



INVESTIGATIVE REPORT
(Finding of Record and Closure)
Public report

Ombudsman Complaint J093-0854
May 5, 1995

SUMMARY OF COMPLAINT

On April 12, 1993, the Office of the Ombudsman received a complaint concerning the Department of Community and Regional Affairs (DCRA) from Jackie Stewart, founder and president of *The Great Alaska Catalog*. Ms. Stewart alleges DCRA has failed to exercise its oversight responsibility in its decision to allocate successive years of federal funding, exceeding \$250,000 annually, to the nonprofit Rural Alaska Community Action Agency (RurAL CAP) to develop a commercial catalog *Aurora-Expressions of Alaska*. The catalog directly competes with small business in the private sector, particularly Ms. Stewart's catalog company.

Ms. Stewart says DCRA has failed to require data to support RurAL CAP's claim that the catalog is serving low-income rural people as required for projects funded with CSBG funds. She contends a complete business plan was not provided and there is no data to support the agency's projections that the catalog will become self-sustaining within an established time frame. In her complaint Ms. Stewart alleged:

Allegation: The Department of Community and Regional Affairs' continued approval of Federal Community Services Block Grant (CSBG) Funds to the Rural Alaska Community Action Program, Inc. (RurAL CAP) for the development of a mail order catalog is unreasonable in that:

(1) The catalog has not been supported by an adequate departmental review for compliance with federal requirements that funded activities must have a measurable and potentially major impact on the causes of poverty in the community or those areas of the community where poverty is a particularly acute problem.

(2) DCRA's approval of federal funds for this project is in conflict with Alaska's stated encouragement of private enterprise and the development of small businesses to provide needed goods and services whenever possible.

In February 1995, DCRA's new administration requested the Office of the Ombudsman conclude its report and submit its findings and recommendations to date in order to make the information available to DCRA, to the University of Alaska Center for Economic Development (UA/CED) with whom DCRA has contracted for further evaluation, and to the Legislative Audit Division which is considering a long-standing

audit request regarding the catalog. The Ombudsman agreed this procedure would be in the best interest of the agency, the complainant and those members of the legislature or the public interested in this issue.

Assistant Ombudsman Diane Shriener conducted the investigation of this complaint. The investigation focused on three areas:

- The use of CSBG funds in the for-profit ventures of nonprofit agencies in Alaska and other states.
- The number of catalog items offered which are produced by rural low-income artists. The sale of those items would directly benefit the artists and bring new income into the villages where poverty is most acute.
- The financial information on which DCRA is assessing the ability of the project to meet DCRA's goal that the catalog will become self-sustaining in a reasonable period.

BACKGROUND

Community Service Block Grant Funds

The Omnibus Reconciliation Act signed August 13, 1981, (Public Law 97-35) repealed all but Title VIII and Title X of the Economic Opportunity Act of 1964. The repeal ended the federal government's 18 year practice of directly funding private, nonprofit, anti-poverty programs run by Community Action Agencies and instead channeled these funds directly to states as Community Service Block Grants. This gave state governors more direct control over the expenditure of these funds at the local level for low-income residents. Funds are administered by the state and allocated to eligible Community Action Agencies for approved program use.

DCRA, the administering department in Alaska, states CSBG funds are intended to help low-income people secure and retain meaningful employment; obtain an adequate education; make best use of available income; maintain adequate housing; obtain emergency assistance if needed; and attain greater self-sufficiency and participation in programs and projects which directly affect their lives and well-being. Since the purpose of the grant money is to alleviate poverty in local communities, funds received may be used to provide a range of services and activities within different program components.

The federal government requires the states to make assurances regarding the use of the funds. These assurances are listed in Public Law 97-35, as amended, and require that the chief executive officer of the state, the Governor, certify to use the funds available under **Subtitle 675 (c)** to:

(A) Provide a range of services and activities having a measurable and potentially major impact on causes of poverty in the community or those areas of the community where poverty is a particularly acute problem;

(B) Provide activities designed to assist low income participants including the elderly poor

(i) to secure and retain meaningful employment;

(vi) to remove obstacles and solve problems which block the achievement of self-sufficiency.

CSBG Funds in Alaska

Each year, the State of Alaska allocates funds through DCRA to the state's only remaining Community Action Agency, RurAL CAP which has existed since 1965. One of 900 such Community Action Agencies in the United States, RurAL CAP operates as a nonprofit corporation with a 501(c)(3) tax exempt status. RurAL CAP's focus is rural communities where there are few jobs and high levels of unemployment. The agency employs approximately 200 persons, 65 percent of whom are villagers throughout Alaska. Most are employed in Head Start programs operated by RurAL CAP.

Agency oversight is provided by a 21-member board of directors representing the major poverty areas of Alaska. In addition to area representatives, the board has several public representatives including the governor, lieutenant governor, legislative representation and the DCRA commissioner. RurAL CAP's annual budget averages between \$8.4 and \$8.8 million dollars. The amount of CSBG funds allocated to RurAL CAP has grown from \$676,872 in Federal Fiscal Year 1989 (FFY89) to \$1,344,508 in FFY94.

RurAL CAP submits an annual CSBG State Plan to DCRA explaining what programs and projects it requests to fund with CSBG money. RurAL CAP also presents its annual proposal to the Alaska House Committee on Community and Regional Affairs which must conduct public hearings on the proposed use of the funds. Committee approval is considered by DCRA but is not a requisite for the plan to be accepted by the state and forwarded to the federal government.

Former DCRA Commissioner Edgar Blatchford said, "While many funding sources have narrow restrictions on the scope of use, CSBG funds can be used to respond to the most pressing and unmet needs of people in poverty." He said the state plan's development reflects a strong commitment to be responsive to local community needs and to improve the economic self-sufficiency of the low-income individuals and families served. The FFY92 CSBG State Plan further explains the intent of several of the components of the plan including the Economic Development Component:

The Program Support Component ensures adequate staff to strengthen the core capability of the agency and to contract for proposal writing services. CSBG funds enable the agency to obtain other funds outside of CSBG to provide services and programs to alleviate the causes and conditions of poverty among low-income people in rural Alaska.

The Planning Component enables the Community Action Agency (CAA) to research and provide the education and information needed by both the low-income population and appropriate governmental and other social service programs in order to establish linkages to assure effective delivery of services.

The Economic Development Component funds programs which help to provide employment opportunities, job counseling, and related activities, as well as encouraging the use of the private sector. Private sector usage is achieved through coordinating efforts of other agencies, programs and through the boards of directors of the CAAs.

Following state review of the annual plan, DCRA submits the written proposal to the U.S. Department of Health and Social Services, assuring the funds will be used for the purposes intended.

The reporting requirements in Section 1742(a) of the Omnibus Reconciliation Act are as follows:

- (1) a statement of goals and objectives;
- (2) information on the types of activities to be supported, geographic areas to be served, and categories or characteristics of individuals to be served, and
- (3) the criteria and method established for the distribution of funds, including details on how the distribution of funds will be targeted on the basis of need to achieve the purposes of the block grant funds. Beginning in the fiscal year 1983, the report required by this subsection shall include a description of how the state has met the goals, objectives, and needs in the use of funds for the previous fiscal year as identified in the report prepared pursuant to this subsection for that previous year.

Progress reports must be submitted throughout the fiscal year.

RurAL CAP traditionally has used CSBG funds to address alcohol and drug abuse prevention, energy conservation and weatherization, child development and education, subsistence and natural resource preservation, village participation conferences linking widespread villages, and for agency planning and research.

In 1987, RurAL CAP launched its first for-profit business activity: Rural Energy Enterprises Inc. (REE), is a wholly-owned subsidiary of RurAL CAP which serves as a wholesale distributor for advanced, energy-saving products for rural Alaskans. A Department of Energy grant of \$35,000 in 1985-86 funded the project feasibility study after which, RurAL CAP says it used CSBG funds (amount not reported) to incubate the new activity within its Energy Conservation Program. The agency reported these funds were limited and it also sought loan funds to continue the business.

The funding history as reported by RurAL CAP in *A CAA For-Profit Enterprise in Alaska* does not mention the use of CSBG funds but does mention "nonprofit incubation," and lists funding received through private loans, bank loans and an Alaskan Community Enterprise Development Corporation loan. Even those opponents of RurAL CAP's entry into the for-profit sector agreed that requiring RurAL CAP to borrow funds helped "level the playing field" with the private sector and the scrutiny of the loan process helped to insure that a venture is sustainable.

By 1991, REE had created 90 new jobs in remote villages through the establishment of product dealerships. The project also impacts poverty by allowing stove owners to save up to one quarter of their previous fuel costs according to the agency. RurAL CAP has since expanded both within Alaska and to other states. RurAL CAP states the company contributed \$13,000 in unrestricted funds to RurAL CAP in 1991 with a current equity position of \$369,349.

