrs for DS
FY 2006-07	670,000	231,000	901,000	Gas Tax Tfrs for DS
FY 2005-06	586,000	124,000	710,000	Gas Tax Tfrs for DS
Audit Adjustment	\$ 4,391,000	\$739,769	\$5,130,769	

Based on the facts as stated above, if any amount would need to be repaid to the State relating only to the Fresno 1991 COP it would be only \$5,130,769.

However, what the audit does not consider is case law that concludes that a long-term pledge of monies in a fund comprised of Gas Tax revenues satisfies the “special fund” test that provides an exception to the rule about having approval of 2/3rds of the voters (or voter-approved debt). The available financing structure that would avoid the need for an election is the use of Certificates of Participation (“COP”), or Lease Revenue Bonds (“LRB”). These two structures involve granting a lease or permit in the site to a non-profit public benefit corporation or joint powers authority and a leaseback or installment-sale of such site, along with the completed project, to the City. COP or Site Leases and Site Subleases (in the case of LRB) were prepared by the trustee that requires the City to make installment payments (in the case of COP) or base rental payments (in the case of LRB) to the Joint Powers Authority, with the Joint Powers Authority repaying the COP or LRB. Since COP in lease or installment payments are generally held not to be bonds or notes for purposes of debt limitations, this structure has been successfully utilized by cities, counties, and special districts to finance capital projects.

For this reason, the City firmly believes it has met all the requirements for receiving and properly using the Gas Tax revenues that it has received and should not be required to repay any of it back to the State or the Fund.

For support of the above argument, presented as evidence is a Memorandum dated March 6, 1991 by Barney A. Allison of Nossaman, Gunthner, Knox and Elliott, Special Counsel to the 1991 COP, addressed to Jesse J. Avila, Assistant City Attorney for the City of Fresno that cites two cases providing precedence for the City’s pledge of Gas Tax for the repayment of the Fresno COP 1991 Street Improvement Project, and for the use of Gas Tax moneys to repay any LRBs that funded qualified street projects. In addition to several published citations from the State Attorney General, two cases cited are California Toll Bridge Authority vs. Kelly, 218 Cal. 7, 14, 21 p. 2d 425 (1933) and Wenke v. Hitchcock, 6 Cal. 3rd 746, 751; 100 Cal. Rptr. 290; 493 O, 2d 1154 (1972).

Also, please note that Nossaman, Gunthner, Knox and Elliott did provide a letter to Sutro & Co, as underwriters on the 1991 COP, stating that all sections of the Official Statement relating to the use of Gas Taxes for the payment of the Installment Payments are “correct and accurate in all material respects to the best of our knowledge and belief.”

SCO’s Comments

Our original finding schedule stated that the ineligible debt service payment was for the “Fresno COP 1991 Street Improvement Project, Trust No 65141.” In fact, the correct statement should have stated “Fresno COP 1991 Street Improvement Project, Trust No. 65141; the 2002 Street Light Acquisition Project LRB; and 2004 LRB Debt Service,” making it three separate bond transactions.

Our audit finding schedule computation was derived from the city's accounting records. Per the accounting records submitted by the city for our review, during FY 2012-13 specifically, the city transferred \$303,070 and \$766,254 for a total of \$1,069,324 from the Gas Tax Fund Nos. 20101 and 20102, respectively, to make the ineligible debt service payments. From FY 2005-06 to FY 2012-13, the city transferred a total of \$10,783,977 to make the debt service payments.

There is no provision in the Streets and Highway Code that authorizes the use of Gas Tax Fund to pay for debt service. Gas Tax Funds are used specifically for street related expenditures.

Subdivision (a) Section 1 of Article 19 of the State Constitution restricts the use of gas tax funds to the following purposes:

The research, planning, construction, improvement, maintenance, and operation of public street and highways (and their related public facilities for non-motorized traffic), including the mitigation of their environmental effects, the payment for property take or damaged for such purposes, and the administrative costs necessarily incurred in the foregoing purposes.

Section 5 of Article 19 of the State Constitution states that:

The Legislature may authorize up to 25 percent of the revenue available for expenditure by any city or county, or by the State, for the purposes specified in subdivision (a) of Section 1 of this article to be pledged or used for the payment of principal and interest on voter-approved bonds issued for such purposes.

