



FEDERAL ELECTION COMMISSION
WASHINGTON, D.C. 20463

December 1, 2010

MEMORANDUM

TO: Joseph F. Stoltz
Assistant Staff Director

FROM: Christopher Hughey *ch*
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SUBJECT: Preliminary Audit Report for McCain-Palin 2008, Inc. and McCain-Palin Compliance Fund, Inc. (LRA 759)

The Office of the General Counsel has reviewed the proposed Preliminary Audit Report ("PAR") for McCain-Palin 2008, Inc. (the "General Committee") and McCain-Palin Compliance Fund (the "GELAC").¹ Our comments primarily focus on Finding 1: Campaign Travel Billing for Press. We agree that the General Committee should refund the amounts of excess reimbursements to the press rather than transferring funds to the candidate's primary election committee. We concur with your calculation of the amount the media should reimburse to the General Committee for the actual costs of the air charter contract paid for and used by both the primary and general campaigns. We question, however, the legal basis for your calculation of reconfiguration costs billable to the press. We recommend that you raise the reconfiguration costs issue for the Commission's consideration.

Your cover memorandum also requests comments on two issues that are not included in the proposed PAR: Issue 1 -- Media Vendor Earned Interest and Issue 2 -- Hybrid Communications. We reiterate our informal advice concerning the interest issue

¹ We recommend that the Commission consider this document in Executive Session because the Commission may eventually decide to pursue an investigation of matters contained in the proposed Report. 11 C.F.R. §§ 2.4(a) and (b)(6).

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to formalize our advice and inform the Commission. We also comment briefly on the hybrid communications issue. We recommend that you raise both of these issues for the Commission's consideration in the cover memorandum to the Commission. Finally, we concur with the remaining findings not specifically discussed in this memorandum. If you have any questions, please contact Delanie DeWitt Painter, the attorney assigned to this audit.

I. CAMPAIGN TRAVEL BILLING FOR PRESS (Finding 1)

A. Background

The draft PAR states that the auditors reviewed travel billing and press reimbursements and concluded that the General Committee must refund \$382,299 to the press for excessive reimbursements. The press traveled with the presidential candidate on a plane chartered through Swift Air LLC ("Swift Air"). John McCain 2008, Inc. ("Primary Committee") had used the same chartered airplane during the latter part of the primary campaign. The press traveled with the vice presidential candidate on a plane chartered through JetBlue Airways Corporation.² The auditors calculated the total actual transportation cost to the press was \$3,722,208. They determined that the maximum that the General Committee could bill the press was 110% of this actual cost, \$4,094,429. The General Committee billed the press \$4,503,658 and, in response to those bills, received reimbursements of \$4,476,728. Thus, the auditors conclude that the General Committee must refund the excessive amount of \$382,299 (\$4,476,728 - \$4,094,429) to the press. The excessive reimbursements were caused by the Committee's method of calculating the actual travel costs on the leased airplane from Swift Air and the costs of reconfiguring the leased Swift Air and JetBlue airplanes.

1. Swift Air Flight Costs

The Swift Air charter contract for the leased aircraft covered a portion of the primary campaign and the entire general campaign and ran between June 30, 2008 and November 15, 2008. The contract was signed on behalf of the Primary Committee, but the General Committee appears to have assumed the payments and terms of the contract and made weekly payments to Swift Air during the general election period. The total contract cost was \$6,384,000, to be paid in 19 weekly payments of \$336,000. The contract entitled the campaign to 22.4 flight hours per week for a total of 425.6 flight hours for the entire contract. Flight hours in excess of 22.4 hours per week were to incur additional charges and unused hours could be rolled over to later weeks, but if a total of fewer than 425.6 hours had been flown by the end of the contract, the campaign was to remain liable for the total contract cost of \$6,384,000. In other words, the campaign was

² The press also traveled on aircraft chartered through CSI Aviation Services, as well as by ground transportation, but the excessive reimbursements were primarily related to the air travel on, and costs of reconfiguring the Swift Air plane, and to a lesser extent, to the reconfiguration costs for the JetBlue plane.

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entitled to no refund or rebate for flight hours that remained unused at the end of the contract.³

The Primary Committee paid Swift Air \$336,000 per week each week for nine weeks and the General Committee paid the same weekly amount each week for ten weeks during the general election period. The General Committee made its first weekly payment on September 8, 2008. Over the ten weeks it had the aircraft, the General Committee paid Swift Air a total of \$4,047,402, which included the contract cost of \$3,360,000 plus \$687,402 for fuel, catering, passenger taxes and ground handling fees. Neither the Primary Committee nor the General Committee used up the flight hours that they were entitled to use; the Primary Committee used 111.8 flight hours and the General Committee used 140.3 flight hours.

To determine the amount that the General Committee could receive in press reimbursements, the General Committee had to calculate the pro rata share of the actual cost of travel for each passenger. The General Committee and the Audit Division used two different methods to calculate this pro rata share.

The General Committee's calculation was based on the cost over the entire life of the contract and included the entire amount that the General Committee paid as well as a portion of the amount that the Primary Committee paid on the contract. Specifically, the General Committee's calculation is based on the combined actual flight hours that both committees used during the campaign. Since the contract price with Swift Air was fixed, the committees could develop the cost of operating the plane for each hour by dividing the contract price by the hours flown. The committees used the cost of operating the plane for each hour to determine the pro rata share for each passenger.⁴ During the course of the campaign, however, the committees could not have known the total actual hours. The committees, therefore, estimated the hours and adjusted the estimate on a

³ In addition to the contract cost, the Swift Air contract required the campaign to pay additional costs for fuel, catering, passenger taxes and ground handling fees. These costs are included in the auditors' calculation.