CSBG Funds Used For Catalog Project

In 1992, RurAL CAP began developing the catalog, *Aurora-Expressions of Alaska*. This is a for-profit venture which RurAL CAP hopes will provide the agency with a source of unrestricted revenue as well as benefit low-income rural Alaskans. The

catalog represents RurAL CAP's first use of CSBG funds in an identified Economic Development Component. RurAL CAP Executive Director Jeanine Kennedy explains that as state and federal funds dwindle it is necessary for nonprofit agencies to look toward the private sector in seeking new sources of unrestricted revenue to bolster their traditional funding.

Initial Funding Request

Ms. Kennedy received approval from the RurAL CAP Board of Directors in February 1992 to research the development of a for-profit catalog. Ms. Kennedy authorized use of CSBG Planning and Research Component funds to begin the project. The agency did not discuss the catalog under any of the component sections of the 1992 CSBG State Plan, although the budget components in both Planning and Research and in Program Support were each increased by over \$100,000 from the previous year's allocation. RurAL CAP staff said money also was borrowed from program components such as child care and alcohol/substance abuse programs to initially fund the project. RurAL CAP did not raise the catalog for discussion in the 1992 legislative public hearings and there was no public comment elicited regarding the catalog project.

During 1992, CSBG funds were used for a planning coordinator, for travel to access resources, and for contracts to prepare business plans and conduct a feasibility study. The development contract was with Aesthetics Marketing of San Francisco, a catalog consulting and development corporation, hired to work with RurAL CAP to establish the catalog and "testing program to market Native crafts and products." Following the initial feasibility study, the consultants produced the *Feasibility Report* which identified the goals of the catalog as follows:

- To develop income opportunities for Artists/villagers and as a result help offset the 65 percent unemployment rate in the villages, and promote openings for increased self-sufficiency.
- To develop a larger market for village arts and crafts.
- To create value for the Subsistence way of life through accurate information and education about rural Alaska.
- To provide another unrestricted source of revenue for RurAL CAP in order to continue providing a range of services for low-income people throughout the state of Alaska.

Ms. Kennedy initially traveled to nine villages to discuss the idea of a catalog and to buy \$4000 worth of sample arts and crafts from villagers. Village artists thought having broader marketing opportunities would enable them to receive a better price for their arts. Some artists said they are presently receiving low prices for items that take a long time to make and in available markets the wholesale prices are too low compared to the retail mark-up. RurAL CAP representatives told the artists the agency would pay their asking price without negotiation and would work within the artists' schedule by requesting goods around the village timetable. Recently, the agency said its attempt to pay the highest prices possible to rural vendors and to pay for goods on receipt has depleted the agency's allotted cash-flow.

In December 1992, RurAL CAP requested an amendment of \$190,000 to its FFY92 grant to add the "New Component: Economic Development Project-Catalog." DCRA Grant Administrator Jennifer Long denied the request stating DCRA was not willing to involve itself with the proposed component as an amendment. Ms. Long noted

the proposed catalog was a controversial issue and had not gone through the application process nor been a part of the public hearing for FFY92.

Economic Development Component

In the next funding cycle, RurAL CAP did include *Aurora-Expressions of Alaska* as the Economic Development Component of the FFY93 CSBG grant request and identified the goals and benefits of the catalog as follows:

GOALS: To lessen the conditions of poverty in rural Alaska by increasing the flow of cash into rural communities by RurAL CAP's buying of village arts and crafts which RurAL CAP will market through a high quality catalog distributed nationally. The catalog, *Aurora-Expressions of Alaska* will be a vehicle through which to educate people about the value and beauty of the Native lifestyles of Alaska and to provide accurate information about Alaska and our artists.

BENEFITS: Unemployment in rural Alaskan communities are 60 percent to 65 percent. Through purchase of art work from rural Alaskans, income opportunities will be increased for low-income individuals in villages where jobs continue to be very limited. Living conditions which include lack of adequate water and sewer systems, poor housing, and other harsh conditions continues to make life in rural communities rival that of third world nations. The benefit of focusing on distribution of arts and crafts through a nationally distributed high quality catalog is that the strength of the community will be drawn upon.

RurAL CAP requested \$250,000 in funding for Phase I, the preparation of the *Feasibility Report* by Aesthetics Marketing of San Francisco (already completed); and for Phase II the proposed initial catalog test distribution period. The actual marketing of the catalog was termed a "feasibility test" by RurAL CAP. Ms. Kennedy said this would be a more practical test of project viability than would a market study and would show whether there was a demand for rural arts and crafts as featured in the catalog and whether the catalog could eventually sustain itself. The agency said it planned to evaluate the results at the end of the test period and decide whether to continue the project.

In the fall of 1993, 187,000 catalogs were distributed nationally in two test runs and sales exceeded expectations according to the agency. RurAL CAP claimed the catalog contains 102 items and features 40 percent village/Native products and 60 percent urban Native and non-Native goods. RurAL CAP said that 3300 items were sold for a total of \$240,000. and that 33 percent of the goods sold came from rural community vendors returning \$68,741 to the villages. The agency said this exceeded the anticipated level of sale of village items which was expected to net \$32,000. The catalog showed an overall operating loss of \$200,000.

Second Year Funding Requested

In FFY94, DCRA again approved CSBG funds of \$253,626. for second year funding of the catalog. Using 22 percent of the available FFY94 CSBG funds, the catalog represented the single largest percentage of the total CSBG fund allocation to the agency. At the beginning of this funding cycle, Ms. Stewart, members of the legislature and the public expressed increasing concern with continued public funding of a commercial venture competing against private enterprise. They also raised questions

regarding the products offered in the initial catalog, stating few if any of the goods were being produced by rural low-income artists whom the catalog was intended to serve.

DCRA and RurAL CAP both stated that where the goods came from was less important than the catalog's overall potential for success. Mr. Blatchford said he hoped the catalog would accomplish the goals set forth in the CSBG State Plan and that he also intended the catalog to do the following:

- * Foster a nationwide market for Alaska Native crafts.
- * Support a rural enterprise.
- * Realize the larger, social objectives of RurAL CAP's various programs.
- * See that monetary benefits flow to rural artisans rather than a middle man.

Former DCRA Deputy Commissioner Bruce Geraghty said the catalog would provide an economic benefit and a boost to self-esteem for rural villagers and will also help finance other RurAL CAP programs. He said RurAL CAP anticipates catalog sales of about \$3 million in its second year and profitability within five years. Mr. Geraghty did not provide data supporting the projections but said once the catalog is profitable, RurAL Cap can spin it off as a private company just as other government agencies have done in the past.

Former DCRA Division Director Tony Nakazawa said the catalog's goal is to purchase arts and crafts from villagers and urban craft-workers, sell the products nationwide, then use profits from the sales to fund such things as alcohol and drug abuse programs, child care, energy conservation and weatherization. "The whole intent is to eventually use profits to support other programs."

RurAL CAP published a second catalog in the Fall of 1994 and 370,000 catalogs were distributed. Sales were anticipated to exceed \$400,000 with a return to village artists of approximately \$160,000. Overall, RurAL CAP's studies predicted a continuing loss for the catalog for the first three years and RurAL CAP states it views operating at a loss as a program expense. The agency initially said the catalog would be self-sustaining in two to three years but that projection recently has been extended. The agency now says that in three to four years it would like to realize a profit which would finance projects for which state and federal funding cannot be secured. Recently the agency has added that if the catalog cannot sustain itself over time it will abandon the endeavor rather than continuing to use federal money for the activity.

RurAL CAP said with the \$250,000 in FFY95 CSBG money it will be able to leverage and raise at least \$500,000 more by August 1995. Referring to an unexplained "state partnership," the agency plans an aggressive fund raising plan, using a two-season track record, copies of the catalog, results of the feasibility study, and the anticipated results of the UA/CED evaluation of the project to assist the agency to raise the money.

In 1995, the agency plans to circulate at least 700,000 catalogs and plans to move the fulfillment aspect of the project to Alaska at an estimated cost increase from \$9 to \$15 per order. RurAL CAP projects 15,000 orders and net sales of \$1,500,000. The cost of goods is estimated at \$800,000, and at least \$300,000 of that will go to the villages, according to the agency.

Support for the Catalog Project

RurAL CAP has circulated petitions supporting the catalog at Native community and village functions and to date has gathered 240 signatures of support. There have been many letters of support for the catalog from individuals and village corporations. For example, the Village of Savoonga stated, "Our hope is that through a catalog, Savoonga artists and craftspeople will have a wider market to sell their products. We are committed to selling crafts to RurAL CAP for resale through a catalog."

State Senator Jay Kerttula wrote to RurAL CAP, "The idea of using RurAL CAP as a central marketing house for rural Alaska products has much merit and should give many of our rural artists and craftpersons a much wider audience for their work."

Dewey Skan, President of RurAL CAP's Board of Directors and Chairman of the 1994 Village Participation Conference, submitted a resolution on behalf of the *Aurora-Expressions of Alaska Catalog*. Citing that rural Alaska has little or no economic development, and cottage industries have difficulty gaining exposure due to their remoteness; that art dealers obtain handicrafts from rural areas at low prices increasing their profit margins at the expense of the Native artisans; and that competition is a healthy and economic means of providing for a livelihood in the rural areas, Mr. Skan resolved, "That the 1994 Village Participation Conference hereby urges the State of Alaska to offer support of RurAL CAP's catalog, *Aurora-Expressions of Alaska*, to give rural artisans the opportunity to continue the marketing and selling of their handicrafts."