Under that constitutional authority, the Legislature enacted Streets and Highways Code section 2107.4 which provides that:

Not more than one-quarter of the funds allocated to a city or county from the Highways Users Tax Account in the Transportation Tax Fund for the construction of streets therein may be used to make principal and interest payment on bonds issued for such construction, if the issuance of such bonds is authorized by a proposition approved by a majority of the votes cast thereon. The term of any such bonds shall not exceed 25 years.

Consequently, cities may only use up to 25% of their gas tax apportionments to pay principal and interest on voter approved bonds.

The State Constitution might not prohibit indirect road construction-related expenditures of state gas tax revenues, such as the use of an Installment Sale Agreement. According to *City of Costa Mesa v. Connell*, 87 Cal.Rptr. 2d 612, this does not grant the Cities "carte blanche to disregard other restrictions. There still remains the prohibition against using state gas tax funds to service the debt on bonds not approved by voters. For that reason, the indirect expenditure here (to be rerouted to pay the debt on unapproved bonds) is an illegitimate use of the moneys." Just as in the Costa Mesa case, the indirect expenditure of gas tax revenues (rerouted to pay the interest and principal on the non-voter approved bonds), is an illegitimate use of the money.

The city did not meet any of the above criteria and, therefore, the SCO's finding and recommendation remain unchanged.

**FINDING 2—
Unallowable negative
interest charges**

The City of Fresno allocates interest earnings to all city funds based on the average daily cash balance in each fund. The city's Gas Tax Fund periodically had a negative cash balance during the period of July 1, 2010, through June 30, 2013. As a result, the city allocated \$27,542 of negative interest charges to the Gas Tax Fund.

Streets and Highways Code section 2101 specifies that Highways Users Tax apportionments are to be expended for the construction, maintenance, and operation of public streets and roads. It does not identify negative interest charges as an allowable use of gas tax funds.

As a result, the negative interest charged to the Gas Tax Fund is unallowable.

Recommendation

The city should transfer \$27,542 to the Gas Tax Fund and establish procedures to ensure that the Fund is not allocated negative interest charges in the future.

The city agreed with our finding and recommendation and reimbursed the Gas Tax Fund \$27,542 by Journal Entry #232785, dated January 28, 2014.

City's Response

The city agreed with the finding and implemented our recommendation.

**FINDING 3—
Proposition 1B Fund
negative balance**

On June 30, 2013, the City of Fresno's Proposition 1B Fund had a negative balance of \$7,189. This resulted from the city charging street expenditures to the Proposition 1B Fund in excess of funds available.

Streets and Highways Code section 2101 restricts expenditures to actual street-related costs. Additionally, the California Constitution, Article XVI, section 18 states “. . . no county, city, . . . shall incur any indebtedness or liability in any manner or for any purpose exceeding any year the income and revenue provided for such year.

Recommendation

The city should transfer \$7,189 to the Proposition 1B Fund to correct the negative fund balance. Also, the city should establish procedures to ensure that there are sufficient funds in the Proposition 1B Fund prior to charging expenditures.

The city agreed with our finding and recommendation and reclassified excess expenditures of \$7,189 by Journal Entry #232770, dated January 28, 2014

City's Response

The city agreed with the finding and implemented our recommendation.

**FINDING 4—
TCRF expenditure
requirement not met**

During FY 2011-12, the city did not expend its TCRF allocations within the fiscal year following the fiscal year in which the allocations were made, as required by Streets and Highways Code section 2182.1(g). The unexpended allocations total \$6,711.

Streets and Highways Code section 2182.1(g) states “. . . funds not expended within that period shall be returned to the Controller. . . .”

Recommendation

The city should return the unexpended TCRF allocations of \$6,711 to the State Controller's Office. Additionally, the city should review its TCRF expenditure levels to ensure compliance with program requirements.

The city provided additional TCRF expenditure information during fieldwork. The auditor reviewed the additional information and agreed that there were additional eligible TCRF expenditures. The city, therefore, reclassified the expenditures by Journal Entry #232771, dated January 28, 2014 to eliminate the unexpended allocations.

City's Response

The city agreed with finding and implemented our recommendation.