⁴ Here is a simplified example of how the General Committee's calculation worked. (These are not the actual figures, and do not reflect the continual re-estimation by the General Committee of the total cost over the entire life of the contract. They are simplified figures used to illustrate the principle at issue here). Assume that the Primary Committee and the General Committee are viewed as one entity. The fixed contract price with Swift Air is \$100,000. The Primary Committee and the General Committee have flown a total of 20 hours. The hourly operating cost would be \$5,000 per hour (\$100,000/20). If there were 50 passengers on the plane for each of the 20 hours flown, then the pro rata share for each passenger would be \$100 per hour (\$5,000/50). Further assume the Primary Committee used the plane for six hours, and the General Committee for 14 hours and all 50 passengers flew for each of the 20 hours. Under this example, the Primary Committee's passengers would be billed \$600 (\$100 x 6) and the General Committee's passengers would be billed \$1,400 (\$100 x 14). Now assume that the Primary Committee possessed the plane just under half the time and paid for just under half the cost of the plane, and the General Committee possessed the plane just over half the time and paid for just over half the cost. But \$600 is more than "just under" half the cost per passenger and \$1,400 is more than "just over" half. The Committee's method more accurately reflects the comparative use of the plane between the two committees; but it does not accurately reflect the comparative cost of the plane as paid by the two committees.

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segment-by-segment basis. Using this method of calculating the pro rata share, the General Committee claims that it received press reimbursement of only 106% of the actual cost – less than the regulatory maximum of 110%.

The Audit Division took a different approach to calculate the pro rata share and concludes that the General Committee received reimbursements in excess of the maximum 110%. It looked only at the actual cost paid by the General Committee to Swift Air for travel during the general election portion of the contract, not the entire cost of the contract over its entire life during both the primary and general campaigns. The auditors' calculation was based on the \$336,000 weekly payments to Swift Air, as well as costs for fuel, catering, passenger taxes and ground costs and some reconfiguration costs (see below). Thus, the Audit Division concludes that the Primary Committee billed press travelers less than their pro rata share of the total amount the Primary Committee actually paid on the Swift Air contract, leaving an amount that the Primary Committee had paid on the contract but did not bill. Consequently, the General Committee billed press travelers *more* than their pro rata share – in fact, more than 110% of their pro rata share – of the amount the *General Committee* actually paid on the contract because the General Committee's calculation included a portion of the entire contract that had been paid by the Primary Committee.

2. Reconfiguration Costs

In addition to the Swift Air contract costs, the Committee and the auditors included different amounts for reconfiguration costs for the Swift Air plane in their calculations. The Swift Air aircraft total reconfiguration cost was \$650,000.⁵ The Primary Committee initially paid for the reconfiguration and the General Committee reimbursed the Primary Committee \$390,000, the total reconfiguration cost less 40% depreciation. The General Committee's calculation of the press's share of reconfiguration costs originally included the entire \$650,000 amount of reconfiguration costs, but it apparently later accepted the auditors' exclusion of \$162,657 in costs for logos, painting, and a divider curtain.

The auditors, however, accepted only \$422,620 in reconfiguration costs as actual costs of press travel, based on the costs the auditors concluded reasonably benefitted the press. The auditors determined that the General Committee could include in the actual cost of travel 100% of reconfiguration costs attributable primarily to the convenience and needs of the press; 78%, based on the proportion of press passengers to the number of total passengers, of reconfiguration costs attributable to the convenience and needs of all passengers; and zero percent of those costs that were allocable only to the convenience

⁵ This amount paid for goods and services including painting and application of decals and campaign logos to the aircraft; a portable satellite phone system; divider curtains for the cabin; seat parts; engineering and design work; repairs; labor; and the cost of returning the aircraft to its original condition once the campaign was over.

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and needs of the campaign.⁶ The auditors then took 60% of \$422,620, because the General Committee had purchased the reconfiguration from the Primary Committee at 40% depreciation. The auditors concluded that \$253,572 was billable to the press by the General Committee. They then divided this by the 140.3 flight hours flown by the General Committee to determine the reconfiguration cost per flight segment. The auditors also accepted as actual travel costs billable to the press \$33,814 in reconfiguration costs for battery packs and satellite phones for the JetBlue aircraft, out of total reconfiguration costs of \$77,119 for that airplane, but did not accept the remaining reconfiguration costs for applying logos, repainting the plane and placement and removal of divider curtains.

B. Excessive Media Reimbursements Determined By Calculating Actual Travel Cost

1. General Committee and Audit Division Disagree on How to Calculate Actual Travel Cost

We understand that the center of the disagreement between the General Committee and the Audit Division is which accounting method should be used to calculate the actual cost for the passengers' pro rata share under 11 C.F.R. § 9004.6(a). The General Committee argues its accounting method, in combining the contract cost of both committees, was more reasonable than the auditors' accounting method given that the contract price was not directly proportional to the actual use of the aircraft over the period of the contract. While the auditors' method relied on the cost that each committee paid under the contract, the General Committee argues that the cost that the committees were paying for the contract was not directly reflective of the flight hours that they were using as they proceeded through the campaign.

As a legal matter, however, we question whether the Commission should apply the General Committee's approach because it requires the Commission to combine the contract cost and use of both the Primary Committee and the General Committee. The problem with the General Committee's argument is, as noted at footnote four above, its method may accurately reflect the comparative actual use of the aircraft between the two committees, and even may accurately reflect the combined pro rata shares of the actual cost to the Primary Committee and the General Committee, but is out of proportion to the comparative actual costs paid by the two committees. And because, of the two committees, the General Committee is the only one that is publicly financed and the only one that is the subject of this audit, it is the "actual cost," 11 C.F.R. § 9004.6(a), to the General Committee with which we are concerned here.

⁶ If both sides agree that \$161,490 for logos and painting and \$1,167 for a divider curtain could not be included in actual cost, then \$650,000 minus \$162,657 = \$487,343. Thus, the real difference between the General Committee's position and the auditors' position appears to be the difference between \$487,343 and the auditors' \$422,620. Presumably, that difference is accounted for by the costs that benefitted all passengers, which the Committee included at 100% and the auditors included at 78%.

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The public financing rules allow general election committees to seek limited reimbursements from the media for travel expenses. See 11 C.F.R. § 9004.6(a)(2) and (3). "The amount of reimbursement sought from a media representative . . . shall not exceed 110% of the media representative's pro rata share (or a reasonable estimate of the media representative's pro rata share) of the actual cost of the transportation and services made available." 11 C.F.R. § 9004.6(b)(1). The pro rata share is calculated by "dividing the total actual cost of the transportation and services provided by the total number of individuals to whom such transportation and services are made available."⁷ 11 C.F.R. § 9004.6(b)(2). While we can apply this regulation to the travel expenses of one committee operating in one election, neither the regulation itself, nor its Explanation and Justification provide a formula for calculating the actual cost of air travel on a chartered airplane used by two committees in two different elections (primary and general).