INVESTIGATION

Complainant Jackie Stewart contends that neither DCRA nor RurAL CAP has shown that the catalog project is using CSBG funds as intended. Ms. Stewart asked DCRA and the Ombudsman to investigate the following concerns:

1. Why is RurAL CAP unwilling to cooperate with private enterprise by joint-venturing its catalog within the private sector? Ms. Stewart asked DCRA to further consider Alaska's policy of encouraging private enterprise to provide needed goods and services whenever possible. She said RurAL CAP's nonprofit status and access to public funds gives it an unfair economic advantage over the private sector.

2. Is there any evidence that the catalog is substantially serving low-income villagers as stated in the CSBG State Plan's Goals and Objectives for the Economic Component of the grant proposal? Ms. Stewart said that almost all of the goods offered in the catalog are produced by well-established commercial artists who live in the state's urban centers.

3. Why has DCRA not required RurAL CAP to provide a sound and complete business plan to support its financial projections? Ms. Stewart claims that the pro-forma plan as presented lacks essential elements needed for evaluation, the catalog is operating heavily in the red and there is no evidence that the catalog can become self-sustaining in the period of time projected by the agency.

Ombudsman's Initial Inquiry

The ombudsman investigator contacted the U.S. Department of Health and Social Services, Office of Community Services in Washington D.C. This agency initiates the CSBG Block Grant funding process. The agency's Federal Director Don Sykes says that in the past states have encouraged programs to try new avenues of alleviating poverty at the local level but have not focused on developing measurable outcomes. However, since enactment of the Government Performance and Results Act of 1993 individual states must now require outcomes to be "results oriented" and specific to each project proposal. Use of the funds must show a measurable and potentially major impact on the causes of

poverty within a community. Each year's funding request must address those measurements in its evaluation.

Office of Community Services Agent Mae Brooks said the federal government does not dictate specific program use to the states but does require the states to assure that the goals and objectives of the CSBG Act are substantially and not just incidentally being met. Ms. Brooks confirmed that other states have used CSBG's Economic Development Component funds to develop for-profit businesses. These businesses have focused on bringing significant numbers of new jobs and new income into the local communities. All profit generated from such activities must be put back into the same type of CSBG activities and this must be addressed in the evaluation component of the grant project.

Ms. Brooks said the question which must be answered is, "What is the project doing for the poor people of the state?" She said Alaska must evaluate whether the program is primarily meeting the intended use of the CSBG Economic Development Component and must determine whether the economic benefit to the rural communities of Alaska will be primary or incidental. Ms. Brooks cautioned that even for projects which anticipate multi-year funding, each year should stand alone as future funding is not guaranteed.

Since May 1993, the Office of the Ombudsman has attempted to elicit factual information from both RurAL CAP and DCRA regarding its evaluation of the catalog project and its response to Ms. Stewart's concerns. The Office of the Ombudsman requested DCRA's cooperation in providing the data rather than using depositions or subpoena power to compel the agency to respond.

The ombudsman investigator also examined the requests for catalog information submitted to DCRA by Alaska legislators and other residents. These requests consist of letters, legislative intent language, and state audit requests. The investigator also contacted several other states, including those named by RurAL CAP as funding for-profit enterprises with CSBG funds, and asked how those states evaluate, approve and provide oversight of CSBG funded programs. That information is included in this report.

In general, both RurAL CAP and DCRA provided much narrative dialog regarding their respective intentions, hopes and beliefs for the project. *However both agencies were essentially non-responsive in providing verifiable factual data or measurement information on which the investigator could rely.* Former Commissioner Blatchford emphasized his belief that DCRA essentially serves as an advocate for rural Alaska and told the Ombudsman he left determination of a project's ability to meet CSBG general and specific goals and objectives to RurAL CAP.

Recently there has been a change in leadership within DCRA. In February 1995, the ombudsman investigator was requested to meet with DCRA Director of Administrative Services Remond Henderson who assured her he agreed that many of the questions necessary to determine the propriety and effectiveness of using CSBG funds for the catalog project had not been answered. He affirmed his department recently has signed a contract with the University of Alaska Center for Economic Development (UA/CED) to independently evaluate RurAL CAP's present CSBG Economic Development Component. Mr. Henderson stated that further funding for the catalog would not be allocated pending completion of the study and DCRA's further evaluation.

Mr. Henderson requested that the Office of the Ombudsman conclude its report and findings to date, in order to make that information available to DCRA, the UA/CED and the Legislative Audit Division which is considering a long-standing audit request regarding the catalog. The Ombudsman agreed this would be in the best interest of the

agency, the complainant and those members of the legislature or the public interested in this issue. In late March, Jeff Smith, the newly appointed Director of DCRA's Community and Rural Development Division, also affirmed that further funds for the catalog would not be released until the UA/CED study was available for review by the department. The Ombudsman's investigative report focuses on three areas:

- The use of CSBG funds in the for-profit ventures of nonprofit agencies in Alaska and other states.
- The number of catalog items offered which are produced by rural low-income artists. The sale of those items would directly benefit the artists and bring new income into the villages where poverty is most acute.
- The financial information on which DCRA is assessing the ability of the project to meet DCRA's goal that the catalog will become self-sustaining in a reasonable period.

Funding For-Profit Ventures of Nonprofit Agencies

In early 1993, Ms. Stewart learned at a product trade show in Anchorage, that RurAL CAP was planning on starting a catalog of rural Alaskan goods with federal funds and was looking for products to include in the catalog. She then contacted DCRA who arranged for her to meet with RurAL CAP. Ms. Stewart urged RurAL CAP to consider a cooperative venture. She cited her established list of buyers and experience in all aspects of the business from catalog production and management, to order fulfillment, which could be shared with RurAL CAP. She offered to devote any number of pages to RurAL CAP's choice of products and would provide RurAL CAP a proportionate share of the profits. Ms. Stewart pointed out to DCRA and RurAL CAP that a cooperative venture would eliminate passing development funds to a California consulting company and would bolster and support an existing Alaska business.

Ms. Stewart said she was unaware at the time she met with RurAL CAP that the agency already had hired the consulting firm and invested many thousands of dollars to embark on its own project. Following the meetings which had been arranged by DCRA to "explore a cooperative venture," RurAL CAP's Planning Manager Jeanine Triplett told Ms. Stewart RurAL CAP had already invested far too much money in the project to consider Ms. Stewart's offer.

Mr. Blatchford assured the Ombudsman that DCRA is sensitive to the concerns of the private sector. He said the catalog is intended to increase markets and support rural enterprise through the use of public funds. The catalog is also intended to bring new income to RurAL CAP but "there is more to the project than the profit motive; government should not be in the business of making money. After all that would be the point at which taxpayers' money is truly competing with the private sector."

Ms. Kennedy told the ombudsman investigator, "The agency is primarily interested in paying craftsmen their asking price without negotiation and in educating consumers about Alaska." In a June 14, 1993 letter to DCRA Director Nakazawa, Ms. Kennedy said that the agency, "firmly believe(s) that the goals, objectives and purpose of our nonprofit catalog are not compatible with a for-profit venture." Ms. Kennedy described Ms. Stewart's bottom line is making a profit and said Ms. Stewart must satisfy investors and lenders. Ms. Kennedy said:

Profit is secondary to our goals. Our bottom line is working to benefit the artists, vendors and promote the Native way of life in Alaska; if we break even and don't ever make a profit we will still be realizing our goals.

In addition, since one of our goals for the catalog is to be educational, in a joint venture, RurAL CAP stands to lose control over the design, marketing and promotion which are tied very closely with how we communicate to the public the Native lifestyle and history.

However in December 1993, Ms. Kennedy wrote to DCRA Grants Administrator Jo Cooper that RurAL CAP rejects the assumption that since the catalog has received federal assistance, it should be prepared to operate at a loss:

This is contrary to the whole purpose of federal assistance to economic development to community action programs and anyone else, for that matter. The financial support for the program has always been meant to help get the project off the ground. . . If the catalog cannot sustain itself over time, then RurAL CAP would abandon the endeavor, rather than continuing to use federal money for the activity.

Ms. Stewart told DCRA from her experience in catalog development she believed that as RurAL CAP seeks additional financing from private sources such as foundations or lending institutions, the agency increasingly will be compelled to show a profitable position and its pricing structure, lay out and educational space will be constrained by its production costs.

Ms. Kennedy also said RurAL CAP was not competing with Ms. Stewart and the two catalogs did not market the same goods or artists. Investigation shows RurAL CAP's claims that it is not marketing the same artists as Ms. Stewart are inaccurate. Some of the few village artists able to produce catalog quality and quantity for any market are now selling to RurAL CAP and have left Ms. Stewart's orders unfilled. Many of the other items featured in RurAL CAP's catalog are the same mix or type of commercial goods sold extensively in catalogs and retail outlets throughout the state.