**Attachment—
City’s Response to
Draft Audit Report**



2600 Fresno Street, Suite 2156 • (559) 621-7001 • FAX (559) 488-4636
Fresno, California 93721-3622
www.fresno.gov

Finance Department

Michael Lima
Finance Director/Controller

January 6, 2015

Mr. Mike Spalj, Chief
Local Governments Audits Bureau
c/o California State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

SUBJECT: CITY OF FRESNO SPECIAL GAS TAX STREET IMPROVEMENT FUND AUDIT

The City of Fresno would first like to once again thank Mr. John Cobbihan for taking the time to educate the City during the course of his audit and to assist us in better understanding the use and reporting of the funds under audit.

We have reviewed his findings in detail and reaffirm that we concurred with Findings # 2, 3 and 4. We do not however concur with audit Finding #1 for the reasons stated below. We have also attached documentation to this letter in support of our position. We respectfully request that you review our submission and reconsider the recommendation of audit Finding #1.

**State Auditor Finding #1 -
Ineligible debt service payments**

The city improperly charged the Special Gas Tax Street Improvement Fund \$10,783,977 for debt service payments (principal and interest) for the period from July 1, 2005, through June 30, 2013. The principal and interest was for the "Fresno COP 1991 Street Improvement Project, Trust No. 65141." The proceeds were used to finance long-term capital improvements to the city's streets and highways.

There is no provision in the Streets and Highways Code for debt service payments relating to the issuance of Certificate of Participation (COP).

A COP is similar to bond, and as such, principal and interest costs may be eligible for Gas Tax funding. The Streets and Highways Code allows for Gas Tax funding of principal and interest when the following three criteria are met:

- 1. Bonds are voter approved,*
- 2. The terms of the bonds do not exceed 25 years, and*
- 3. The bonds are limited to 25% of the annual Gas Tax allocations.*

Street and Highways Code section 2107.4 states:

Not more than one-quarter of the funds allocated to a city or county from the Highway Users Tax Account in the Transportation Tax Fund for the construction of streets therein may be used to make principal and interest payments on bonds issued for such construction, if the issuance of such bonds is authorized by a proposition approved by a majority of the votes cast thereon. The term of any such bonds shall not exceed 25 years.

As a result, the following debt service charges to the gas tax fund are unallowable:

Debt service Payments	Principal	Interest	Total
FY 2012-13	\$867,149	\$202,175	\$1,069,324
FY 2011-12	849,612	218,034	1,067,646
FY 2010-11	839,102	233,176	1,072,278
FY 2009-10	1,136,895	581,557	1,718,452
FY 2008-09	1,637,808	309,926	1,947,734
FY 2007-08	1,526,924	391,366	1,918,290
FY 2006-07	767,000	326,753	1,093,753
FY 2005-06	586,000	310,500	896,500
Audit Adjustments	\$8,210,490	\$2,573,487	\$10,783,977

State Auditor Recommendation

The city should reimburse the Gas Tax Fund for the ineligible debt service payments totaling \$10,783,977 from FY 2005-06, through FY 2012-13.

City of Fresno Rebuttal and Statement of Position

The Fresno COP 1991 Street Improvement Project, Trust No 65141 debt service was far less than stated, and therefore, the reimbursement should be less than stated (if at all). Please see the schedule below for the correct principal and interest payments, which can be verified by page 9 of the Official Statement of said COP:

Debt service payments	Principal	Interest	Total
FY 2012-13	\$0	\$0	\$0
FY 2011-12	920,000	60,950	980,950
FY 2010-11	860,000	117,925	977,925
FY 2009-10	810,000	171,588	981,588
FY 2008-09	760,000	221,937	981,937
FY 2007-08	705,000	268,644	973,644
FY 2006-07	670,000	313,031	983,031
FY 2005-06	630,000	354,611	984,611
Audit Adjustments	\$5,355,000	\$1,508,686	\$6,863,686

In addition to the schedule above, the City however, did not pay the entire amount of debt service on these bonds as stated in the Official Statement from Gas Tax, but instead used other available funds as reflected below:

Debt service payments	Principal	Interest	Total	Source
FY 2012-13	\$0	\$0	\$0	
FY 2011-12	0	0	0	Pd w/ Bond Reserve
FY 2010-11	0	0	0	Prepaid in 2010
FY 2009-10	1,670,000	54,720	1,724,720	Gas Tax Tfrs for DS
FY 2008-09	760,000	140,791	900,791	Gas Tax Tfrs for DS
FY 2007-08	705,000	189,258	894,258	Gas Tax Tfrs for DS
FY 2006-07	670,000	231,000	901,000	Gas Tax Tfrs for DS
FY 2005-06	586,000	124,000	710,000	Gas Tax Tfrs for DS
Audit Adjustments	\$4,391,000	\$739,769	\$5,130,769	

Based on the facts as stated above, if any amount would need to be repaid to the State relating only to the Fresno 1991 COP it would be only \$5,130,769.