The auditors' calculation of the actual cost of the Swift Air contract and related costs is simple. The auditors determined that the actual cost was the amount paid by the General Committee to Swift Air for travel during the general election period. The calculation was based on the weekly installment payment of \$336,000 and additional costs, the weekly flight hours, and the number of passengers. Under the Audit Division's method, the General Committee billed the press and received reimbursements from the press, not only for the amounts the General Committee paid to Swift Air during the general election period, but also for a portion of the travel costs that the Primary Committee paid to Swift Air for transportation attributable to the primary campaign.

The Audit staff's calculation is appropriate because the cost of the Swift Air contract paid for and used by both the primary and general campaigns should be divided based on the amount each committee actually paid for travel during the primary or general campaign. The regulatory history provides no guidance about how to determine the "actual cost" in a case like this one, where a candidate's primary and general committees shared a contract for use of the same leased *airplane*. But the Commission has noted, in addressing what types of costs could be charged to the media as the "actual cost" of *ground* transportation and facilities, that "campaigns should already be well aware that each media representative may only be charged his or her own pro rata share of costs" and "committees may not force the traveling press to absorb the costs" of services "used or consumed" by others. Explanation and Justification for 11 C.F.R. § 9004.6, 64 Fed. Reg. 42,581-2 (Aug. 5, 1999). *Id.* at 42,582. This reasoning would support the conclusion that media traveling with a candidate's general election campaign should pay only for general election period travel and not be forced to absorb air travel costs more properly viewed as attributable to the candidate's primary campaign, and specifically to the media who traveled with that campaign.

⁷ The travel reimbursement rule at section 9004.6 has changed in some ways over the years, but the Commission has consistently stated that committees should determine the media representative's pro rata share of the "actual cost" of the transportation. See, e.g., Explanation and Justifications for 11 C.F.R. § 9004.6, 45 Fed. Reg. 43,376 (June 27, 1980); 56 Fed. Reg. 35903 (Jul. 29, 1991), 60 Fed. Reg. 31,858-59 (June 16, 1995), 64 Fed. Reg. 42,581 (Aug. 5, 1999).

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2. General Committee's Actual Cost Should Be Based On Travel Cost Paid By General Committee

The General Committee's press billing and reimbursement calculation should be based only on the General Committee's payments for travel in furtherance of the general election campaign during the general election period. The General Committee cannot incur primary-related travel expenses because they are not in furtherance of the general election campaign. See 26 U.S.C. § 9002(11); 11 C.F.R. § 9002.11. As the General Committee cannot incur expenses for primary-related travel, it should not be able to effectively bill the press for those costs either. The publicly-funded General Committee and McCain's non-publicly funded Primary Committee should keep their expenses separate because the two campaigns operated under different rules, requirements and limitations. Senator McCain agreed to use only public funds for his general election campaign; to take no contributions; and to keep his spending within the general election expenditure limitation, which equals the amount of public funds he received. See 26 U.S.C. §§ 9002(11), 9003(b); 2 U.S.C. §§ 441a(b)(1) and (c); 11 C.F.R. § 9002.11. By contrast, Senator McCain opted not to participate in the primary matching payment program; his primary campaign was entirely privately funded.

Because primary and general election campaign expenditures must remain separate, the Commission created "bright line" rules for attributing expenses between the primary and general expenditure limitations after issues arose in prior election cycles about how to divide expenses that benefitted both campaigns between publicly funded primary and general committees. 11 C.F.R. § 9034.4(e); see Explanation and Justification for 11 C.F.R. § 9034.4(e), 60 Fed. Reg. 31,854 at 31,866-68 (Jun. 16, 1995). These rules were later revised to also apply to this situation, where the candidate received public funds in only one election. *Id.* Many of these bright line rules are based on timing. Under the bright line attribution rules, travel costs are attributed based on when the travel occurs. 11 C.F.R. § 9034.4(e)(7). If the travel occurs before the date of the nomination, the cost is a primary expense, unless the travel is by a person working exclusively on general election campaign preparations. *Id.* While these bright line rules are normally applied to situations to determine the attribution of travel cost to a primary and general campaign sharing expenses, we believe that it is appropriate for the Commission to use these same rules to determine the attribution of the travel costs between these committees and how much these committees should bill the press for travel cost.

Under the bright line attribution rules, the General Committee's weekly payments to Swift Air were for general expenses and the Primary Committee's weekly payments were for primary expenses because the weekly payments appear to be related to the weekly use of the leased plane. To the extent that the payments and the amounts billed to the press were related to travel occurring at the same time as the payments were made, those amounts were attributable to the Primary Committee prior to the date of the

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candidate's nomination and to the General Committee after the date of the candidate's nomination. *See* 11 C.F.R. § 9034.4(e)(7).⁸

In addition, the separate reporting of expenditures by these separate committees supports the conclusion that General Committee and Primary Committee travel expenditures must remain separate. The General Committee and the Primary Committee file separate reports and are separate committees.⁹ Publicly funded authorized committees shall report all expenditures to further the candidate's general election campaign in reports separate from reports of any other expenditures made by those committees with respect to other elections. 11 C.F.R. § 9006.1.