The ombudsman investigator contacted Eleanor Davenport, former manager and buyer for the Alaska Museum Gift Shop and asked her to examine both *The Great Alaska Catalog*, produced by Ms. Stewart and *Aurora-Expressions of Alaska*, produced by RurAL CAP. Ms. Davenport said the catalogs offer a similar mix of products. She noted there is almost no item in the RurAL CAP catalog which is not readily available through wholesalers or other established market outlets. Her experience leads her to say that the catalog is providing little if any forum for new non-established artists. Ms. Davenport said she is familiar with all of the artists represented and in her opinion they are not those in need of CSBG target funds or assistance.

Ms. Davenport pointed out that nonprofit and for-profit agencies can coexist if the financing, mission, pricing structure, overhead and cost of goods sold are relatively equal. She also described the destructive environment for private enterprise when those elements are heavily weighted in favor of nonprofit agencies. Continued public funding, tax-exempt status, mailing privileges and staff support to lower overhead all lend themselves to creation of an unfair playing field, according to Ms. Davenport. She said nonprofits are also able to enhance sales by appealing to customers desire to "feel good" when the agency claims a portion of the revenue will fund an agency's social programs. Often there is no evidence that any profit is occurring or being used in such a way.

The ombudsman investigator reviewed the findings of the 1989 Governor's Conference on Small Business whose task force was comprised of nonpartisan small business persons from across Alaska. A small business was defined as having 100 or fewer employees and \$10,000,000 or less in gross annual revenues. Delegates were owners, officers, employees or partners of a qualifying small business. The goal of the conference was to define clearly and seek solutions to the top 20 economic impediments faced by small business entrepreneurs. After conducting a series of 13 regional conferences, a statewide conference was held to prioritize the top 20 problem statements and recommendations for small businesses statewide. The Final Report to the Governor was issued in November 1989. Recently, Governor Knowles' Transition Team's Small Business Subcommittee has again endorsed the conference's recommendations.

Number eight in the list of prioritized problems was competition with the private sector by public-funded nonprofit agencies. Recommendations included suggestions that federal and state governments should stop the practice of giving grants to nonprofits rather than contract with existing businesses that can provide the same services. The delegates asked the state to reinforce the need for the federal government to avoid issuance of grants that compete with private enterprise. In the final report, they recommend the State of Alaska:

Recognize that geographic isolation and historically small private sector have created a situation in which state and local governments provided some services more typically filled by private businesses ... We must adhere to the principle that state and local governments and agencies that derive their funding from such governments are put in place to provide necessary public services and not to act as surrogate businesses.

Conference participants also asked the state to prohibit unfair competition in which nonprofit tax-exempt organizations use their tax-exempt status, mailing privileges and other advantages in selling products and services which are unrelated to their primary service mission.

Legislative Concerns

State Representative Cynthia Toohey, a member of the 1993 House Community and Regional Affairs Committee echoed the conference concerns in her statements to then Commissioner Blatchford. She told Mr. Blatchford that the playing field between RurAL CAP's catalog and private business is not level. She asked why not use the federal funds in a manner which complements, rather than competes with, the efforts of private enterprise? She suggested the federal funds could be used to wholesale the crafts or to sell the crafts to existing mail order catalogs.

State Representative Bill Hudson wrote to Mr. Blatchford on March 19, 1993, and expressed concern about the use of grant funds for the catalog. He said, "I believe more appropriate use of grant funds by RurAL CAP would be to assist rural areas in accommodating the needs of broader markets . . . rather than developing a business which competes with an existing business and further limits product availability." Representative Hudson urged DCRA to take whatever steps were necessary to ensure that:

1. Unfair competition against private enterprise through the use of a federal grant is not allowed.
2. Block grant dollars are used in accordance with the assurances that (then) Governor Hickel has made to the U.S. government.

3. The opportunities for development of the Native crafts industry are pursued in a way that is logical, culturally compatible and self-sustaining.

Former State Senator Arliss Sturgulewski, a board member and investor in Ms. Stewart's company also has opposed RurAL CAP's use of federal funds to develop a business in direct competition with the private sector. She cites examples of agencies which have exercised restraint in this area, "A great deal of care has been exercised by some state agencies, specifically Prison Industries to make sure they don't compete with private enterprises. I think DCRA did not do their job of looking closely at this, and now they have gotten in the position of having to justify this without doing the work to see what's needed."

State Senator Drue Pearce, who initially supported the concept of the catalog, asked for additional information before further grant funds are allocated for 1995. In November 1994, she asked House Committee on Community and Regional Affairs Chairman Harley Olberg to postpone the hearing on the CSBG FFY95 grant until more information is available. She stated, "I am concerned that almost \$600,000 of the public's money has been spent to compete with private enterprise and that hard data to support these expenditures is not available." The hearings were held on schedule in November and public testimony both for and against the project was entered into the record for DCRA's consideration.

DCRA Seeks Attorney General's Opinion

In an April 5, 1993 letter, Commissioner Blatchford responded to Representative Hudson's letter and said that DCRA was sensitive to the issues raised. He stated he had asked for a letter of advice from the Alaska State Attorney General's office regarding what constitutes unfair competition with the private sector and "hoped to receive guidance on the issue soon." He then asserted, "the Department is in compliance with all assurances which have been made to the federal requirement with respect to this program. Program guidelines do authorize funds for the purposes which RurAL CAP has proposed."

A year later, on March 3, 1994 Assistant Attorney General Marjorie Odland sent a one paragraph memorandum to Mr. Blatchford which noted the Department of Law had also provided oral advice to DCRA on the issue. The memorandum addressed only the legality of using public funds toward a for-profit enterprise and found no legal prohibition in state or federal law against the concept. The memorandum neither set out policy guidelines regarding what constitutes unfair competition with the private sector nor addressed the policy impact of the department's actions regarding any specific project.

RurAL CAP's narrative in the FFY95 State Plan asserts the agency considers its use of CSBG funds for the catalog project:

(To be) entirely correct and appropriate. More than 900+ community action agencies across America are finding that the best way to get people out of poverty is to provide them an opportunity for a job! Examples of for-profit enterprises bought, run and subsidized by Community Action include a *Dunkin' Donut* shop in Alabama; a *Lady Footlocker* enterprise in Peoria. Currently a CAA in Missouri is beginning the process of developing an arts/crafts production business among low-income people in that state.

Other States' CSBG Fund Management

The ombudsman investigator contacted the states mentioned by RurAL Cap as using CSBG funds to begin businesses and also consulted with several other states to gain information on how the applicable state departments evaluate, approve and provide oversight of CSBG funds.

Alabama

Joe McNeese, CSBG Program Coordinator for the State of Alabama told the ombudsman investigator that no CSBG money was used in the purchase or operation of the *Dunkin' Donuts* franchise mentioned by RurAL CAP. He said his department is very sensitive to the issues of competition in starting any business venture and has involved local business entities for advice in securing local city funding. This has the benefit of ensuring local cooperation and in avoiding the charge that CSBG funds would be used first to secure unrestricted income for the agency rather than to directly provide employment to low-income persons. Actually the *Dunkin' Donuts* franchise did hire 30-40 very low-income people according to Mr. McNeese. The franchise has since been sold. McNeese said that of 23 Community Action Agencies in the state only one presently is involved in a for-profit enterprise. That agency now is employing low income people on private construction crews to rehabilitate housing for low-income families and Mr. McNeese said the project is enjoying success.

Mr. McNeese added that workshops at the national level do encourage nonprofit agencies to work toward becoming more self-sustaining but most agencies charged with assisting the poor have avoided using CSBG funds to start for-profit businesses to benefit the agency. According to Mr. McNeese, the federal Office of Management and Budget emphasizes that nonprofit agencies should maintain an arms length from for-profit businesses including having a separate advisory board made up of private business participants and other local community leaders already involved in the field of endeavor.

Illinois

Illinois CSBG State Director Gray Warner reported his department is housed in Commerce and Community Affairs and thus is sensitive to the interests of the private business community as well as the mission of the Community Action Agencies to assist low-income persons. CSBG funds were used to purchase the franchise and inventory for the *Lady Footlocker* franchise but other aspects of the business were financed with a department revolving loan. Mr. Gray said the nonprofit agencies attempt to be very careful that no local charges of unfair competition are levied as the agencies' board members live in and represent the local business communities. He cautioned:

It is sometimes a thin line but the department also attempts to assure the for-profit business of nonprofit agencies is not unfairly hurting private enterprise and insists that the public-funded business must create new jobs for poor people whom private enterprise cannot afford to train or maintain.

The agency insists that a direct benefit be shown and for every \$5000 in allocated economic development grant funds one new job must be created for, and filled by, a low income person within a specified time period. Mr. Gray said the preferred method of financing for-profit ventures is through state or private loan programs which help "level the playing field."

Mr. Gray mentioned two other current business ventures in Illinois. A spaghetti restaurant is doing very well and the entry level training and job experience help employees prepare for other market opportunities. He also said the people employed are "the poorest of the poor," addressing homelessness, drug and alcohol problems and other serious impediments which make them initially less reliable or attractive to private sector employers. He also cites housing rehabilitation as a growing field of interest and notes Illinois is increasingly requiring contractors who work on state or federally funded projects to employ low-income persons. The benefits of learning skilled trades while providing housing for low-income families is a dual benefit to those employed.

