

December 28, 2011

Secretary Dale A. Rodman
Kansas Department of Agriculture
109 SW 9th Street, 4th Floor
Topeka, Kansas 66612-1280

Dear Secretary Rodman:

I am writing in response to your letter dated December 19 regarding KBA investment outcomes and other issues. I have forwarded your letter and my response to the Board and we will discuss these issues at our next meeting when the audit report is also presented.

The Kansas Bioscience Authority Board and staff are committed to the mission of growing the bioscience sector of the Kansas economy. We believe the KBA has been successful in driving toward this mission and that investment outcomes KBA has reported reflect that progress.

At our Dec. 7 meeting, you stated your displeasure that KBA had released information regarding 2011 investment outcomes. It has been the KBA's annual practice to report outcomes following the October board meeting. The Board encouraged management at the November 2011 Board meeting to do more to communicate KBA outcomes to the public. To address your concerns about outcome data, I stated at our Dec. 7 meeting the Board's and management's interest and willingness to review outcome methodology and reporting as well as involving a qualified third-party to validate a methodology to ensure the information reported is as sound, accurate and meaningful as possible.

Other views your letter expresses, after you have spent the past eight months closely monitoring the KBA and actively participating in an exhaustive forensic audit, cause me concern. The KBA has cooperated fully with you and others in the Administration, opening every aspect of KBA operations and documentation to you and those conducting the forensic audit whose broad scope you have fully and totally defined. Given your views on KBA investments and expenditures, the Venture Accelerator, conflicts of interest and other matters after your extensive involvement and the draft findings of BKD, I am unsure that explanations we provide regarding the KBA will mitigate your opinions. Nevertheless, I believe it is important to address the issues you raise with information that I believe is pertinent to a fair analysis of the KBA and its activities.

The KBA Board and management have sought to work collaboratively with other state agencies, including the Department of Commerce. We are all working toward the same end. The reporting of KBA outcomes is intended to show progress for the entire state's efforts to grow the biosciences, while specifically reporting the outcomes of companies and universities funded by the KBA. The outcomes news release distributed on Nov. 16, 2011, quotes me:

"The outcomes reported today demonstrate KBA grants and investments are succeeding in building the bioscience sector in Kansas and fueling the Kansas economy. We acknowledge

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and appreciate the efforts of the partners that helped achieve these outcomes for the state, including the Kansas Department of Commerce.”

Like other aspects of KBA operations, outcomes reporting and documentation has improved as the KBA has matured and a full-time staff person has been dedicated to that effort. We believe that this process will continue to improve as we review our methodology and reporting requirements and trust that future reports will be sound and meaningful.

The extensive and exhaustive forensic audit will provide a definitive look at other matters you raise.

BKD has spent eight months engaging in an in-depth review of KBA activities at significant expense. This comprehensive audit has examined all KBA expenditures and contractual arrangements since its inception in 2004, potential conflicts of interest, analysis of specific investments, the process which approved the Venture Accelerator and KBA offices, as well as issues related to former KBA president Tom Thornton and other matters brought to BKD's attention by you and others. BKD has provided you updates contemporaneously with our own.

BKD professionals have spent over 1,900 hours conducting the investigation, which at the last draft produced a 142-page report, with an additional 600+ pages of exhibits. BKD interviewed 67 individuals during the investigation, including current and former KBA employees and Board members, current and former lawmakers with knowledge pertaining to the KBA, and persons and companies doing business with the KBA.

Your letter cites “several major inefficiencies” and your view that “the Board of Directors and the Management of the KBA have allowed excessive spending, poor investment returns with a lack of jobs, encouraged high overhead, self expenditures and allows apparent conflicts of interest.”

I believe the draft forensic audit reflects the following:

- There is no pattern or practice of unauthorized or improper expenditures;
- The investment process and Investment Committee are thorough in their review of investments;
- The KBA investment process is sufficiently diligent to prevent the improper approval of investments;
- No grants or investments were deemed inappropriate or in violation of KBA's Conflict of Interest policy or the Kansas Economic Growth Act of 2004 (KEGA) which defines the parameters of the KBA;

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- The level of documentation, organization and completeness of KBA files related to contracting with third parties improved markedly over the years and most exceptions noted occurred in the early years of the KBA;
- The decision to construct the Venture Accelerator and KBA offices was made in 2007 and all aspects of following through on this decision are set out.

If the conclusions set out in your letter are publicly put forth as those of the Administration, I believe it will unfairly and wrongly send a dissonant message to KBA partners, clients, potential clients and others with whom KBA currently has significant credibility. I believe the audit report should speak for itself and that we should then move forward constructively in carrying out the mission in KEGA.