3. Draft Preliminary Audit Report Requires Additional Explanations

The draft PAR addresses a number of the General Committee's arguments including arguments based on GAAP accounting principles, its contention that the auditors' methodology conflicts with section 9004.6(b)(3) of the Commission's regulations, and its interpretation of previous audits including Dole-Kemp 1996, Bush-Cheney 2000 and Kerry-Edwards 2004. We defer to the Audit Division's expertise in analyzing the correct application of accounting and auditing principles and procedures. We suggest, however, that you expand the explanation of why the Audit staff's approach is more appropriate and why the Committee's arguments and citations of precedent are not correct, if possible. The Committee raises complex accounting arguments and additional explanation would help clarify the auditors' analysis of those arguments for readers who do not have accounting expertise. In particular, the auditors may wish to address whether this issue arose in prior audits in such a way that the General Committee

⁸ The regulations allow a limited exception for qualified campaign expenses incurred prior to the general election expenditure report period for property, goods or services to be used during the expenditure report period in connection with the general election campaign. 11 C.F.R. § 9002.11(a)(2), 9003.4, 9004.4. The Commission explained that this exception is "designed to permit a candidate to set up a basic campaign organization before the expenditure report period begins." Explanation and Justification for 11 C.F.R. § 9003.4, 45 Fed. Reg. 43375 (Jun. 27, 1980). The rule lists examples of expenses such as establishing financial accounting systems and organizational planning. 11 C.F.R. § 9003.4(a). The General Committee has not demonstrated that the Primary Committee's weekly lease payments were related to travel after the date of nomination or were somehow pre-paying for the General Committee's use of the leased plane during the general election period. Nor is there any indication that travel during the primary period was by persons who were working exclusively to prepare for the general election. *See* 11 C.F.R. § 9034.4(e)(7). It would be difficult for the General Committee to make such a demonstration because both campaigns paid the same weekly amount for the leased plane and both campaigns used the leased plane. Although unused hours rolled over from week to week, neither committee used all of the flight hours they could have used under the contract. Nevertheless, if the General Committee is able to demonstrate that some portion of the Primary Committee's contract payments was to further the general election and should have been paid for by the General Committee, its actual cost of travel and the amount it may bill the press might increase.

⁹ Generally, publicly funded general election candidates set up a separate authorized committee for the general election, which they authorize to incur expenses on their behalf, as well as a separate legal and compliance fund. *See* 26 U.S.C. §§ 9002(1); 11 C.F.R. §§ 9002.1, 9002.2, 9003.3.

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would have been on notice that its choice of accounting method might have negative consequences.

We also suggest that the PAR explain the Audit staff's response to the Committee's argument that the auditors' methodology is in conflict with section 9004.6(b)(3), which requires that media representatives be given a bill that specifies amounts charged for air and ground for each segment within 60 days. We understand from communications with the Audit staff that the auditors' approach is consistent with that regulation because the auditors used the number of travelers to calculate a pro rata amount of billable costs and accounted for varying numbers of travelers on each flight segment. The Committee could have used a similar calculation and timely billed the media. We suggest that the Audit staff explain this in the PAR.

With respect to the precedents cited by the Committee, the proposed PAR notes that the Bush-Cheney 2000 committee used a similar billing methodology to the General Committee, but that method did not result in any material overbilling of the press or audit finding in that audit. The absence of a finding in that audit is not a precedent, and does not indicate the approach or billings by the Bush-Cheney 2000 committee were correct. It merely indicates that the difference between the committee's and auditors' calculations in that audit was not large enough to raise an issue of material noncompliance. Here, the difference in the calculations is large enough to result in a finding. Moreover, according to the Audit staff, the General Committee seeks to apply the hourly calculation used in the Dole-Kemp 1996 audit to the total Swift Air costs over the life of the entire contract for both the General Committee and Primary Committee, and not, as in Dole-Kemp 1996, to a general election committee's portion of the costs for travel during the general election campaign.

The General Committee states in its response to the exit conference that there was no "overbilling" of any press traveler but, at most, a "misallocation" of the proceeds of press billings between the Primary Committee and the General Committee. Consequently, it concludes, it should not have to make any refunds to any press entities, but may simply transfer funds from the General Committee to the Primary Committee to correct the misallocation. The General Committee's proposed transfer of funds to the Primary Committee will not resolve the issue that the General Committee received reimbursements from the press in excess of its actual cost. If the General Committee's public funds are transferred to the Primary Committee and used to pay for primary campaign expenses, the payments would be non-qualified campaign expenses that may be subject to repayment because they would not be made to further McCain's campaign for the general election. See 26 U.S.C. §§ 9002(11), 9007(b)(4); 11 C.F.R. §§ 9002.11, 9004.4, 9007.2(b)(2). In the absence of any demonstration that the Primary Committee paid for general election travel, *see supra* note 8, the transfer would not resolve the excess press reimbursement problem. The amount of excess press reimbursements the General Committee received should be returned to the media representatives. 11 C.F.R. § 9004.7(d)(2).

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Finally, we address the degree to which this finding matters. One of the principal benefits to publicly funded general election committees of the regulations' provisions permitting press reimbursements is that the committee may deduct properly received reimbursements from the overall expenditure limitation.¹⁰ 11 C.F.R. § 9004.6(a). Here, however, the auditors conclude that the Committee did not exceed the expenditure limitation, even when the excessive reimbursements are included.¹¹ Nevertheless, the General Committee's receipt of excessive press reimbursements is significant. The purpose of the travel reimbursement rules at section 9004.6 is to eliminate the possibility that a committee could effectively be subsidized by the media through charging the media higher amounts than their pro rata shares for transportation provided by the campaign. See Explanation and Justification for 11 C.F.R. § 9004.6, 45 Fed. Reg. 43,376 (June 27, 1980). The Commission has pursued press travel billing and reimbursement issues in the enforcement context. See MUR 3385, Bush Quayle '88 (Committee agreed to a conciliation agreement with a \$10,000 civil penalty for a violation of section 9004.6).¹² In the 1996 cycle, the Dole-Kemp '96 ("DK96") audit resulted in a payment for expenses in excess of the expenditure limitation, which included press and Secret Service reimbursements collected in excess of actual costs, and the Commission pursued the issue in enforcement. See MURs 4670, 5170, 5171 (Commission and DK96 ultimately negotiated a Global Settlement and Release and a conciliation agreement with a \$75,000 civil penalty to resolve the payment and pending enforcement matters, but the final negotiated agreements do not address the press reimbursement issue or require that DK96 reimburse the press.) Thus, we believe that the facts surrounding the Swift Air flight costs and the press reimbursements for them merit inclusion in the PAR, notwithstanding that they have no impact on this particular case on the General Committee's compliance with the overall expenditure limit.