Washington

Washington State Community Programs Unit Manager Steven Asher, is in charge of approving CSBG fund requests for the State of Washington. Mr. Asher said that the number of nonprofit agencies has grown significantly in recent years and many of them are engaging in for-profit enterprises. The issue of whether nonprofit agencies should compete with private business and whether those activities must be related to the agency's service mission is "another question altogether," according to Mr. Asher. However, he said that in Washington the funding sources for such ventures are carefully controlled. Nonprofits have fund raising capabilities similar to Alaskan agencies, including significant gaming permits which are capable of generating substantial revenue. These revenues in turn are sometimes used to establish for-profit arms of the agency.

Mr. Asher stated the use of CSBG funds is limited in a fairly strict way and the thrust of CSBG funding must be to directly improve the economy of the target community rather than to support the nonprofit agency. The money may not be taken from other service components and used for business development that will only secondarily benefit those program components or the communities in a "Robin Hood" or "trickle down" fashion. Mr. Asher said that in Washington a proposal such as DCRA is envisioning for the catalog project would not be an approved use of CSBG funds. Washington would require the Community Action Agency to use fund raising or other sources of revenue to finance the project.

Montana

CSBG Director for Montana, Jim Nolan noted that there is nothing illegal in most proposals to use CSBG funds to finance for-profit businesses to support nonprofit agency activities but that it is often very bad policy. He said these proposals are, "a tough call for the executive branch which must certify to the federal government that the primary purpose of the money is to assist low-income participants to secure meaningful employment."

Idaho

This sentiment was echoed by CSBG Director Jenny Brennan of Idaho who said that Idaho does not support use of CSBG funds to establish for-profit arms of nonprofit agencies. CSBG money appropriately might be used to provide staff and administrative support to business planning or to create direct employment opportunities for low income persons in endeavors such as thrift shops where any profits are immediately redistributed within the business.

Accountability Legislation Suggested

The March/April 1988 Issue of *Governing, Incorporating City and State* contained an article addressing the for-profit efforts of nonprofit agencies. The article states in part that the growth of the nonprofit sector in the last 20 years has been astronomical and there is growing apprehension regarding the amount of revenue it is generating. The article states, "This concern for revenue is entwined with the question of competition with for-profit business." Pennsylvania State Representative Italo Cappabianca said in the article that nonprofit agencies justify their revenue-raising activities on the basis of need, but he contends supporting data is often lacking. He recommended that states enact accountability legislation.

Current Availability of Rural Village Arts and Crafts.

While RurAL CAP states it hopes to use the catalog to generate a source of unrestricted revenue for the agency, the agency's written CSBG State Plan proposals have stressed the importance of providing employment and new income for rural Alaskan artists and craftspeople. In the workplan narrative of the FFY94 CSBG State Plan, RurAL CAP describes the impetus for the catalog project as coming from the fact there is a 60-65 percent unemployment rate in rural Alaska communities. The narrative continues:

Arts and Crafts production is a hidden economy in rural Alaska which assists people to survive and to continue to practice a subsistence way of life. Every village has talented artists and craftspeople. It is almost a cultural norm. RurAL CAP decided to focus on what is positive and natural in villages to promote increased income to villagers across the state. RurAL CAP has a viable and credible relationship with villages and communities statewide. RurAL CAP will work to develop a project which is envisioned in the long run to promote the indigenous people's way of life and their crafts. RurAL CAP hopes to heighten the awareness of non-Natives on the value of the Alaskan Native way of life so that their way of life may continue.

Ms. Kennedy initially told the ombudsman investigator that RurAL CAP believed adequate village arts and crafts already exist to support the agency's catalog and because of its long standing acquaintance with over 40 rural villages, the agency would have no problem obtaining sufficient quality products from the villages to supply a catalog. She said this venture is the first ever to allow low-income Native American people to be in charge of marketing their own arts and crafts in a way they choose. Ms. Kennedy cited additional benefits of its catalog to market village arts and crafts: The artisans will earn a fair price for their work; they do not need to leave their villages to increase their income potential; they do not need to learn another language; many people in the community, from youth to elder, can participate; and the program educates and sensitizes others to the value and worth of ancient indigenous cultures.

The Economic Component narrative said, "With an expanded opportunity to nationally market high quality arts and crafts for which artisans are paid good prices, RurAL CAP anticipates increased levels of dollars from outside of the state going to rural Alaskan communities. Expanded opportunities for marketing of these arts and crafts and receiving top dollars for quality work have the potential to increase incentives for producing arts/crafts."

RurAL CAP Planning and Research Coordinator Jeanine Triplett said the catalog would give villagers an opportunity to earn money as a result of their skills and handicraft work. She noted the ability for artists and craftspersons to earn money while living and working in rural Alaska helps stimulate the local economies and lessen the need for government assistance.

Ms. Stewart repeatedly has said she believes RurAL CAP's initial intentions were well-founded but that RurAL CAP quickly found that, at present, low-income rural artisans are not able to produce either the quality nor quantity of items needed to supply a nationally distributed catalog which anticipates rapid growth.

RurAL CAP's own feasibility study showed an inadequate quantity and quality of rural goods to supply the catalog and the consultants subsequently recommended expanding the commercial work of well established urban artists, both Native and non-Native, and other commercially produced items in order to ensure the financial success of

the catalog. Those few rural artists who have the resources and stability to produce sufficient quantity and quality for the catalog are already selling to existing wholesale and retail markets.

The Southeast Alaska Native Artists Cooperative Marketing Study produced in 1991 by the McDowell Group, a Juneau and Ketchikan based consulting company which specializes in economic survey and marketing studies, noted:

Starting a catalog is a major endeavor in itself. . . However there are a number of existing catalog operations which may have market potential for Southeast Alaska Native Art. The key ingredient for successful catalog marketing is quantity. If an item is included in a catalog, there has to be an adequate supply of that item to fulfill all of the orders received. The people who run catalog operations look for suppliers they know can provide this volume.

When Aesthetics Marketing of San Francisco suggested that rural village goods were limited and recommended expanding the space given mainstream artists and companies, RurAL Cap continued its plan to launch a national catalog without reexamining whether it still would meet the goals and objectives required by the funding source. CSBG Economic Development funds are intended to be used directly to create new jobs and sources of income for the eligible poor. With increasing frequency, RurAL CAP now says it will suffice to gain secondary benefit for the poor if the catalog becomes commercially successful and money is returned to the agency to support its traditional service programs.

DCRA Objects to Ombudsman Investigation's Focus

In an April 14, 1994 letter to the ombudsman investigator, Mr. Nakazawa objected to the focus on whether the catalog was providing a direct source of new income for low income village artists. Mr. Nakazawa wrote:

You seem to be focusing on the short term objective of simply offering and selling Native (village) crafts, whereas the Department was looking at the longer term goal of generating enough profit from product sales to support other RurAL CAP programs which will provide direct client services to the poor and assist them out of poverty

It's important to understand that the catalog is not, in DCRA's opinion, the end product but rather it is the means to an end product. As stated many times, we are not looking solely at how much money is going to whom for purchase of catalog products and whether or not those individuals are low income. We are attempting to determine if a catalog like this can become self sustaining and in fact, profit making, so that the proceeds from sales can be used to provide direct CSBG services to low income people in the state.

The only product-source statement provided by RurAL CAP or DCRA in consecutive State Plan narratives is that "forty percent of the catalog sales come from Native produced merchandise." A May 1, 1994 *Juneau Empire* article quoted Mr. Nakazawa as saying, "About 40 percent of the items sold were crafted by Native villagers." RurAL CAP has declined to demonstrate that any of the artists, Native or non-Native are low-income village artists rather than mainstream commercial artists who already have wide market contacts with other wholesale and retail outlets.

Almost all of the artists featured in the catalog live on a major road system and have ready access to existing markets. Some of the artists on the Native/villager list are full time salaried employees of RurAL CAP and others also have full time employment in their communities. The investigator noted that Ron Komuk, who is described in the catalog as a "Yup'ik Eskimo of Nome", actually lives in Seattle and has hired or authorized carvers in Seattle to produce work for his signature.

The ombudsman investigator repeatedly has asked DCRA and RurAL CAP to provide the following data:

- (1) Through December 31, 1993, (now through 1994) what is the description and number of individual items in the catalog which were produced by a member of the CSBG primary target population (those low income Alaskans living and creating their products in rural communities)?**
- (2) What is the name of each artist whose work is included in this list?**
- (3) What amount of new income to the rural communities was generated by actual catalog sale of these specific items?**

To date RurAL CAP has provided only one list of artists divided into two sections: Native artists-both urban and rural, and all other Non-Native suppliers. It cannot be determined from that list which, if any, of the artists are low-income residents of rural communities. DCRA said it has not asked for further data from RurAL CAP with which to assess the number of low-income villagers represented in the catalog.