Attached to this letter are responses to the bulleted points in your letter.

In light of the short time frame between now and January 5th, the fact that we do not anticipate receiving a final BKD draft report until sometime in the first week of January at the earliest, the difficulty in holding a special Board of Directors meeting and briefing all board appointing authorities prior to January 5th, the fact that the CIBOR audit will not be finalized by January 5th and the importance of these issues to the Board, I believe it is a more realistic course to have both BKD and the CIBOR auditors present their findings to the KBA Board at our regularly scheduled meeting on January 23rd with a meeting to present the findings to KBA appointing authorities (Governor and legislative leadership) on January 24th with public release made quickly thereafter. I informed the Governor's Chief of Staff of these concerns and my preference for the audit reports to be made at the scheduled KBA Board meeting and public release after briefing the appointing authorities on the findings.

I am willing and available to discuss these matters should you desire it.

Very truly yours,

Daniel L. Watkins
Chair of the Board

Cc: Governor Sam Brownback
Steve Anderson
Caleb Stegall
David Kensinger
KBA Board

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**Bullets in Sec. Rodman's letter dated Dec. 19, 2011, in italics
followed by Watkins Responses**

1. *It should be noted that the actual formalization of the existing KBA management and board structure began in 2007 and many of the claimed outcomes predate that time frame.*
2. *Since 2007 only 347 jobs are shown in the investment outcomes as created by the KBA.*

The KBA was established by the Kansas Economic Growth Act of 2004. The first board of directors was formed in August 2004 and met for the first time in September 2004. The KBA made its first investment commitment in July 2005. It is not clear why jobs created by companies which received KBA investments prior to 2007 should not be included—or should somehow be treated differently—than outcomes for investments made after 2007. Early KBA investments are as pertinent as current investments.

The Quintiles investment made in fiscal 2006 accounts for 55% of the 1,347 full-time bioscience jobs (751 jobs) created by 41 companies. Quintiles also accounts for \$45 million in reported capital expenditures. The investment in Quintiles has obviously paid significant dividends in the development of the Kansas bioscience industry and is thus included in KBA outcomes.

3. *Commitments and payments by the KBA in the statement from 2007 are \$246.1 million. The investment cost per job exceeds \$708,000 and is certainly actually higher because KTEC and Commerce made additional investments in many of these companies as well.*

The calculation assumes all commitments since 2007 have been paid and are already at work, and implies that the sole purpose of KBA investments is job creation.

As articulated in KEGA, growing the biosciences is a long-term strategy. If the KBA focused solely on short-term job creation, it would invest only in large, late-stage expansion and attraction deals, which would not necessarily result in the broad, long-term industry growth envisioned by KEGA. If the KBA's only goal were short-term job creation, it would not have invested in helping the University of Kansas Cancer Center prepare for National Cancer Institute designation, NBAF, a large number of early-stage companies with promising bioscience discoveries, or other opportunities for long-term growth of the biosciences.

\$87.5 million has been paid on all \$250.5 million in KBA investment commitments through June 30, 2011. Over time, many additional jobs will be created, spurred in part as milestones are met and these investment commitments are paid out.

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- 4. The \$816.4 million cumulative equity investment claimed by the KBA also appears to be incorrect and overstated.*

\$816.4 million is the cumulative impact of wages, external research funding, capital expenditures and equity investments reported in the November 16 news release based on information provided by KBA client companies and other entities. The total cumulative equity outcomes reported are \$78.9 million.

- 5. Included in the press release numbers is \$86.7 million spent by Homeland Security outside of the State of Kansas and cannot be credited to the KBA.*

The Department of Homeland Security has to date awarded \$86.7 million in contracts related to NBAF. These contracts are integrally related to the eventual construction of the lab in Kansas, which was the aim of the investments and efforts of KBA and others in recruiting NBAF to Kansas. Without these investments by DHS, NBAF could not be realized in Kansas.

- 6. Research grants are included as total amounts although much of the funds are designated payments in future years.*

Grants that are awarded to Kansas research institutions and companies are highly likely to be delivered by the granting entity. For that reason, the KBA does not require these institutions and companies to report on exactly when the cash arrives in the state. However, under regular reporting, the KBA does identify those rare instances when awarded funds are not received and they are then deducted from KBA outcome reports.

- 7. There are numerous instances of what appear to be double counts where KBA numbers invested in a company are added to the funds being invested by the receiving company for the same asset.*

KBA grants are not supposed to be counted as part of any KBA outcome. All client reporting forms indicate this very clearly. If there are identified specific instances where this may have occurred, they will be corrected as we are currently not aware of such instances.

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8. *KTEC and Commerce have also invested in some of these businesses so KBA cannot claim all the investment leverage or the outcomes.*

The KBA works with many partners, including KTEC and the Department of Commerce, to grow the bioscience sector in the state. The state's universities, federal agencies, philanthropies, private investors, and others often match our grants. We actively collaborate with others and annually report outcomes as a gauge of the state's success, and say so in KBA releases.

9. *One of the major issues raised by critics of the KBA has been unnecessary and wasteful expenditures of state money. My review of the expenses of the KBA from public documents from 2007 through 2011 included the overhead costs of not only the KBA but also of the affiliated Centers of Excellence and Heartland Bioventures. The KBA and its created affiliated entities have a total overhead cost of nearly 40 cents for every dollar invested when all costs are considered.*

Since its inception the KBA has incurred approximately \$17 million in administrative expense. This amount does not translate into a 40% overhead cost. As a proportion of total investment commitments, it equates to approximately 7 cents on the dollar. As a proportion of investments actually paid, it is approximately 20 percent.

The Centers of Excellence are KTEC programs that are unaffiliated with and have never received funding from the KBA. While the KBA has helped fund four Centers of Innovation, they are independent entities with independent boards and other independent investors. Including the operating costs of these centers or overhead of other entities in which KBA invests as part of KBA operating costs is not a generally accepted accounting practice.

10. *KBA has entered into debt commitments of over \$10.0 million in regards to the Olathe industrial park and office that are due after the scheduled sunset date for KBA.*

The KBA made a financial decision to finance the Kansas Bioscience Park through debt as most capital improvements are financed. This has been contemplated in financial KBA projections, and the KBA clearly has planned to cover this debt as it matures. The statute provides a mechanism for the KBA to exist in some form after sunset specifically to pay these types of longer-term commitments. In addition, the KBA could elect to pre-pay any debt amount at any time.

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11. *The \$18,489,616 spent on the office in Olathe was ill advised and excessive. KBA had adequate office space prior and this was a waste of Kansas money.*

The fundamental purpose of the Venture Accelerator is to serve as an incubator where Kansas helps jump-start early stage bioscience companies, in line with KEGA. The KBA's offices are within the incubator, making its business professionals readily accessible to tenants. The decision to construct the incubator was made by the Kansas Bioscience Authority board of directors in 2007, under the direction of then-KBA Chairman Clay Blair. The construction cost of \$285 per square foot compares favorably to comparable buildings, including the neighboring K-State Olathe Innovation Campus.

12. *KBA was created to provide funding for private entities to create jobs but appears to have used much of its public funding for internal investments. In 2010 over \$90 million and in 2011 over \$80 million was on KBA's balance sheet as cash or securities held for investment. The use of taxpayer dollars to create investment income for KBA operations is a dubious use of citizen dollars.*

The amount of cash KBA receives is defined within the funding formula outlined in KEGA, and is administered by the Kansas Departments of Labor and Revenue. KBA does not pay out commitments in a lump sum, as KBA grants and investments are earned based on the achievement of specific milestones. Funds that have been received and committed but not yet paid are maintained in interest-bearing accounts, in accordance with sound financial practices.

13. *I was recently told by the acting CEO of the KBA "The KBA is not here to create jobs."*

This supposed quote is not a view held by or expressed by Mr. Vranicar as a flat statement with no other context. Mr. Vranicar supports the purpose and mission of KEGA, "to make Kansas the most desirable state in which to conduct, facilitate, support, fund and perform bioscience research, development and commercialization, to make Kansas a national leader in bioscience, to create new jobs, foster economic growth, and advance scientific knowledge and improve the quality of life for citizens of the state of Kansas." While an important part of this mission is generating jobs today, the longer-term mission is more robust: to build a bioscience infrastructure that will generate high-paying bioscience jobs today and for future generations of Kansans. KBA investments reflect this mission and do not solely focus on near-term job creation. I believe this is the point Mr. Vranicar made in our Dec. 7 meeting to which I think you refer.

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14. The Board of Directors and the Management of the KBA have allowed excessive spending, poor investment returns with a lack of jobs, encouraged high overhead self expenditures, and allowed apparent conflicts of interest.

I do not believe the exhaustive forensic audit conducted by BKD and its findings will support those conclusions. I trust the audit report will speak for itself and that upon its conclusion we can make any needed adjustments and move forward toward achievement of KBA's mission.