¹⁰ Expenditures for transportation, ground services or facilities provided to media are qualified campaign expenses that count against the overall expenditure limitation, but committees may seek reimbursement from the media and may deduct the reimbursements received from the expenditures subject to the overall expenditure limitation. 11 C.F.R. § 9004.6(a).

¹¹ The auditors' calculation of the overall expenditure limitation includes a GELAC reimbursement that lowers the General Committee's total expenditures below the limitation. The GELAC may reimburse the General Committee for certain types of expenses such as winding down costs and compliance expenses initially paid by the General Committee. To the extent that the GELAC reimburses the General Committee for these expenses, the expenses no longer count against the General Committee's expenditure limitation. The auditors' calculation also assumes the General Committee will pay the excess reimbursement amount to the press or make a transfer to the Primary Committee.

¹² Also in the 1988 cycle, the Commission ordered the Robertson 1988 Committee to refund \$105,634.56 in press overpayments. In a judicial review of the repayment determination, the Robertson Committee argued that the Commission did not have the authority to order the refund, but the court noted that the "issue is not before us" in the review of the repayment because the Commission conceded "that any challenge would have to frame" Robertson's "press charges as impermissible corporate campaign contributions," enforceable through the procedures of section 437g. *Robertson v. FEC*, 45 F.3d 486, (D.C. Cir. 1995), n.4.

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C. Reconfiguration Costs Issue Should be Raised for Commission Consideration

We recommend that you raise in the cover memo for the Commission's consideration the issue of which reconfiguration costs should be considered actual costs of travel and included in calculating the pro rata amounts billable to the press. The Audit staff's analysis is based on whether reconfiguration costs reasonably "benefitted" the press. You state: "Historically, the Commission has only allowed the Press to be billed for those aircraft reconfiguration costs that could be reasonably considered as having benefitted the Press." Draft PAR at 10. In contrast, the General Committee considered all costs for reconfiguring the Swift Air aircraft, except for decal painting and some cabin dividers, as actual costs of travel. Applying a reasonable benefit test to the reconfiguration costs, the auditors accepted that 100% of costs where there was "an association" with the press were actual costs of travel, but asserted that only 78% of costs that were "not clearly associated" with the press but were instead for the convenience and needs of all passengers were accepted as actual costs of travel permissibly factored into the press reimbursement calculation. The 78% figure was based on a percentage derived from the proportion of press seats on the plane. But the auditors did not include any amount of the reconfiguration costs for logos and painting as actual costs of travel. For the JetBlue aircraft, the auditors accepted as actual costs of travel only the costs of battery packs and satellite phones because the press benefitted from those items, but did not accept reconfiguration costs for applying logos, repainting the plane and a divider curtain.

We question the legal basis for this approach and believe this issue should be considered by the Commission.¹³ The regulations do not set forth a "reasonable benefit" test for including airplane reconfiguration costs as actual costs of travel in determining the amount of travel expenses for which a committee may seek reimbursement from the press. With respect to the Commission's past practice, the draft PAR does not cite any previous audits where the Commission applied a reasonable benefit test to press billings for airplane reconfiguration costs. We have been unable to locate any prior Title 26 audit report that directly addressed this issue one way or the other. If the Audit Division is aware of Commission precedent on point, you should cite that precedent in the proposed report. We note that 11 C.F.R. § 9004.6 allows for reimbursement of a pro rata share of the actual costs of travel and does not distinguish between actual costs for aircraft operating costs (such as flight costs) and reconfiguration costs. The regulation requires

¹³ While we question this approach, we agree that the Committee's reliance on the Kerry-Edwards 2004, Inc. audit for the reconfiguration issue is misplaced. The dispute in Kerry-Edwards concerned how to calculate the amount of leased airplane reconfiguration costs that would count against the expenditure limitation, not the amount included in "actual cost" in determining the amount of travel expenses for which reimbursement from the press may be sought. The Kerry-Edwards general committee, like the General Committee, purchased a leased plane reconfiguration at 40% depreciation from its primary committee, but the issue in that audit was different. The Kerry-Edwards audit did not concern the calculation of reconfiguration costs that could be billed to the press. Moreover, the Commission never definitively addressed the reconfiguration valuation in that audit because the expenditure limitation issue was resolved when adjustments to other expenditures brought the total expenditures below the limitation. See Statement of Reasons, Kerry-Edwards 2004, Inc. (November 14, 2007).

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that the actual cost of travel be determined, and only then apportioned into pro rata shares for the press travelers. Thus, the part of the process where the number of press seats should be considered is not in calculating the actual costs of the reconfiguration (the 78%), but in apportioning the pro rata share of the actual travel costs for press passengers.

II. MEDIA VENDOR INTEREST

The cover memorandum to the draft PAR notes the issue of interest earned by the Committee's media vendors totaling \$14,499. The issue is not in the draft PAR and there is no repayment recommendation because the Committee did not benefit from the earned interest. This Office previously responded to your informal query about whether the interest earned by the media vendors must be repaid to the United States Treasury and whether this matter should appear in the PAR as a finding or issue. As we said in our response, we conclude that because the interest earned by media vendors did not benefit the Committee, the Audit Division should not recommend any repayment of the interest. This conclusion is based on the Commission's actions in the 2004 cycle general election committee audits. We recommend, however, that you raise this issue for Commission consideration in the cover memorandum forwarding the PAR to the Commission.

The Committee used a media consultant, MH Media, and three media vendor subcontractors including Smart Media Group ("SMG"), which did television media buys. The auditors found that MH Media (\$1,325) and SMG (\$13,174) earned interest totaling \$14,499.79 on Committee funds between August 29, 2008 and January 31, 2009. The interest remained in the media vendors' bank accounts and none of the interest was used for media buys, compensation, or any other campaign purpose. The Committee states that it advised the media vendors to keep all earned interest separate and not to use it for any media buys or compensation. SMG transferred the interest to another account and did not use the funds, while MH Media kept the interest in the deposit accounts. The media vendors provided documentation to the auditors including bank statements and general ledgers demonstrating that the earned interest was not spent. The Committee believes the media vendor interest need not be repaid.