Studies Address the Present Needs of Rural Artists

Many studies, including DCRA's own efforts, show an already rapidly expanding general market for Alaskan arts but a continued limited ability of rural Alaskan artists to meet those demands. The studies show also that quality village-produced goods can be absorbed into existing markets as rapidly as they are produced.

Such studies include the McDowell Group's study previously mentioned, *The Report of the Joint House and Senate Economic Mini-Summit*, 18th Alaska Legislature March 1993; *Toward a Comprehensive Alaska Rural Development Strategy*, produced collaboratively by The Department of Community and Regional Affairs, the Department of Commerce and the US Forest Service; *The Yukon Kuskokwim Region Arts and Crafts Opportunity Study*, prepared by Calista Professional Services, Inc.; *Alaska Native Arts and Crafts Cooperative Association, Inc., A Recommended Program for Alaskan Native Handicraft Development*, prepared by Ernst and Ernst Consultants.

These studies consistently show what is most needed is training and development opportunities for rural craftsman in their own communities. Crafters must be able to accommodate the needs of the numerous available markets; providing adequate quantity, consistent quality, timely delivery, and constant pricing, while producing items most in demand. The studies also show that new crafters and business managers also require training in sound business planning and marketing strategy including production techniques, quality control, access to existing markets and pricing considerations within an expanding industry.

The Yukon Kuskokwim Region Arts and Crafts Opportunity Study showed that 6.24 percent of the population were artisans. Comments and summaries from the study include the following:

Those 40,000 separate hand-crafted items which are being produced each year by approximately 800 Yup'ik artists find their way into one of the multitude of crafts distribution channels available to them. With but few exceptions, each craft enters the distribution channels almost immediately after being completed by its creator. Product inventory is almost nonexistent, for every craft not utilized by the immediate family or presented to someone as a gift is either bartered for goods or sold for cash on an "as needed" basis as quickly as a buyer can be found. . . These buyers absorb the annual crafts production of virtually every Yup'ik artisan now living in the region.

In this same study a Fairbanks Gallery owner is quoted, "I am always on the lookout for high quality Yup'ik crafts; there is always a strong demand for excellent work and I can't get enough of it." These findings are consistent with those of the McDowell Group's work, *The Southeast Alaska Native Artists Cooperative Marketing Study*:

There is a shortage of supply in the middle price range (roughly \$500 to \$2000.) Shops in Alaska and Outside both mentioned difficulties finding high quality work in this price range. A producer that could offer consistent supply and quality would do well. [Page 2.]

Most people shopping for Native art are tourists according to the retailers interviewed. This large tourist market is not being fully served because sufficient items are not available in their price range. (Another recent study showed that in 1989 586,000 tourists visited Alaska spending an average \$60 each on souvenirs, amounting to a \$31 million market, much of which presently is being filled by imported goods.) [Page 21.]

Master artists including weavers and carvers working in and building on traditional forms are currently able to sell all that they can produce. [Page 25.]

Well established master artists generally already have outlets for their work; they have the least need of marketing assistance of any of the potential cooperative members. Most have existing relationships with particular retailers, agents and institutions. [Page 26.]

These studies emphasize that workshops and training are the most needed assistance to improve the quality of production techniques, marketing and pricing of the present industry. Financial assistance in obtaining raw materials and in accessing existing wholesale and retail markets also is needed.

During RurAL CAP's 1993 Village Participation Conference held in Juneau, the development of cottage industry was repeatedly listed as an economic development priority of local communities. Ms. Stewart has suggested that with a large infusion of CSBG funds in these areas, many low income rural artists could increase their production and access the numerous existing markets thus rapidly expanding rural village income potential in a more measurable and potentially major way as the CSBG funding program intends.

Recently, the Alaska Regional Development Corporations (ARDORS) around the state applied for an Alaska Enterprise Foundation Grant. The grant proposal pointed out that in spite of substantial markets for Alaskan and Native Alaska art and handicrafts, many markets were difficult for rural Alaskans to access. Villages also needed extensive

support in accessing raw materials, increasing production and learning the necessary business skills to become more independent.

Mr. Henderson told the ombudsman investigator that his office will explore whether village goods are available which should be included in any public-funded catalog developed to serve low income rural people or whether there is a lack of such goods and other development avenues should first be explored. The agency is also interested in assessing the ability of any public funded endeavor to become self-sustaining within a reasonable period of time.

The Catalog's Financial Projections

In a June 14, 1993 letter to Mr. Nakazawa, Ms. Kennedy said,

A for-profit business managed by a 510(c)(3) organization is not a new concept and many businesses have been developed with the assistance of federal monies. Since government funds cannot support these businesses indefinitely, the assumption is that these funds are the catalyst for the creation of viable, self-sustaining businesses. . . Our goal is to initiate this project with CSBG money and for the project to become self-sufficient through other funding sources. . . .

RurAL CAP's *Feasibility Report* was prepared by the consultants who conducted the feasibility study and also produced the catalog. The report projected that with an investment of nearly \$1 million during a two-year period the catalog project would generate over \$800,000 in product sales for rural villages. Start up costs were estimated to be approximately \$200,000. The consultants said within five years the catalog could exceed \$25 million in revenue and return \$6 million to the villages.

Neither the consultants nor RurAL CAP indicated how the difference between the CSBG funds and the needed \$1 million initial investment was to be obtained. RurAL CAP acknowledged that the agency did not have the optimum amount of start up cash on which the income projections were based. Although RurAL CAP had commissioned the study on which the *Feasibility Report* was based, Ms. Kennedy told Mr. Nakazawa that she did not expect the consultants to explain their final sales or income projections:

This study is based upon statistics and projections normally used by experts in the catalog industry to calculate income based on expenses, cost of goods sold, income, list rentals and many other variables. They took into account industry norms plus other factors relevant to this catalog in projecting and predicting their figures for this study. The formulas they used to arrive at their projections are confidential/proprietary information on their part that we did not have access to.

Ms Stewart asked DCRA to examine the *Feasibility Report* closely as the published projections have not been substantiated, the business plan lacks essential elements and there is no data in the study supporting the product makeup, projected profitability or the cost base necessary to produce such profit. Later reports from the consultants have revised the estimated sales sharply downward and have increased the time period necessary to reach a profitable position.

In spite of projected losses of over \$200,000 in 1993, Ms. Triplett, told the Alaska Journal of Commerce in January 1994 that the project was already "basically breaking-even." She noted that, "most catalogs don't break-even for three to five years." Ms. Triplett did not explain her definition of "breaking-even" in light of the previously projected catalog losses for the next two to three years. The budget support sheets in the

FFY94 State Plan are unrelated to the 1994 Pro-forma prepared by the consultants. The 1994 Pro-forma projects a loss of \$521,814 and the agency did not provide an updated business plan showing future profits in support of the catalog's projected financial feasibility.

In February 1994, Ms. Stewart asked DCRA for the following information pertaining to RurAL CAP's catalog under Alaska's Public Records Act, AS 09.25. 110-120:

- (1) The 1993 Income Statement;
- (2) the Balance Sheet as of December 31, 1993;
- (3) the written evaluation report of the 1993 test run due to be produced by January 30, 1994;
- (4) the updated business plan due to be completed February 1994;
- (5) the source of capital to purchase inventory in 1994 and the total amount needed.

Ms. Stewart suggested that since RurAL CAP initially anticipates requiring three to five years of public funding before it becomes self sustaining and is presently requesting third-year funding, a well documented business plan covering the anticipated progress for the next three years of operation would be a prudent requirement by DCRA. In the agency's response Commissioner Blatchford told Ms. Stewart that only item number three would be made available when completed and the estimated completion date had been moved to April or May of 1994. The department said it had not required RurAL CAP to submit the additional data. DCRA claimed it might review such data during any monitoring visit to RurAL CAP but would not request hard copies of the data for its grant file.

The FFY95 State Plan narrative again discusses project sales and anticipated revenues in the narrative section which was last updated in February 1994. Neither a more recent narrative, an updated business plan nor a complete budget on which the support data is predicated are included in the funding request. RurAL CAP has included only the "Test Program Pro-Forma, Plan C -Revised March 30, 1993," in the FFY95 State Plan.

DCRA has repeatedly said it believes the catalog has the potential to meet both DCRA's goals and the intent of the CSBG program, and the Ombudsman has asked the department to provide the financial data to support DCRA's confidence in long range financial success. Other interested individuals have also asked DCRA and RurAL CAP to provide verifiable data to support confidence in the project. The requests are reflected in legislative intent language and in a request for a legislative audit of the catalog project.

Legislative Intent Language Drafted

During the 1994 legislative session, Representative Eileen MacLean's office drafted Intent Language within the Capital Budget addressing DCRA's approval of CSBG funds. The language which was supported by other legislators read:

It is the intent of the legislature that RurAL CAP prepare a report to the Legislature before grant funds are released showing solid evidence that use of CSBG funds for the economic development catalog project meets the following requirements:

- (1) The catalog will provide a market to low-income rural Alaskans whose artwork comprises the majority of items for sale.
- (2) The catalog is achieving financial solvency and will break even after the first three years of production excluding an subsidy.
- (3) RurAL CAP will provide training opportunities to low-income rural Alaskans in an effort to boost production of artwork available for the catalog.