However, what the audit does not consider is case law that concludes that a long-term pledge of monies in a fund comprised of Gas Tax revenues satisfies the "special fund" test that provides an exception to the rule about having approval of 2/3rds of the voters (or voter-approved debt). The available financing structure that would avoid the need for an election is the use of Certificates of Participation ("COP"), or Lease Revenue Bonds ("LRB"). These two structures involve granting a lease or permit in the site to a non-profit public benefit corporation or joint powers authority and a leaseback or installment-sale of such site, along with the completed project, to the City. COP or Site Leases and Site Subleases (in the case of LRB) were prepared by a trustee that requires the City to make installment payments (in the case of COP) or base rental payments (in the case of LRB) to the Joint Powers Authority, with the Joint Powers Authority repaying the COP or LRB. Since COP in lease or installment payments are generally held not to be bonds or notes for purposes of debt limitations, this structure has been successfully utilized by cities, counties and special districts to finance capital projects.

For this reason, the City firmly believes it has met all the requirements for receiving and properly using the Gas Tax revenues that it has received, and should not be required to repay any of it back to the State or the Fund.

For support of the above argument, presented as evidence is a Memorandum dated March 6, 1991 by Barney A. Allison of Nossaman, Guthner, Knox and Elliott, Special Counsel to the 1991 COP, addressed to Jesse J. Avila, Assistant City Attorney of the City of Fresno that cites two cases providing precedence for the City's pledge of Gas Tax for the repayment of the Fresno COP 1991 Street Improvement Project, and for the use of Gas Tax moneys to repay any LRBs that funded qualified street projects. In addition to several published

citations from the State Attorney General, two cases cited are California Toll Bridge Authority vs. Kelly, 218 Cal. 7, 14; 21 p. 2d 425 (1933) and Wenke v. Hitchcock, 6 Cal. 3d 746, 751; 100 Cal. Rptr. 290; 493 O, 2d 1154 (1972).

Also, please note that Nossaman, Gunthner, Knox and Elliott did provide a letter to Sutro & Co, as underwriters on the 1991 COP, stating that all sections of the Official Statement relating to the use of Gas Taxes for the payment of the Installment Payments are "correct and accurate in all material respects to the best of our knowledge and belief."

We would greatly appreciate your consideration of the information presented in this response as well as the attachments. We look forward to discussing this matter further with you.

Thank you for your consideration and assistance. Please do not hesitate to call me at (559) 621-7006 should you have any additional questions.

Most sincerely,



Michael Lima
Finance Director/Controller

Attachments:

Memorandum dated March 6, 1991 (Barney A. Allison of Nossaman, Guthner, Knox and Elliott, Special Council)

Published Citations (California Toll Bridge Authority vs. Kelly, 218 Cal. 7, 14; 21 p. 2d 425 (1933) and Wenke v. Hitchcock, 6 Cal. 3d 746, 751; 100 Cal. Rptr. 290; 493 O, 2d 1154 (1972))

NOSSAMAN, GUTHNER, KNOX & ELLIOTT

M E M O R A N D U M

TO: Jesse J. Avila, Assistant City Attorney, City of Fresno
FROM: Nossaman, Guthner, Knox & Elliott
by Barney A. Allison
DATE: March 6, 1991
RE: Use of Fuel Tax Revenues to Secure COP Obligations

SECTION I. QUESTIONS PRESENTED.

What legal structure is available to the City of Fresno (the "City") to access future state fuel tax revenues through a tax-exempt borrowing to finance local street improvements.

SECTION II. CONCLUSIONS.

Certificates of participation ("COPs") in lease or installment sale payments to be made by the City to a nonprofit public benefit corporation or joint powers authority sponsored by the City can be sold on a negotiated basis to finance local street improvements.

SECTION III. ANALYSIS.

Fuel tax revenues are allocated to cities, counties and transportation commissions on the basis of certain formulas relating to highway miles maintained, number of registered vehicles, population and other criteria. S.B. 300 and A.B. 471 established broad categories of expenditures to accomplish a variety of transportation programs, including a requirement that CTC allocate half of the approximately \$3 billion expected to be received by the State as subventions to cities on a per capita basis. Cities can expect to receive an average of \$6.68 per capita annually once the full fuel tax increase is in place. Cities must maintain their current local expenditures of discretionary funds for transportation as a condition for receiving gas tax funds under this program.

While Article XVI, Section 18 of the California Constitution provides that the City may not incur indebtedness without the approval of 2/3's of the voters, the courts have carved an exception to this limit for obligations payable out

of a special fund. California Toll Bridge Authority vs. Kelly, 218 Cal. 7, 14; 21 P.2d 425 (1933). In Kelly, the Court concluded that a long term pledge of moneys in a fund comprised of gas tax revenues satisfied this "special fund" test, and would not create an indebtedness in violation of Article XVI, Section 1. Id. at 14, 15.

However, there is an additional limitation on use of gas tax revenues contained in Article XIX of the California Constitution. Section 1 of Article XIX provides that such revenues shall be used for the "research, planning, construction, improvement, maintenance, and operation of public streets and highways (and their related public facilities for nonmotorized traffic)" and exclusive public mass transit guideways (and their related fixed facilities). Section 5 of Article XIX, however, provides that "the Legislature may authorize up to 25% of the revenues available for expenditure by any city, county or the state, for [street and highway projects] to be pledged or used for the payment of principal and interest on voter-approved bonds issued for such purposes." Section 4 of Article XIX provides that gas tax revenues shall not be spent on mass transit projects until the voters in the area affected approve such use. Once approved, such funds can be used to pay principal and interest on voter-approved bonds. But for these limited exceptions, there is no express authorization in Article XIX for using gas tax revenues to pay principal and interest on a borrowing.

While there are no relevant cases relating to use of gas tax revenues in light of Article XIX of the Constitution, there are numerous opinions of the Attorney General relating to former Article XXVI, which was the predecessor to Article XIX. These opinions provide a strong argument that the language in Section 5 prohibits the issuance of interest bearing indebtedness, without voter approval. Although opinions of the Attorney General are not of controlling authority, and therefore do not have precedential value, such opinions have been accorded great respect by the courts. Wenke v. Hitchcock, 6 Cal.3d 746, 751; 100 Cal.Rptr. 290; 493 P.2d 1154 (1972).

In prohibiting the use of gas tax revenues to pay debt service on bonds other than those specifically provided for, the Attorney General has relied on the rule of interpretation that the expression of one thing usually implies the exclusion of other things not expressed. 47 Cal.Ops.Att.Gen 145, 146 (1966). The Attorney General stated that "it has been the accepted and uniform interpretation of [Article XXVI] that principal and interest on local road and street bonds may not be paid out of State fuel tax apportionments because the single exception in section 1 with respect to designated bonds is

exclusive." *Id.* at 146. In analyzing ballot arguments drafted in opposition to various proposed amendments, the Attorney General concluded that it "[was] untimely and would be inappropriate . . . to give local government agencies authority to mortgage future motor vehicle tax revenues." *Id.* at 147. The Attorney General also analyzed ballot arguments opposing amendments to broaden Article XXVI, and concluded that they indicated the general understanding and interpretation of Article XXVI as a "non-diversionary provision based upon a pay-as-you-go principle," *Id.* at 148, and that Article XXVI has been interpreted to prohibit bond financing by the use of gas tax allocations, with the one exception referred to in Section 1 of Article XXVI. See also 23 Cal.Ops.Atty.Gen. 59; 19 Cal.Ops.Atty.Gen 138; 14 Cal.Ops.Atty.Gen. 288.

It is our view that the language of Article XIX relating to bond financing must reasonably be interpreted as a limitation on the City incurring, without voter approval, interest-bearing indebtedness secured by gas tax funds.

An available financing structure that would avoid the need for an election or an amendment to the State Constitution is the use of certificates of participation ("COPs"). The COP structure would involve granting a lease or permit in the site where a project is to be constructed to a non-profit public benefit corporation or joint powers authority and the leaseback or installment-sale of such site, along with the completed project, to the City. A trustee would prepare certificates of participation in the lease or installment payments to be made by the City, which payments would be in amounts sufficient to repay the COPS, and which would then be sold by the City. The proceeds from the sale of the COPS would be used to finance construction of the projects. This structure avoids any possible association with "bonds," which could cause problems in light of Section 5 of Article XIX, since COPS in lease or installment payments are generally held not to be bonds or notes for purposes of debt limitations.

It should be emphasized that projects would not be pledged as security for payment of the COP's. Instead, the Certificateholders would be secured by the covenant of the City to make the necessary annual appropriations from gas tax revenues. This COP structure has been successfully utilized by cities, counties and special districts to finance capital projects.

In a COP structure, the City would sponsor the formation of a non-profit state transportation improvement corporation or joint powers authority. The NPC or JPA would appoint the City as its agent for purposes of constructing the facilities, and would then lease the completed facilities back to the City.

LAW OFFICES
NOSSAMAN, GUTHNER, KNOX & ELLIOTT
THIRTY-FIRST FLOOR • UNION BANK SQUARE
445 SOUTH FIGUEROA STREET • LOS ANGELES, CALIFORNIA 90071-1602
TELEPHONE (213) 612-7800

December 19, 1991

City of Fresno
2348 Mariposa Street
Fresno, CA 93721

Fresno Joint Powers Financing Authority
2348 Mariposa Street
Fresno, CA 93721

Bank of America National Trust and
Savings Association
55 Hawthorne Street, 8th Floor
San Francisco, CA 94105

Re: City of Fresno Certificates of Participation
(1991 Street Improvement Project)
Final Opinion

Ladies and Gentlemen:

We have acted as Special Counsel in connection with the sale, execution and delivery of \$10,925,000 aggregate principal amount of City of Fresno Certificates of Participation (1991 Street Improvement Project) (the "Certificates"), representing proportionate interests of the Owners thereof in the right of Fresno Joint Powers Financing Authority, a California joint powers agency (the "Authority") to receive installment sale payments (the "Installment Sale Payments") to be made by the City of Fresno (the "City") pursuant to an installment sale agreement, dated as of December 1, 1991 (the "Installment Sale Agreement") between the Authority and the City. The Authority and the City have also entered into a site lease, dated as of December 1, 1991 (the "Site Lease"). The Certificates are being executed and delivered pursuant to a trust agreement dated as of December 1, 1991 (the "Trust Agreement"), between the Authority, the City and Bank of America National Trust and Savings Association, as

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Bank of America National Trust and
Savings Association
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trustee (the "Trustee"). All capitalized terms used herein and not otherwise defined shall have the same meanings assigned to them in the Trust Agreement and the Installment Sale Agreement.

The City is obligated under the Installment Sale Agreement to pay the Installment Sale Payments solely from Gas Tax Revenues, as provided in the Installment Sale Agreement. A portion of each Installment Sale Payment is designated as interest. The Authority has assigned its rights to receive Installment Sale Payments and certain other rights and interests in the Installment Sale Agreement to the Trustee pursuant to an Assignment Agreement, dated as of December 1, 1991 ("Assignment Agreement"), between the Authority and the Trustee.

The Certificates are dated as of December 1, 1991, and are authorized to be executed and delivered in fully registered form in denominations of \$5,000, or any integral multiple thereof, representing principal components of the Installment Sale Payments.

The principal of and interest with respect to the Certificates are payable in lawful money of the United States of America. Such principal is payable at the corporate trust office of the Trustee in San Francisco, California. Interest with respect to the Certificates is payable on December 1 and June 1 of each year, commencing June 1, 1992, by check of the Trustee mailed to the registered Owners thereof on such dates.

As Special Counsel we have examined copies certified to us as being true and complete copies of the proceedings of the Board of Directors of the Authority and the City Council of the City in connection with the authorization and sale of the Certificates. Our services as Special Counsel were limited to an examination of the transcript of such proceedings and to rendering the opinions set forth herein. In this connection, we have also examined such other documents and instruments as we have deemed necessary in order to render the opinions expressed herein. In such examination, we have assumed the genuineness of all signatures (of parties other than the Authority and the City) on original documents and the conformity to the original documents of all copies submitted to us. We have also assumed the due execution and delivery (by all parties other than the Authority and the City) of all documents which we have examined where due execution and delivery are a prerequisite to the effectiveness thereof. As to the various questions of fact material to our opinion, we

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Bank of America National Trust and
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have relied upon statements or certificates of officers and representatives of the Authority, the City, public officials and others.

On the basis of the foregoing examination and assumptions and in reliance thereon and on all such other matters of fact as we deemed relevant under the circumstances, and upon consideration of the applicable law, we are of the opinion that:

1. The Trust Agreement, the Site Lease, the Assignment Agreement and the Installment Sale Agreement have been duly and validly authorized, executed and delivered by the Authority and, assuming such documents have been duly authorized, executed and delivered by the other parties thereto, constitute the legally valid and binding obligations of the Authority enforceable in accordance with their respective terms. The Installment Sale Agreement, the Trust Agreement and the Site Lease have been duly and validly authorized, executed and delivered by the City and constitute the legal, valid and binding obligations of the City enforceable in accordance with their respective terms. The Trust Agreement creates a valid pledge, which it purports to create, of all right, title and interest in and to all amounts on hand from time to time in the funds and accounts created thereunder, subject only to the provisions of the Trust Agreement permitting the application of amounts in such funds and accounts for the purposes and on the terms and conditions set forth in the Trust Agreement. The Certificates are entitled to the benefits of the Trust Agreement.

2. The portion of each Installment Sale Payment accruing under the Installment Sale Agreement designated as and comprising interest and received by the Owners of the Certificates is excluded under existing statutes, regulations, rulings and court decisions, from gross income for Federal income tax purposes pursuant to Section 103(a) of the Internal Revenue Code of 1986, as amended (the "Code"), and is exempt from personal income taxes of the State of California under present law. In addition, the Certificates and the Installment Sale Agreement are not a "private activity bond" as defined in Section 141(a) of the Code, and therefore, the portion of each Installment Sale Payment designated as and comprising

City of Fresno
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Bank of America National Trust and
Savings Association
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interest received by the Owners of the Certificates is not an item of tax preference for purposes of the Code's alternative minimum tax provisions, except to the extent provided in the following sentence. Interest received by a corporation will be included in adjusted current earnings for purposes for computing its alternative minimum tax liability. We are further of the opinion that the difference between the principal amount of the Certificates maturing after December 1, 1993 (the "Discount Certificates") and the initial offering price to the public (excluding bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers) at which price a substantial amount of such Discount Certificates of the same maturity was sold constitutes original issue discount which is excluded from gross income for Federal income tax purposes to the same extent as interest on the Certificates. Further, such original issue discount accrues actuarially on a constant interest rate basis over the term of each Discount Certificate and the basis of such Discount Certificate acquired at such initial offering price by an initial purchaser of each Discount Certificate will be increased by the amount of such accrued discount.

In rendering the opinions expressed in paragraph 2 above, we are relying upon representations and covenants of the Authority and the City in the Trust Agreement and the Installment Sale Agreement and in the Non-arbitrage Certificates of the Authority and the City, each dated as of the date hereof, concerning the use of the facilities financed with Certificate proceeds, the investment and use of Certificate proceeds and the rebate to the Federal government of certain earnings thereon. In addition, we have assumed that all such representations are true and correct and that the Authority and the City will comply with such covenants. We express no opinion with respect to the exclusions of the interest from gross income under Section 103(a) of the Code in the event that any such representations are untrue or the City or the Authority fail to comply with such covenants. Except as stated above, we express no opinion as to any Federal tax consequences of the receipt of the portion of each Installment Sale Payment designated as and comprising interest with respect to, or the ownership or disposition of, the Certificates. We express no opinion with regard to any indemnification, contribution or choice of law provisions contained in the agreements.

NOSSAMAN, GUTHNER, KNOX & ELLIOTT

City of Fresno
Fresno Joint Powers Financing Authority
Bank of America National Trust and
Savings Association
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The opinions expressed in paragraph 1 above are qualified to the extent that enforcement of the agreements referred to in such paragraphs may be limited by bankruptcy, insolvency, reorganization, moratorium or similar laws or equity principles relating to or limiting creditors' rights generally. We express no opinion as to the availability of equitable remedies, and advise you that a California court may not strictly enforce certain covenants if it concludes that enforcement would be unreasonable under the circumstances.

No opinion is expressed herein as to the accuracy, completeness or sufficiency of the Official Statement or other offering material relating to the Certificates.

Respectfully submitted,

Nossaman, Guthner, Knox & Elliott

LAW OFFICES
NOSSAMAN, GUTHNER, KNOX & ELLIOTT
THIRTY-FIRST FLOOR • UNION BANK SQUARE
445 SOUTH FIGUEROA STREET • LOS ANGELES, CALIFORNIA 90071-1602
TELEPHONE (213) 612-7800

December 19, 1991

Sutro & Co. Incorporated
201 California Street
San Francisco, California 94111

Charles A. Bell Securities Corp.
220 Sansome Street, Suite 1000
San Francisco, California 94014

Re: City of Fresno Certificates of Participation
(1991 Street Improvement Project)

Ladies and Gentlemen:

This letter is addressed to you, as the Underwriters, pursuant to Section 5(c)(3) of the Contract of Purchase, dated December 13, 1991 (the "Contract of Purchase"), among yourselves, the City of Fresno (the "City") and the Fresno Joint Powers Financing Authority (the "Authority"), providing for the purchase of the above-captioned certificates (the "Certificates"). The Certificates are being executed and delivered pursuant to a Trust Agreement, dated as of December 1, 1991 (the "Trust Agreement"), among the City, the Authority and Bank of America National Trust and Savings Association, as trustee. Unless otherwise defined herein, or the context otherwise requires, capitalized terms used herein shall have the respective meanings ascribed thereto in the Trust Agreement or, if not defined in the Trust Agreement, in the Contract of Purchase.

In addition to the opinions set forth in our final legal opinion concerning the validity of the Certificates and certain other matters, dated the date hereof and addressed to the City and the Authority (but which may be relied upon by yourselves to the same extent as if such opinion were addressed

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to you), and based on and subject to the matters referred to in the fifth, and seventh through ninth paragraphs of said final legal opinion (which are hereby incorporated herein by reference), and in reliance thereon, as of the date hereof, we are of the following opinions or conclusions:

1. The description of the Certificates and source of payment for the Certificates and statements in the Official Statement under the captions "SUMMARY STATEMENT" (other than under the heading "City of Fresno, California"), "INTRODUCTION", "THE CERTIFICATES" (other than under the headings "Book-Entry Only System" and "Installment Sale Payment"), "GAS TAX REVENUES" (other than the financial information contained under such caption), "SUMMARY OF PRINCIPAL LEGAL DOCUMENTS", "TAX MATTERS" and Appendix B -- "Form of Legal Opinion", insofar as such statements purport to summarize certain provisions of the Certificates, the Trust Agreement, the Site Lease, the Installment Sale Agreement, the Assignment Agreement and our opinion with respect thereto and to the validity and tax status of interest with respect to the Certificates, are correct and accurate in all material respects to the best of our knowledge and belief.

2. The City has full right and lawful authority to enter into and perform its obligations under the Legal Documents and, assuming due authorization, execution and delivery by the Trustee of the documents to which it is a party, the Legal Documents have been duly authorized, executed and delivered by the City and constitute legal, valid and binding agreements of the City and are enforceable in accordance with their respective terms, except as enforcement thereof may be limited by bankruptcy, insolvency or other laws affecting enforcement of creditors' rights and by the application of equitable principles if equitable remedies are sought.

3. The Certificates are exempt from registration pursuant to the Securities Act of 1933, as amended, and the Trust Agreement is except from qualification as an indenture pursuant to the Trust Indenture Act of 1939, as amended.

This letter is furnished by us as special counsel. No attorney-client relationship has existed or exists between our firm and you in connection with the Certificates or by virtue

NOSSAMAN, GUTHNER, KNOX & ELLIOTT

Sutro & Co. Incorporated
Charles A. Bell Securities Corp.
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of this letter. This letter is delivered to you as Underwriters of the Certificates and is solely for your benefit as such Underwriter and is not to be used, circulated, quoted or otherwise referred to or relied upon for any other purpose or by any other person. This letter is not intended to be relied upon by holders of the Certificates.

Sincerely,

Nossaman, Guthner, Knox + Elliott

LA2/SN:399

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>