Candidates must repay income earned from the investment or other use of public funds, less taxes paid on such income. *See* 11 C.F.R. §§ 9007.2(b)(4), 9004.5. This type of repayment "ensure[s] that any income received through the use of public funds benefits the public financing system." Explanation and Justification for 11 C.F.R. §§ 9004.5 and 9007.2, 60 Fed. Reg. 31858 and 31864 (June 16, 1995).

In the 2004 presidential audits, the Commission was unable to reach agreement on whether to seek repayment of interest earned by media vendors on public funds where the interest earned was not paid to the committees or used to pay for media buys, commissions or other campaign purposes that would benefit the committees. In the Bush-Cheney '04 audit, the Commission did not have four affirmative votes to seek repayment of \$19,745 in interest earned on media vendor accounts. *See* Report of the

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Audit Division on Bush-Cheney '04, Inc. and the Bush-Cheney '04 Compliance Committee, Inc. (approved Mar. 22, 2007). Some Commissioners thought that "the standard for repayment should be whether the General Committee received or benefited from the interest earned by having the interest used to make media buys or offset commissions." *Id.* at 11-12. They concluded that because Bush-Cheney '04, Inc. "did not receive or benefit from the interest earned, no finding or repayment determination would be appropriate." *Id.* at 12. Other Commissioners, however, concluded that repayment "may be appropriate" and "that the purpose for payment of interest or income was to ensure that any income received through the use of public funds benefits the public financing system." *Id.* Subsequently, the Commissioners expressed similar views in the Kerry-Edwards 2004, Inc. audit, but agreed on repayment of interest where the interest benefited the committee and was used for campaign purposes. See Report of the Audit Division on Kerry-Edwards 2004, Inc. and the Kerry-Edwards 2004 Inc. General Election Legal and Accounting Compliance Fund (approved June 14, 2007). The Commission determined that Kerry-Edwards 2004, Inc was required to repay \$41,277 for interest that was used to pay for media buys and/or to offset amounts owed to the media vendor. However, the Commission did not require repayment of \$159,446 in interest that was never paid to the committee or used for campaign purposes and was earned on loans from the media firm to its parent company. *Id.* at 33-34.

Based on the Commission's actions in the 2004 audits, this Office concludes that because the interest earned by the media vendors was not used for campaign purposes or otherwise to benefit the Committee, the Audit Division should not recommend any repayment of the interest. We recommend, however, that you raise this issue for Commission consideration in the cover memorandum forwarding the PAR to the Commission. The Commission's regulations remain unchanged and do not include any test of benefit or use for campaign purposes for repayment of interest income. See 11 C.F.R. §§ 9007.2(b)(4), 9004.5. Nevertheless, the Commission's actions in the 2004 audits indicate lack of Commission consensus for repayment of interest beyond those payments that benefit the committee in some way. Some Commissioners may have concerns about whether interest income earned on public funds deposited with a third party vendor actually benefits a committee and is used for campaign purposes and may want to apply a benefit test for repayment of interest income. The Committee relied on the Commission's actions in the 2004 audits when it advised its media vendors to keep any interest income separate. We acknowledge that a benefit test for income repayments could be abused to circumvent the regulations if, for example, a campaign deposited large amounts of public funds with vendors to earn income as a way to enrich the vendors. That potential for abuse is not evident here. The amount of income at issue is minimal, and you have informed us that the Committee has already repaid a larger amount of interest earned on public funds. Therefore, we conclude that raising this issue in the cover memorandum for Commission consideration but not recommending any repayment of the interest income is appropriate.

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III. HYBRID COMMUNICATIONS

The cover memorandum to the draft PAR requests our comment on the issue of hybrid communications. Hybrid communications refer to a clearly identified candidate and make a generic reference to other party candidates without clearly identifying them. The Republican National Committee ("RNC") spent \$30,749,009 on hybrid media communications related to the general election. These expenses were not treated as coordinated party communications or counted against the Committee's expenditure limitation. We concur that this issue should be raised for the Commission's information in the cover memorandum to the PAR.

In 2004, the Commission did not pursue similar hybrid communications in the audits of both major party nominees. This Office commented that the auditors should not include the hybrid ad issue as a finding in the report or count the expenses against the candidates' expenditure limitations, but should raise the issue in the cover memorandum for the Commission's consideration. *See* Attachment 1. We also discussed several legal aspects of the issue the Commission could consider. *Id.* The Commission was divided on the issue and Commissioners issued Statements of Reasons for the audits. *See* Statement of Commissioners Lenhard, Walther and Weintraub, Audit of Bush-Cheney '04, Inc. (March 21, 2007), Statement of Commissioner Weintraub on Audit of Bush-Cheney '04, Inc. (March 21, 2007), Statement of Commissioners Mason and von Spakovsky, Final Audit Report on Bush-Cheney '04, Inc. (March 22, 2007), Statement of Commissioners Mason and von Spakovsky, Final Audit Report on Kerry-Edwards, 2004, Inc. (May 31, 2007). Our analysis of the issue remains the same, and we have attached our legal comments on this issue in the Bush-Cheney '04 audit for your information. Attachment 1. Subsequently, the Commission initiated a rulemaking on hybrid communications, which has not yet been completed and thus, is not applicable to this audit. The Commission considered expanding section 106.8, which applies to telephone banks, to address other types of "hybrid communications." *See* Notice of Proposed Rulemaking ("NPRM"), "Hybrid Communications," 72 Fed. Reg. 26569 (May 10, 2007).

Attachment 1.

Memorandum to the Commission, Preliminary Audit Report of the Audit Division on Bush-Cheney '04, Inc. and the Bush-Cheney '04 Compliance Committee (LRA # 664)" (May 26, 2006)



FEDERAL ELECTION COMMISSION
WASHINGTON, D.C. 20463

May 26, 2006

MEMORANDUM

TO: Joseph F. Stoltz
Assistant Staff Director
Audit Division

THROUGH: Robert J. Costa 
Acting Staff Director

FROM: James A. Kahl 
Deputy General Counsel

Thomasenia P. Duncan 
Associate General Counsel

Lorenzo Holloway 
Assistant General Counsel
for Public Finance and Audit Advice

Delanie DeWitt Painter 
Attorney

Margaret J. Forman 
Attorney

SUBJECT: Preliminary Report of the Audit Division on Bush-Cheney '04, Inc. and the
Bush-Cheney '04 Compliance Committee (LRA #664)

I. INTRODUCTION

The Office of General Counsel has reviewed the Preliminary Audit Report ("proposed Report") of the Audit Division on Bush-Cheney '04, Inc. (the "Committee" or "Bush") and the Bush-Cheney '04 Compliance Committee ("GELAC") that you submitted to this Office on February 1, 2006. This is the second of two memoranda discussing our comments on the proposed Report. In this memorandum, we comment on the issue of possible in-kind contributions Bush received from the Republican National Committee ("RNC") when the RNC and Bush divided media expenses for broadcast advertisements that clearly identified the candidate and/or his opponent and made vague references to other political figures (Findings 1. B. and 2). If you have any questions, please contact Delanie DeWitt Painter or Margaret J. Forman, the attorneys assigned to this audit.