RurAL CAP board members lobbied for removal of the intent language. Stanton Katchatag of Unalakleet said in a letter to Representative Maclean, "the language will restrict RurAL CAP's ability to continue with the catalog." There was no explanation why Mr. Katchatag and others believed the language would have that effect but the language was removed by then Governor Walter J. Hickel in exercising line item veto authority over the FY95 Budget Act. Governor Hickel's staff told the ombudsman investigator the policy was to remove any language to which a constituent objected but such removal was not necessarily a reflection of Governor Hickel's position on an issue.

Legislative Audit Requested

In February 1994, Representative Bill Hudson requested a legislative audit of DCRA's CSBG Program. He included both compliance and performance questions in his request:

Key Compliance Questions:

1. Was a sound "State Plan" developed to support the proposal to begin a state catalog business venture before FFY93 funds were disbursed?
2. Were FFY93 grant funds used in accordance with the approved "State Plan"?
3. Were the results of the first year of the catalog venture used to develop a sound "State Plan" for use of the FFY94 Community Service Block Grant Funds?
4. Do the financial reporting requirements of the catalog venture include all grant funds that have been used for the project; including all start-up, consulting and administrative expenses?

Key Performance Questions:

1. To what extent does the Economic Development Component compete with private enterprise?
2. What if any, restrictions are placed on how state or federal funds may be used to supplement or compete against privately funded venture?
3. Are there any standards, or measurements, whereby policy-makers can determine how, or if, government funding is leveraging or displacing private funding and efforts?
4. Are there any standards, or measurements whereby program administrators can determine what proposals can best promote rural/native arts and crafts?

Legislative Auditor Randy Welker has confirmed his agency's willingness to conduct an audit but has waited for the results of the Ombudsman investigation to narrow the focus and avoid duplication in investigating the issues.

DCRA's Present Response to Requests for Information

As stated, DCRA recently signed a contract with UA/CED to address many of the questions raised by this investigation regarding DCRA's oversight and evaluation of the use of CSBG funds to support RurAL CAP's catalog venture. UA/CED outlined three objectives it would undertake to assist DCRA in evaluating the catalog project effectively:

(1) Determine whether the anticipated cash flow returns from the Aurora catalog project warrant future investment of money based only on direct economic criteria. In other words, answer the question: Ignoring social and other benefits, what is the anticipated return on investment? The University states it is anticipated that this phase would involve an examination of business plans, feasibility reports and other documents to assess the reasonableness of projected cash flow patterns and levels. Phase two would involve taking past cash flows and based upon the findings, forecasting them into the future. The last phase would involve computing internal rates of return.

(2) Evaluate the Aurora catalog's ability to bring cash into rural communities based upon the initial test run and projections of future sales. To accomplish this the University planned to determine the amount and percentage of purchases from rural communities and the relative sales success of such articles, and to estimate the value added from rural areas. The question of rural versus urban sales will be based upon an examination of inventory purchases and sales by vendor and vendor location. It will then be necessary through interviewing a sample of producers and retailers to estimate the original source of the goods and the value added in rural areas.

(3) Determine the extent to which catalogs increase the level of knowledge among non-Natives and non-Alaskans regarding Native life styles and Native culture.

(4) Determine the extent to which sales from Aurora Catalog complemented or replaced sales from other catalogs featuring Alaskan goods/crafts.

ANALYSIS

Based on the recent request by DCRA that the Ombudsman's office conclude its investigative review prior to completion of the UA/CED study, the Ombudsman has agreed to rely on DCRA's present assurance that a complete evaluation of the catalog project will be completed prior to any further determination by DCRA regarding the use of CSBG Economic Development Component funding for the catalog project. This assurance was provided both by DCRA Director Of Administrative Services Remond Henderson and by DCRA Director of the Community and Rural Development Division Jeff Smith.

The following allegation analysis and finding reflect the Ombudsman's ongoing concerns.

Allegation. The Department of Community and Regional Affairs' continued approval of Federal Community Services Block Grant (CSBG) Funds to the Rural Alaska Community Action Program, Inc. (RurAL CAP) for the development of a mail order catalog is unreasonable in that:

(1) The catalog has not been supported by an adequate departmental review for compliance with federal requirements that funded activities must have a measurable and potentially major impact on the causes of poverty in the community or those areas of the community where poverty is a particularly acute problem.

(2) DCRA's approval of federal funds for this project is in conflict with Alaska's stated encouragement of private enterprise and the development of small businesses to provide needed goods and services whenever possible

The Ombudsman's Policy and Procedures Manual at Section 4040(2) states in part that an administrative act may be "unreasonable" in those situations where a procedure imposed or followed by an agency has no bearing on or fails to achieve the purposes for which the procedure was established. The Ombudsman statute, AS 24.55 190 (a) states in part:

The Ombudsman shall report the opinion and recommendations of the Ombudsman to the agency if the Ombudsman finds after investigation, that:

- (1) a matter should be further considered by the agency; or. . .
- (4) reasons should be given for the administrative act;
- (5) any other action should be taken by the agency; . . .

In Alaska, the Department of Community and Regional Affairs is charged with the oversight and evaluation of CSBG funding used for RurAL CAP's program components, including the current Economic Development Component. DCRA agrees that the basis for evaluating the catalog should be as Federal Agent Mae Brooks states: "What is this project doing for the poor people of Alaska and are the stated goals and objectives being met?" The federal government requires the states certify CSBG funds are used for projects which have a measurable and potentially major impact on the causes of poverty in the local communities where they are used. [Emphasis added.]

Alaska's FFY92 State Plan narrative explained that CSBG funds remain one of the most versatile sources of funding allowed to RurAL CAP to meet its mission statement of, "promoting maximum participation by village people in the elimination of the causes and conditions of poverty." The narrative states that while many funding sources have narrow restrictions on the scope of services, CSBG funds can be used to respond to the most pressing and unmet needs of people in poverty.

In requesting CSBG funds to begin its catalog project RurAL CAP hoped to use the fund's flexibility to the agency's advantage. From the beginning RurAL CAP has intended this project to provide the agency with a source of unrestricted income to further its administrative and program goals. However, RurAL CAP recognized that CSBG Economic Development Component funds were intended to be used in a way that directly

created significant new economic opportunities and sources of income for low-income persons in communities where poverty is a particular problem. It is well accepted that in Alaska those areas most affected by lack of employment and disposable income are the more remote village communities. To request funds under an Economic Development Component of CSBG funding, the creation of expanded employment opportunities as a means of alleviating poverty in those villages had to be addressed.

RurAL CAP repeatedly emphasized in its narrative descriptions of the project that *Aurora-Expressions of Alaska* is intended to lessen the conditions of poverty in rural Alaska by increasing cash flow to the villages through marketing of village arts and crafts. Ms. Kennedy said the catalog would allow artists to earn a fair price for their work and remain in the villages. The catalog also is intended to increase village self-esteem and hope for a better economy as well as educate those outside Alaska to the value of the Native culture.

Function Changes

Even before the first catalog was produced, RurAL CAP's consultants recommended changing the function of the catalog from that of primarily marketing the goods of low-income rural artists who had few viable markets. Instead, the purpose increasingly became the marketing of whatever would most guarantee the catalog's commercial success. The emphasis thus was placed on offering the goods of already successful artists and commercially proven products which could be reliably supplied in large numbers or quickly reordered upon demand.

The acknowledged beauty of the catalog layout and emphasis on rural culture helped assure the catalog a glowing reception within Alaska and undoubtedly provoked pride in those Alaskans whose lifestyle it extolled. The question remains whether that increased pride and awareness has become the primary benefit to villagers or whether the catalog is having a significant effect on the 65 percent unemployment rate by measurably increasing income opportunities now for "low-income individuals in villages where jobs continue to be very limited."

CSBG Economic Development Component funds are intended to create new jobs, in this case in rural Alaska, and to have a measurable and potentially major impact on the causes of poverty by their direct application. Other states have emphasized how direct and measurable federal regulations require those efforts to be. Eleanor Davenport, an expert in Alaskan art has said that at present there are few, if any, non-established low-income artists served by the catalog. While there is the possibility that a few such artists gradually could be included in a successful catalog, the driving force continues to be commercial success which demands a high volume of quality items. Numerous studies have shown that without concentrated financial effort directed at increasing rural arts production, the number of village artists able to supply a catalog will be minimal. The studies also recommend that major advocacy effort be directed at helping village artists access a range of already existing markets which can accommodate a broader range of both product type and number.

As the catalog approaches its third year of requested funding, the Ombudsman has asked DCRA to verify whether RurAL CAP's use of CSBG Economic Development Component funds creates significant new income avenues for rural villagers. Can DCRA support RurAL CAP's assertions that its products are from rural villagers who now enjoy a new or expanded market not otherwise provided? Of the village arts and crafts which RurAL CAP purchased for possible catalog inclusion, which were actually sold through its catalog? Some village craftspersons told the ombudsman investigator they endorsed the catalog believing their work would be included when in fact it was not included in any edition of the catalog published to date.