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(LRA # 664)
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II. ATTRIBUTION OF MEDIA COSTS (AUDIT REPORT FINDING 1.B. AND 2.)

The Audit Division found that Bush received in-kind contributions from the RNC for media expenses. The RNC and Bush equally divided media expenses for broadcast advertisements that clearly identified President Bush and/or John Kerry and made vague references to other political figures in Congress. The divided media expenses totaled \$81,418,812. The RNC also paid \$1.7 million in commissions. The proposed Report concludes that Bush should have paid for all of the media and commissions. Since the RNC paid for half of the media expenses and \$1.7 million in commissions, the proposed Report concludes that the RNC made in-kind contributions of \$42,409,406 ($\$81,418,812/2 = \$40,709,406 + \$1,700,000$) to Bush. The proposed Report recommends that, unless Bush demonstrates that it did not receive these in-kind contributions from the RNC, the Audit staff will recommend a repayment of \$42,409,406. See 26 U.S.C. § 9007(b)(3).

This Office recommends that you delete this issue and the related findings from the Report and not count these expenses against Bush's expenditure limitation. In light of recent Advisory Opinion ("AO") 2006-11, this Office believes that the Commission would approve the 50% attribution of these media expenses between Bush and the RNC. Instead, we recommend that you raise the issue in the Audit Division's cover memorandum when the Report is circulated for Commission approval so that the Commission can consider the issue.

In considering this issue, the Commission should note that neither the Federal Election Campaign Act ("FECA") nor the Commission's regulations definitively address the allocation of broadcast advertisements referencing only one clearly identified federal candidate (and/or his opponent) and a vague reference to their political allies in Congress. The Commission's regulations at part 106 address the allocation of similar types of expenses. The regulations at part 106 include both general allocation rules and specific rules for allocating specific types of expenses in particular circumstances. Section 106.1(a) provides the general rule that expenditures made on behalf of more than one clearly identified candidate shall be attributed to each candidate according to the benefit reasonably expected to be derived. 11 C.F.R. § 106.1(a). For a broadcast communication, the "attribution shall be determined by the proportion of space or time devoted to each candidate as compared to the total space or time devoted to all candidates." *Id.* A candidate is clearly identified if his or her name or likeness appears or if his or her identity is apparent by unambiguous reference.¹ 2 U.S.C. § 431(18); 11 C.F.R. §§ 106.1(d) 100.17. However, the advertisements at issue here clearly identify only the party nominees -- the references to leaders, liberals or allies in Congress do not clearly identify any specific candidates. See also Advisory Opinion ("AO") 2004-33 (Ripon Society) (Commission stated that reference to "Republicans in Congress" in an advertisement did "not constitute an unambiguous reference to any specific Federal candidate" under section 100.29(b)(2)). Thus, section 106.1 does not apply.

¹ In 1995, the Commission considered adopting a broader definition of "clearly identified candidate" that would have included groups of candidates but declined to do so after receiving comments that it could be difficult to determine the identities of the candidates in a group, for example, based on a reference to "pro life" candidates. See *Explanation and Justification of 11 C.F.R. § 100.17*, 60 Fed. Reg. 35,292, 35,293-94 (July 6, 1995).

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Section 106.8, which sets forth a flat 50% attribution rule for party committee phone banks, also does not apply here. The language of that section applies only to one narrow category of campaign communications costs: phone banks. Section 106.8 "applies to the costs of a phone bank conducted by . . . a political party" under certain delineated circumstances, which include, *inter alia*, that the communication refers to a clearly identified federal candidate and "generically refers to other candidates of the Federal candidate's party without clearly identifying them." 11 C.F.R. § 106.8(a). When the Commission promulgated section 106.8, the Commission considered whether to "include other forms of communications such as broadcast or print media" but "decided to limit the scope of new section 106.8 to phone banks at this time because each type of communication presents different issues that need to be considered in further detail before establishing new rules." *Explanation and Justification for 11 C.F.R. § 106.8, "Party Committee Telephone Banks," 68 Fed. Reg. 64,517, 64,518 (Nov. 14, 2003).*

The Commission, nevertheless, has approved the attribution of expenditures for communications that refer to one clearly identified candidate and make a generic reference to other party candidates under certain circumstances. Most recently, in Advisory Opinion 2006-11, the Commission considered attribution of the cost of a mass mailing that expressly advocated the election of one clearly identified federal candidate and the election of other party candidates who were referred to generically. The Commission recognized that sections 106.1 and 106.8 do not directly apply, but applied analogous "space or time" principles set forth in section 106.1(a) to measure the "benefit reasonably expected to be derived" by the clearly identified federal candidate. The Commission concluded that *at least 50 percent* of the cost of the mailing must be attributed to the clearly identified candidate even if the space in the mailing attributable to him is less than that attributable to other candidates. However, if the space of the mailing devoted to the clearly identified candidate exceeded the space devoted to the generic party candidates, the costs attributed to the clearly identified candidate must exceed 50 percent and reflect at least the relative proportion of the space devoted to the candidate. Thus, the Commission approved a minimum 50% attribution to the clearly identified candidate, not an automatic 50/50% split.

This Office recognizes that the Commission could follow the attribution principles set forth in AO 2006-11 when it considers Bush's proposed media attribution. We recommend that the Commission take note of the distinctions between AO 2006-11 and this audit, and (2) the policy considerations for a candidate who receives public financing that were not present in AO 2006-11 when it considers whether to apply the attribution method of AO 2006-11 here. As discussed in greater detail below, this audit concerns broadcast advertisements rather than mass mailings and, it is questionable whether some of the advertisements generically refer to other candidates. Indeed, the advertisements appear to be primarily focused on furthering the election of a publicly-financed presidential candidate. Moreover, unlike AO 2006-11, the allocation principles of section 106.1 would be applied in the context of a publicly-financed presidential election. If the amount that is allocated to Bush is improper because it does not include all of the expenses that are in furtherance of his campaign for election to the office of President, 11 C.F.R. § 9002.11(a)(1), this would result in the introduction of private contributions into a publicly funded general election campaign through payment of media costs by the party, and those payments would not count against the candidate's expenditure limitations. *Compare 11 C.F.R.*

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§ 9002.11(a)(1)(expenditures that further the election to the Office of President) *with* 11 C.F.R. § 9002.11(b)(3)(expenditures that further the election of other candidates).

If the Commission decides to apply the attribution method of AO 2006-11, it would attribute *at least* 50% of the media costs to Bush, but there is the potential to attribute *more than* 50% to Bush. In AO 2006-11, the Commission by analogy applied the principles set forth in section 106.1(a)(1) of the "proportion of space or time devoted to each candidate as compared to the total space or time devoted to all candidates" to measure the "benefit reasonably expected to be derived" by the clearly identified candidate. If the Commission applies AO 2006-11 and those principles here, we recommend that the Commission consider three issues. See 11 C.F.R. § 106.1(a)(1); AO 2006-11.

First, the content of the advertisements appears to be primarily focused on promoting the election of the clearly identified candidate and does not make clear that references to other individuals allied with Bush were "devoted" to promoting the election of any other candidates. In fact, some of the vague references in the advertisements do not even rise to the level of "generic" party references that the Commission considered in approving attributions in AO 2006-11 and section 106.8.² The advertisements refer to Congressional allies of Bush or Kerry using vague descriptions such as "our leaders in Congress," "Congressional leaders," "liberals in Congress" and "liberal allies" rather than stating the party names "Democrats" or "Republicans" (except in one Spanish advertisement) or making clear that these officials were party candidates. The ambiguous references address whether legislators supported the plans of Bush or Kerry rather than their status as candidates of a party -- many Senators were not up for re-election and non-incumbent candidates are not included in the references. The references may have had a political purpose of associating Bush or Kerry with groups of Congressional incumbents as a way to increase support for Bush rather as a way to benefit any other unidentified party candidates.

Second, even assuming, *arguendo*, that each reference to a Congressional ally or leader was devoted to other party candidates, the amount of space and time devoted to Bush in the advertisements still may exceed 50 percent. In addition to the repeated references to Bush and his allies or leaders in Congress, all of the advertisements contain several seconds of pictures or footage of Bush alone, stating that he approved the advertisement as required by 2 U.S.C. § 441d(d) and 11 C.F.R. § 110.11(c).³ An attribution based on space and time could treat this portion of the advertisements as solely devoted to Bush and conclude that Bush's attribution

² The Commission explained in the section 106.8 rulemaking that "[g]eneric references to 'our great Republican team' or 'our great Democratic ticket' would satisfy" the requirement for a generic reference to other party candidates. 68 *Fed. Reg.* 64,518. AO 2006-11 provided "Vote John Doe and our great Democratic team" as an example of a message referencing a clearly identified candidate and generically referring to other party candidates. Nothing in the media advertisements is similar to these generic references.

³ Television advertisements must include a statement identifying the candidate and stating that the candidate approves the communication. 2 U.S.C. § 441d(d)(1); 11 C.F.R. § 110.11(c). The candidate statement shall be an unobscured full screen view of the candidate making the statement or the candidate in voice-over accompanied by a photo or image and shall also appear in writing at the end of the communication in a clearly readable manner with reasonable color contrast for a period of at least 4 seconds. *Id.*

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should be higher than 50%. Conversely, the fact that this disclaimer is legally required might support not considering this portion of the advertisement in calculating an attribution. 2 U.S.C. § 441d(d)(1); 11 C.F.R. § 110.11(c).

Finally, the Commission may not have enough documentation from Bush to determine if the allocation to Bush should not be greater than 50%. The Commission could address this issue by including the finding in the Preliminary Audit Report and requesting additional information from Bush in Bush's response to the Preliminary Audit Report. To receive public funds, the candidate agreed that he had the burden of proving that disbursements are qualified campaign expenses, to meet the documentation requirements for disbursements and to provide an explanation, at the Commission's request, of the connection between any disbursement and the campaign. 11 C.F.R. §§ 9003.1(b), 9003.5. Since Bush disbursed public funds as a part of the joint allocation with the RNC, Bush has the burden of demonstrating that its proposed attribution of the media expenses is appropriate and that only 50% of these media expenses were qualified campaign expenses attributable to Bush.⁴ See 11 C.F.R. §§ 9003.1(b)(1), 9003.5; see also 26 U.S.C. § 9002(11); 11 C.F.R. § 9002.11(b)(3); Cf. *Statement of Reasons in Support of Repayment Determination After Administrative Review for Keyes 2000, Inc.* (approved March 8, 2004) at 24-25 (when a publicly-financed committee engages in dual activities it must be able to document the expenses for each type of activity).

⁴ A qualified campaign expense must, *inter alia*, be incurred "to further" a candidate's election to the office of President or Vice President. 26 U.S.C. § 9002(11); see 11 C.F.R. § 9002.11(a)(1). If a committee also incurs expenses to further the election of one or more individuals to federal or non-federal public office, expenses incurred "which are not specifically to further the election of such other individual or individuals shall be considered as incurred to further the election" of the publicly-financed candidates "in such proportion as the Commission prescribes by rules and regulations." 26 U.S.C. § 9002(11). The regulations state that expenditures that further the election of other candidates for public office shall be allocated and paid in accordance with 11 C.F.R. § 106.1(a) and will be considered qualified campaign expenses "only to the extent that they specifically further the election of the candidate for President or Vice President." 11 C.F.R. § 9002.11(b)(3).