There is another important consideration. Can DCRA reasonably assure the villagers who support the catalog that this project will expand their markets as they hope; in a sustainable and non-exclusive way? To do that, DCRA will need to evaluate RurAL CAP's intention to pay vendors their asking price which may be more than other markets are able to pay. Will those prices be sustainable without the availability of public funds? Is RurAL CAP competing fairly and helping rural vendors face realistic market constraints? Is RurAL CAP helping vendors avoid the costs of a "middleman or has RurAL CAP taken on that role?

DCRA also is asked to examine if RurAL CAP is competing in an arena already served by private business (*i.e.* wholesalers, retailers and other catalogs)? Is RurAL CAP providing a service and a substantial impact which the private sector is unable or unwilling to accommodate? The issue of competition is a valid one when public funding is supporting a for-profit venture which may have an adverse effect on the ability of existing private sector businesses to secure available products or essential financing. As this investigation has shown, nonprofit agencies are increasingly interested in adding for-profit components to their traditional service roles. State governments will more often be asked to critically evaluate the need for such competition and its possible negative effect on small businesses which the state also has nurtured and encouraged. Any department charged with evaluation and oversight of nonprofit entry into the for-profit sector will need to anticipate close public scrutiny of the department's decision-making and oversight process.

As long as RurAL CAP requests public funds, it must answer to the public for the use of those funds and the private sector has a legitimate interest in closely examining the stated premises and promises on which the current catalog project is based. While RurAL CAP's catalog is an appealing product and may be a worthwhile venture on any number of fronts, the use of CSBG funding confers a responsibility on the Alaska state agency responsible for that oversight to more narrowly certify that those funds are used in the manner defined by the federal assurances and in a way which considers both the public benefits and the legitimate private interests within the state.

DCRA Addresses Its Oversight Responsibility

DCRA has been charged by the governor with providing that oversight and evaluation of CSBG fund application in Alaska. Recently the agency has made arrangements for UA/CED to conduct an independent evaluation of the catalog. It is hoped that study will provide some definitive financial and marketing information on which DCRA may rely in formulating the required federal assurances and in making any further funding decisions.

In addition to the UA/CED evaluation however, DCRA has in-house capability to fully evaluate business plans and projections and to identify and request any missing elements. The department routinely handles business loan applications as well as grant requests for individuals and other entities. Because the department processes applications from governmental agencies, private enterprises and individuals, it also has the experience and awareness to address the issue of competition and to evaluate when public funds serve to augment private sector goals and when they are used to compete against them.

The Ombudsman urges DCRA to use all available resources to further exercise its oversight responsibility in evaluating the catalog project and assuring compliance with the Government Performance and Results Act of 1993. In this effort DCRA should require RurAL CAP's outcomes to be "results oriented" in assuring that the use of any CSBG economic development funds will have a measurable and potentially major impact on the causes of poverty within the community as required by federal law and regulation.

Recent Agency Action

The Ombudsman's preliminary report was given to DCRA for consideration and response on March 20, 1995. The Ombudsman requested a reply by April 5. On March 30 DCRA Director of Community and Rural Development Jeff Smith asked for an extension to May 5. Due to the complainant's declining patience with delay in concluding the investigation and releasing the report, and both public and legislative interest in the report, the extension was granted only to April 24. Mr. Smith agreed to that extension.

On April 24, Mr. Smith asked for a few more days to complete the response and the ombudsman investigator met with Mr. Smith on April 27. At that time he stated that DCRA Commissioner Mike Irwin was reviewing the decision by both Administrative Services Director Remond Henderson and Community and Rural Development Director Jeff Smith to withhold further funding of the catalog pending completion of the review of the project by UA/CED and DCRA. Mr. Smith said Commissioner Irwin possibly would reverse that decision. Mr. Smith acknowledged the potential negative impact on the complainant and the adverse effect of continuing delays in releasing the investigative report. Mr. Smith was asked to have the agency decision and response to the Ombudsman by the close of business May 28 for inclusion in the final report.

Mr. Smith also had a lengthy discussion with Ms. Stewart the evening of April 27, and told her the agency "wanted to do the right thing and had not made a final decision on release of the money." He promised to talk with her before a final decision was made. Ms. Stewart reiterated the request made to the Ombudsman that the report be made public no later than May 1 so that it would be available to the public prior to the end of the legislative session. According to the complainant, the public, including several legislators, are becoming impatient and fearful that the agency is deliberately stalling in its response to avoid further scrutiny. Ms. Stewart also expressed her concern that further release of funds without data supporting the benefit to low-income rural villagers would perpetuate the grounds on which the initial complaint was made: DCRA would again allow the catalog to operate for another full year regardless of the lack of available data to support the project. Further, if the pending studies showed the catalog did not meet the grant requirements, the funds could not then be withdrawn.

DCRA had approximately six weeks to respond to the preliminary report. 21 AAC 20.220 gives an agency 15 days to seek modification of the Ombudsman's finding or opinion. The response period is intended to allow the agency to make factual corrections or submit additional facts in support of a request for modification of the Ombudsman's findings. While extensions for good cause may be granted, failure to provide a timely response should not afford the agency an opportunity to avoid meeting a deadline or indefinitely postpone release of the report. Delay in release also must be weighed against the complainant's need for a timely response in order to reverse past injury or prevent further harm.

The regulations also allow the Ombudsman, "*in his discretion*," to request an agency to respond to the recommendations. The Ombudsman may ask the agency to respond within 30 days. The request that an agency respond formally to the recommendations was intended to formalize the agency's intention to correct a situation or change a policy or procedure in light of the investigative finding.

In this case, DCRA was aware of the investigative process and probable findings for several months but apparently is having difficulty, not with the investigative report itself, but with the agency's previous position and present choices. Because DCRA has not indicated that further factual information will be forthcoming at this time the

Ombudsman's finding and recommendations are based on all information available to date.

FINDING

Based on the information presently available to this office, the Ombudsman proposed to find the allegation *justified*. This basis for this finding is provided for in 21 AAC 20.210(b)(1)

(b) When presenting a finding or opinion under (a) of this section, the Ombudsman will, in his or her discretion, determine that the complaint or an allegation within it is (1) "justified" if, on the basis of evidence obtained during the investigation, the Ombudsman determines or believes the complainant's criticism of the administrative act is valid;

RECOMMENDATIONS

The Ombudsman recommended to the agency that:

1. DCRA urge the UA/CED to complete its study in a timely manner and that DCRA make the study available to the Ombudsman, the Legislative Auditor and to the public.
2. DCRA use all in-house resources at its disposal to aid both the University of Alaska and its own staff in fairly and completely evaluating the concerns raised by Ms. Stewart and others as reflected in the Ombudsman's report.
3. DCRA adhere to its initial resolve that no further CSBG funds be allocated for the catalog project unless such studies and evaluation demonstrate the project's present and continuing ability to impact the causes of poverty in rural Alaska in a measurable and potentially major way.
4. DCRA consider those recommendations adopted by the 1989 Governor's Conference on Small Business as well as policy positions supported by the current administration, in its evaluation of any public-funding request to provide a service or product which competes with the small business sector of Alaska.
5. If DCRA finds the catalog project does not meet the goal of having a measurable and potentially major impact on rural poverty as well as the goal of providing activities which directly assist low income participants to secure and retain meaningful employment opportunities, then DCRA should explore with RurAL CAP staff other options which would direct the resources available toward linking rural artists with the expanding marketplace in a way that is culturally compatible and financially sustainable.

AGENCY RESPONSE

The agency response to the investigative report was provided on May 4 by DCRA Commissioner Mike Irwin. Commissioner Irwin wrote:

Jeff Smith spoke with Ms. Shriner to respond to specific requests which Ms. Shriner made during this telephone conversation (to submit the formal agency response), but I must make it clear that by so doing, I am not concurring with the findings and recommendations of the initial (preliminary) report as identified in your March 20, 1995 correspondence.

During our conversation last week, Ms. Shriner asked that I provide my written assurance that the Department of Community & Regional Affairs is in fact under contract with the University of Alaska, Center for Business Development, for completion of an independent evaluation of the Aurora Catalog project. We expect to have the results of that evaluation no later than July 17, 1995, with a preliminary status report by June 18, 1995. We will be happy to share that evaluation with you at that time.

Secondly, Ms. Shriner requested that I provide written assurance that no additional Community Services Block Grant funds will be released until after the aforementioned evaluation is completed and reviewed by the department. We are in the process of working with RurAL CAP and the University that will allow me to make a decision on future funding with the best information available.

CONCLUSION

The finding and recommendations presented to the agency remain the finding and recommendations of record in this matter. This complaint will be closed as justified, based on the data and information presently available to this office. However, because DCRA has committed to further review of the catalog project by UA/CED and because that project also may be the subject of an audit by the Legislative Auditor, the Ombudsman will consider modifying the finding in an addendum to the final investigative report following DCRA's consideration of that data in making its final administrative decision regarding future funding of the catalog project.

SCH:DMS:cld: