

DEBT RESERVES:

Legal reserves meet requirements,
but internal reserves need more accountability

August 2012

LaVonne Griffin-Valade

City Auditor

Drummond Kahn

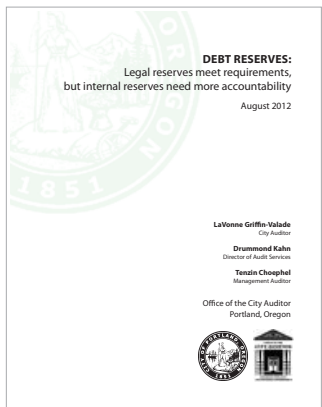
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August 28, 2012

TO: Mayor Sam Adams
Commissioner Nick Fish
Commissioner Amanda Fritz
Commissioner Randy Leonard
Commissioner Dan Saltzman
Jack Graham, Chief Administrative Officer, Office of Management and Finance
Rich Goward, Chief Financial Officer, OMF Bureau of Financial Services

SUBJECT: Audit Report – Debt Reserves: Legal reserves meet requirements, but internal reserves need more accountability (Report #425)

The attached report contains the results of our audit of the City's debt reserves. We identified this topic because of the City's growing debt described in prior audit reports. We conducted this audit to determine whether City practices related to debt reserves aligned with any best practices and applicable requirements.

We make specific recommendations to strengthen the clarity, accountability and transparency for internal debt reserves. Mayor Sam Adams and Chief Administrative Officer Jack Graham submitted written responses to this audit. Their responses are included at the back of this report.

We ask the Bureau of Financial Services within the Office of Management and Finance to provide us with a status report in one year, through the Office of the Mayor, detailing steps taken to address our recommendations in this report.

We very much appreciate the cooperation and assistance we received from Bureau of Financial Services staff as we conducted this audit.

Drummond Kahn
Director, Audit Services Division

Audit Team: Drummond Kahn
Tenzin Choephel

Attachment

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Summary

Governments borrow money to make long-term investments in capital assets and infrastructure. The City's outstanding debt reached \$3.3 billion at the end of Fiscal Year 2011. The City uses debt reserves to provide protection, security and stability to its bonds and, therefore, to the General Fund. We conducted this audit to determine whether City debt reserve practices aligned with best practices and applicable requirements.

Based on the values of good governance and stewardship over public resources, the City's debt reserves should have the following features:

- Clarity in the policy purpose for why reserves were set aside and the permitted uses for any excess
- Accountability to ensure reserves are used for specified purposes and follow any other rules
- Transparency in decisions if reserves are not used for specified purposes

We found the City has different practices related to its debt reserves depending on the type of debt reserve. We characterized debt reserves and the City's practices into two groups:

1. **Legal reserves** – debt reserves created due to legal requirements when bonds are secured by sources other than the General Fund (i.e. urban renewal, water, sewer, parking)
2. **Internal reserves** – debt reserves created due to internal requirements when bonds are secured by the General Fund (i.e. special assessment reserve, pension obligation bond reserve)

We found that the City consistently adhered to requirements for **legal reserves**, but could strengthen its practices over **internal reserves**.

The City established and maintained legal reserves in accordance with requirements in the bond rules. However, we found the City sometimes used its internal reserves for purposes other than debt repayment.

When no clear legal requirements exist, more accountability over the internal reserves would help ensure the City consistently uses these reserves as intended. Specifically, we recommend the Bureau of Financial Services:

- Work with Council to ensure current and future funds have ordinances that meet City policy requirements, including the purpose of any reserves and transfer activity.
- Work with stakeholders from appropriate debt-issuing bureaus to obtain any Council action needed to adequately protect internal reserves, and ensure sufficient guidance exists to manage these reserves and permitted use(s) of any excess.
- Better document how internal reserve use has complied with any restrictions, the reserve's purpose, and the rationale for and implications of the City's decisions when it chooses not to follow the reserve's stated purpose.
- Improve communication about planned internal reserve use to the public, property owners and other stakeholders responsible for debt repayment.

The Audit Services Division of the Office of the City Auditor developed this report independently for the public as well as for City officials. This report is the result of a performance audit, and was not part of the City's annual financial audit on the City's financial statements. Expressions of opinion in the report are not intended to guide prospective investors in securities offered by the City and no decision to invest in such securities should be made without referencing the City's audited Comprehensive Annual Financial Reports and official disclosure documents relating to a specific security.

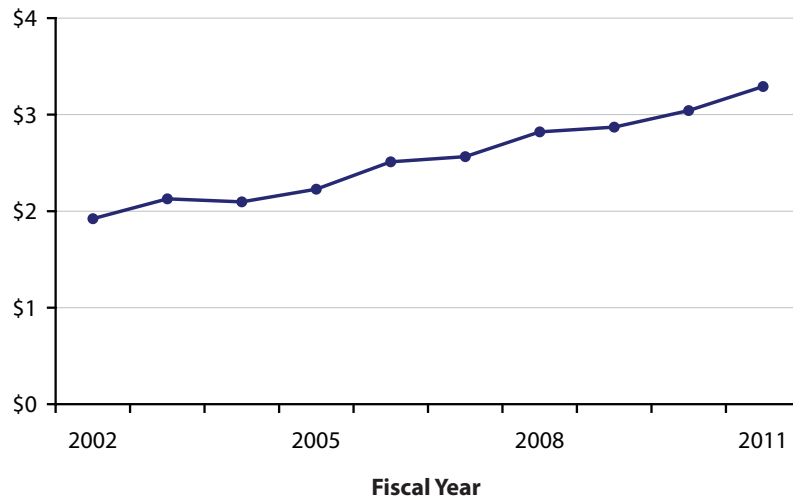
Chapter 1 **Background**

City borrows to finance long-term investments

Governments – just like individuals and businesses – borrow money to make long-term capital investments. Borrowing provides the City of Portland with the flexibility to fund projects and improvements that cannot or should not be paid exclusively from current operating budgets. For example, the City borrows money for various purposes that include urban renewal, sewer and water system infrastructure, and its pension obligation. Borrowing money may more equitably match costs with those who will benefit from spending, allow repayment in cheaper dollars during times of inflation, and increase cash available for other needs.

In our 2011 report, *Portland's Fiscal Sustainability and Financial Condition: Actions now can reduce risk of future problems* (Report #399), we described the overall growth trend in the City's debt. At the end of Fiscal Year (FY) 2011, the City's outstanding debt was about \$3.3 billion, as shown in Figure 1. Like a home mortgage or an education loan, the City's bonds have repayment schedules that can span many years. The City includes its repayment plans when developing its annual budget, City service rates, financial and capital plans, and other related activities. Based on an assessment by the City's debt professionals, the Bureau of Financial Services (Financial Services) concluded that the City's debt position is favorable when compared to available benchmarks.

Figure 1 City outstanding debt (billions, unadjusted)



Source: Statistical section of the City of Portland's *Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2011*

Debt reserves can provide security and protection

Debt reserves are one type of reserve commonly used by public and private sector borrowers to ensure full and timely repayment of outstanding debt. Debt reserves can be created as a security enhancement for investors, or when necessary to insulate a cash flow risk related to debt. Debt reserves can also help accelerate debt repayment or refinance debt to lessen overall borrowing costs. A debt reserve can be structured in various ways – the reserve can be used to protect risk related to a single debt issue, project, fund, bureau, or an entire government organization.

Accountability helps ensure reserves fulfill purpose

Clear reserve policies can address purpose and objectives

Reserves should be established and managed for an authorized and necessary purpose. A governing body should develop a clear written policy that communicates to those contributing to the reserve why the money is being set aside. The policy should address reserve objectives, optimal funding levels, and conditions for when the reserve is used and replenished. When conditions warrant, the governing body should reduce reserves to reasonable levels, or liquidate and discontinue a reserve when no longer needed.

Funds can fulfill purpose and restrictions, including debt repayment

Government has a duty to meet various restrictions related to the money it receives and uses. Some of these restrictions are self-imposed by the governing body, while others are enforceable legal restrictions – like contractual requirements with bond investors – imposed by others. One way the City meets these requirements is to segregate its money into a “fund” established for a particular purpose and in accordance with specific regulations, restrictions or limitations. Often governments set aside resources to meet current and future repayment of long-term debt, and this money may be set aside in separate funds. The City has 35 funds related to debt repayment.

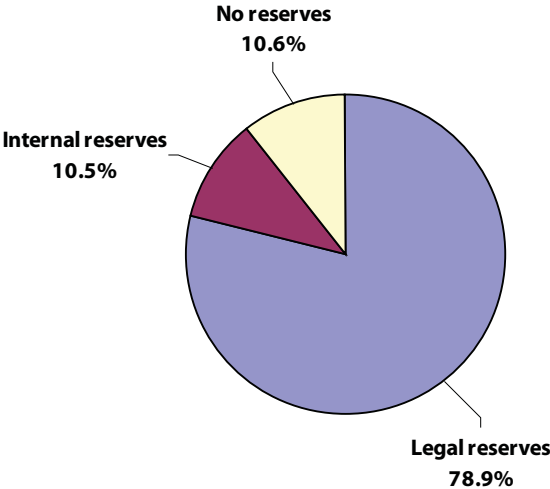
Transparent decisions can keep activity visible

Once reserves are established, reserve activity should be transparent and visible. As stewards of public money, government must balance the need for reserves with the burden on taxpayers or others that contribute to the reserve. By making provisions to raise resources for reserve funds explicit, the governing body gives voters, residents and other stakeholders an opportunity to know the plan for funding reserves. Communicating this information about reserves promotes visibility of the governing body’s actions to those reserve contributors impacted by these decisions.

Chapter 2 **Audit Results**

We found the City has different practices related to its debt reserves, depending on whether or not the reserves are legally required. Historically, investors require legal reserves when the City issues bonds secured by sources other than the General Fund. Since most City bonds are not secured by the General Fund, the majority of the City's bonds have legal reserves. For bonds secured by the General Fund, the City has internal reserves for about half of its outstanding bond debt, and no debt reserves exist for the other half. Figure 2 shows whether a debt reserve exists, type of reserve, and how it compares to the City's outstanding bond debt. We provide an overview of City bonds and debt reserves in the Appendix.

Figure 2 Outstanding City bond debt with type of reserve



Source: Audit Services Division

We found the City consistently adhered to its **legal reserve** requirements, but could strengthen its practices over **internal reserves**, as summarized in Figure 3. The City established and maintained legal reserves in accordance with requirements in the bond rules. The City established internal reserves based on internal requirements. These requirements specified that the policy purpose of the reserve was related to debt repayment. However, we found the City used two of its internal reserves for purposes other than debt repayment. City Council approved these uses of internal reserves.

Figure 3 City practices for debt reserves

| Reserve type | Reserve requirement | | City practice | Security |
|--------------|---------------------|----------|---|---------------|
| | External | Internal | | |
| Legal | Yes | No | City meets legal requirements | Other sources |
| Internal | No | Yes* | Internally segregated reserves established for future bond repayment or to insulate the General Fund from financial risk Reserves not always used as originally intended | General Fund |

Source: Audit Services Division analysis of City documents

* Requirements for internal reserves exist formally or informally

LEGAL RESERVES: City adhered to debt reserve requirements

For most of its bonds, the City made various legally-binding promises to investors that include creating and maintaining debt reserves for specific bond issues. Since most of the City's outstanding debt is not secured by the General Fund, the focus shifts from the City's taxing power to the earning power of the specific projects funded by individual bonds. Financial Services told us that investors historically required these debt reserves. A debt reserve then serves as additional security to repay the debt if revenues are ever too low to satisfy the repayment requirements.

There would be serious repercussions if the City used these legally required debt reserves for other purposes. Generally, if a reserve is used to repay debt, then it must be replenished. An unscheduled draw on the reserves might be perceived by the investors and rating agencies as reflecting financial difficulties. Therefore, the City is required to disclose the use of any of these legal reserves. If use of these reserves is not limited to their intended use, the action may result in a technical default, potential litigation by investors, or change in the City's credit rating.

We found the City's practice is to create and maintain debt reserves when legally required by its bond documents. For all legal reserves we reviewed, the City created subfunds with bond proceeds to meet the reserve requirement for a particular bond issue. The debt management policy states the City will monitor compliance with bond rules. Debt-issuing bureaus and Financial Services share this responsibility. A Financial Services official said they review debt reserves at least annually as part of the City's financial audit, and more frequently as needed to confirm ongoing compliance with bond rules. Financial Services told us that legal reserves remain untouched, other than legally mandated payments or changes, during the life of the bonds. They said the City's practice is to use the reserve money for the last scheduled repayment of the bonds.

INTERNAL RESERVES: City did not always adhere to internal requirements

While not legally required, the City chose to establish internal debt reserves for about half of its General Fund secured bonds. A Financial Services official explained that the City has the discretion to establish internal debt reserves for various reasons – to protect the General Fund or help prevent possible bond default if there is volatility in the revenue streams responsible for repayment. During interviews and through our analysis, we identified three instances when the City created internal reserves.

Of these three internal reserves, we found that one reserve was used in accordance with requirements, and that two reserves were sometimes used for purposes other than debt repayment. When the City used the reserves for other purposes, it did not always describe the reason for these decisions in the official documents. City Council approved the use of internal reserves whenever the City deviated from its internal policy requirements.

1. Reserve for housing project maintained in accordance with requirements

We found that the City established and maintained one reserve for project costs and debt repayment, as required in its bond documents and internal discussions. The City issued bonds to finance the construction, acquisition and development of the Headwaters Apartments, a 100-unit rental housing development. Project reserves are not unusual for building projects, particularly those that may need time after construction to generate revenue. As a result, the City created the reserve to provide a cushion through the initial years when it was unlikely that rental income would meet bond repayment requirements. The Portland Development Commission (PDC) Project Manager and the City Debt Manager determined the reserve amount when the bonds were issued. At the end of FY 2011, the City had about \$10.9 million outstanding and a \$254,000 project reserve.

2. Reserve for special assessments sometimes used for other purposes

Why did the City issue bonds?

The City offers financing to property owners assessed for the cost of public infrastructure projects that primarily benefit their properties (for example, local improvement districts or sidewalk repairs) or assessed system development charges. “Special assessments” are common in local government, and authorized by Oregon law or City Code. The City assesses property owners based on the estimated benefit to their property, with the option of paying in cash or entering an assessment contract loan from the City. While numerous City bureaus generate assessment activity, the Assessment, Finance and Foreclosure Division in the Office of the City Auditor is responsible for managing the program, and works with Financial Services for debt management and financial planning.

Why did the City establish an internal reserve?

Financial Services indicated that the City experienced difficulty with its special assessment financing program in the 1980s and as a result, established a binding City policy and an internal reserve for these activities. Figure 4 presents information about the fund and reserve requirements. The policy refers to “a dedicated reserve...used to cover debt repayment in the event of an assessment loan default.” Money enters the reserve when a bond issue is fully repaid and there are still outstanding assessment contracts for that bond issue. For property owners who use the loan option, the City applies an adjusted interest rate for “administrative costs, cash flow requirements and the reserve requirements.”

Figure 4 Special assessment reserve requirements

| Source | Requirement |
|---|---|
| Fund creation ordinance | None specified |
| City policy for special assessments | “Proceeds from an interest rate adjustment shall be deposited in a dedicated reserve account to be used to cover debt repayment in the event of an assessment loan default ” |
| City policies for special assessments and debt management | The interest rate adjustment authorized by City Code is sufficient to cover “administrative costs, cash flow requirements and the reserve requirements ” |
| Fund overview in City budget | “Accounts for resources, and the allocation thereof, to pay principal and interest on outstanding indebtedness related to financing public infrastructure improvements requested by property owners” |

Source: Audit Services Division analysis of City documents

How did the City use the reserve?

During initial interviews, Financial Services told us about activity in the reserve fund that was not related to debt repayment as required in City policy. We found transfers were made out of the reserve for two purposes as shown in Figure 5. Since 2007, the City transferred a total of \$8.5 million from the reserve to the General Fund. These amounts were described as “excess,” either in the annual budget or by Financial Services, and were used to meet General Fund budget shortfalls. The two temporary operating loans from the reserves were to meet cash flow needs at the Bureau of Development Services. Financial Services reported the reserve has since been repaid in full with interest for these loans. Council approved the transfers through the annual budget, and authorized each loan through an ordinance.

We initially questioned this use of the reserve. We asked for advice from the Office of the City Attorney, and they determined there are no legal restrictions related to the source of this money. The City’s Bond Counsel confirmed this interpretation. The Office of the City Attorney told us that use of this money must comply with Oregon budget law and any internal policy or process. However, the City’s policy about the reserve does not address excess money. The Office of the City Attorney interprets the lack of policy guidance to mean that discretion is left to Council and its fiscal experts.

Figure 5 Special assessment reserve activity not related to debt repayment

| Transfer recipient | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | TOTAL |
|--|------------------|----------|----------|------------------|------------------|-------------------|------------------|
| General Fund | 5,000,000 | | | | 3,500,000 | | 8,500,000 |
| Bureau of Development Services loan | | | | 1,500,000 | 1,500,000 | | 3,000,000 |
| Bureau of Development Services loan repaid with interest | | | | | -1,509,679 | -1,511,738 | -3,021,417 |
| TOTAL | 5,000,000 | 0 | 0 | 1,500,000 | 3,490,321 | -1,511,738 | 8,478,583 |

Source: OMF Bureau of Financial Services

The reserve level is not addressed in policy, but in January 2011, Financial Services calculated the reserve was equal to 20 percent of the outstanding bond debt, and recommended maintaining the reserve “at existing levels.” At that time, Financial Services assessed the fund’s financial condition. It determined the reserve level was healthy, and provided protection to the City’s General Fund. Financial Services did not recommend further reducing the balance for purposes unrelated to the program due to the potential dilution of protection provided to the General Fund. There were no further actions by City Council to make transfers from the fund, or to formally protect the reserve to the recommended level. However, Financial Services reports it continues to regularly monitor the reserve level. At the end of FY 2011, the City had about \$57.5 million outstanding bond debt and a reserve level consistent with Financial Services’ recommendation.

3. Reserve for pension obligation bonds also used for other purposes

Why did the City issue bonds?

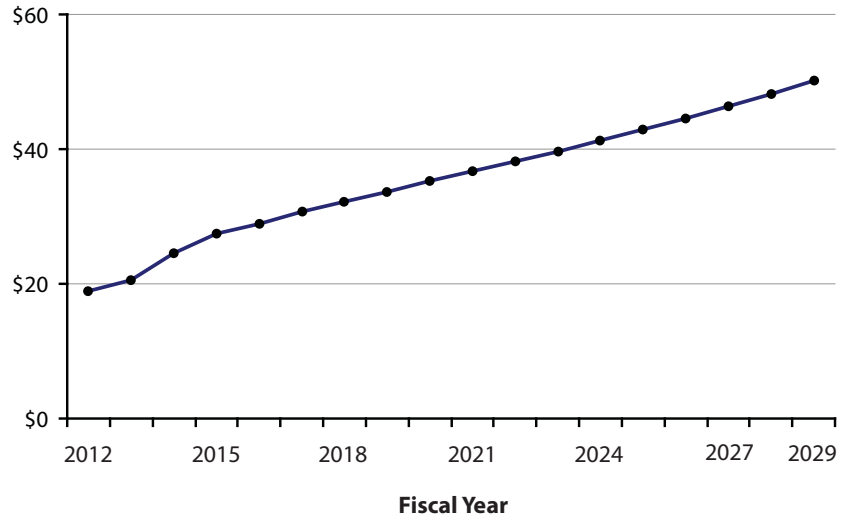
In 1999, the City issued about \$300 million in bonds to address its pension liability with the State of Oregon Public Employees Retirement System (PERS). The year before, PERS notified the City of its revised employer contribution rates, which were nearly double the liability previously calculated. PERS provided the City with various options to pay for this liability and, based on the City's financial analysis, the City found the most cost effective approach was to issue pension obligation bonds. Based on our discussions with City Financial Services, the City ultimately benefited from this decision to issue pension obligation bonds, especially when compared to other local governments in Oregon.

Why did the City establish an internal reserve?

When the City issued pension obligation bonds, it created a reserve to insulate the risk to the General Fund. The City also helped City bureaus transition into their debt repayment responsibilities during the initial years. Council created a fund to "account for resources and expenditures to pay principal and interest on the City's pension obligation bonds." The City allocated the repayment responsibility across City bureaus and the Portland Development Commission based on their FY 1999 actual PERS payments. Financial Services told us that the General Fund is responsible for about 38 percent of the repayment, and the rest allocated to other sources, including the Portland Bureau of Transportation (18 percent), Portland Water Bureau (14 percent), and Portland Bureau of Environmental Services (13 percent).

The City's debt professionals determined the reserve level and how much to collect from each bureau for debt repayment requirements. Figure 6 shows the City's planned repayment between 2012 and when the bonds are retired in 2029. Officials reported that more money was in the fund than annual repayment needs and, at times, Financial Services reduced collections from bureaus accordingly. Since the annual repayment amount increases over time, Financial Services said they initially intended to use the excess bureau collections and their interest earnings to pay off principal or refinance the bonds. City Council chose another option, as described in the next section.

Figure 6 Planned repayment of City pension obligation bonds (millions)



Source: OMF Bureau of Financial Services

Note: The figure represents forecasted repayment of total City pension obligation bonds outstanding as of June 30, 2011. The forecast includes Financial Services' projections for fees and any variable interest rates.

How did the City use the reserve?

Financial Services told us about activity in the reserve fund that was not related to debt repayment as required in the fund's creation ordinance. We found that there were transfers made out of the reserve for three other purposes as presented in Figure 7. Since 2008, the City transferred about \$8.1 million for implementing new financial software (SAP, the City's Enterprise Resource Planning system); about \$600,000 for a policy analyst position related to PERS; and returned \$1.2 million to the General Fund. For the large transfer amounts, the budget documents described the money as "a reduction in planned interest expense" or "surplus." Council approved all of these transfers either through the annual budget or as part of a supplementary budget process. At the end of FY 2011, the City had about \$261.4 million outstanding. According to Financial Services, bureaus are directly responsible for \$226.3 million of that total. The remaining \$45.1 million is held and paid by the fund, which has a reserve of \$926,000.

Figure 7 Pension obligations bonds reserve activity not related to debt repayment

| Transfer recipient | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 budgeted | TOTAL |
|---------------------------|-----------|-------------|-----------|---------|---------|---------------|-----------|
| SAP implementation | 2,175,000 | 4,000,000 * | 1,920,000 | | | | 8,095,000 |
| Policy Analyst** position | | | 134,279 | 138,477 | 142,000 | 166,540 | 581,296 |
| General Fund*** | | | 1,210,000 | | | | 1,210,000 |
| TOTAL | 2,175,000 | 4,000,000 | 3,264,279 | 138,477 | 142,000 | 166,540 | 9,886,296 |

Source: OMF Bureau of Financial Services

- * Of this amount, \$2,613,000 was subsequently transferred to the General Fund to reimburse its initial funding for SAP implementation
- ** Prior to 2010, the position was supported via an interagency agreement and recorded as an expenditure rather than a transfer
- *** The General Fund transfer represents a return of the General Fund's portion of reserves, while the portion related to non-General Fund sources was used for SAP implementation in 2010

Unlike the special assessment reserve, we found various restricted sources contributed to the pension obligation bond reserve. The Office of the City Attorney and the Oregon Department of Revenue (DOR), which has responsibility over Oregon budget law, confirmed the City would have to adhere to any restrictions related to the original source of reserve contributions. A DOR official told us that it was clear that the reserve included both restricted and unrestricted money, and that the law allows transfers only from the unrestricted portion. The debt reserve is comprised of contributions from 22 different sources.

Based on our review of City documents regarding these sources, we found a number of restrictions that are outside of City Council's discretionary authority. For example, the Oregon Constitution states money from gas taxes must generally be used for roads, and tax increment financing must be used for a specific urban renewal area. Similarly, Oregon law requires money collected for 9-1-1 taxes to be used for emergency-related communication. In addition to these state imposed restrictions, the City's Charter restricts the use of money collected from water and sewer ratepayers for those services.

Since the excess reserve contributions were not returned to the original sources, there is a potential that restricted money was used inequitably for the Policy Analyst position and for SAP implementation. As mentioned earlier, the allocation across bureaus for pension obligation bond repayment is based on FY 1999 actual PERS payments. The allocation does not represent current PERS participants who benefit from the Policy Analyst position.

The financing of the City's SAP implementation was complex, with more contributing sources as well as initial financing from the General Fund. We identified differences between the allocations used for SAP implementation and pension obligation bond repayment. For example, we found the Portland Bureau of Transportation's share of pension obligation bond repayment was 6 percent more than its planned share for SAP implementation.

Moreover, the level of knowledge about the transfer decisions and any possible inequities varied across the bureaus we contacted. According to Financial Services, no legal review or allocation analysis was done prior to Council's approval of these transfers. Financial Services told us they believed any differences would be very small, and that the overall project was under the guidance of the then-Chief Administrative Officer.

**Greater accountability
needed over internal
reserves**

The City creates internal reserves because it determines this additional security helps insulate the City from risk. Since the City creates and maintains debt reserves, more accountability over the use of internal reserves would help ensure they are consistently used as originally intended and communicated to reserve contributors.

**Fund creation ordinances must meet policy requirements,
including guidance on reserves and transfers**

City Council has the statutory authority to create and close funds, however, we found fund creation ordinances did not include the level of detail required in City policy. Since 1992, the City's Comprehensive Financial Management Policies require fund creation ordinances to include key information about the fund and its management. The policy requires fund creation ordinances to include the purpose, sources of money, size and use of any contingency as well as means of meeting any required reserves. Moreover, the City's budget documents state that transfers from reserves are only permitted under circumstances clearly specified when the fund is created. In the absence of this information, the City's practices related to the three internal reserves we reviewed appear to be more permissive than restrictive about which activities were allowed. Financial Services acknowledged its fund creation template does not reflect these requirements, and plans to update its templates accordingly.

**City's commitment to internal debt reserves could be further
protected through Council action**

Unlike legal reserves that are protected by legal restrictions, the City's internal debt reserves are only protected by internal policies, which make them more susceptible for other uses. Creating and maintaining internal reserves are long-term decisions that may span multiple City Councils and bureau officials. One way the City could demonstrate its consistent commitment to the purpose of these internal reserves is through Council action. For example, the City has a General Fund Reserve guided by clear policy direction over its use, reserve level, and conditions for when the reserve can be used. Council could adopt an ordinance or resolution to formally protect the internal reserves, and these decisions would remain in force until another Council action removes that commitment.

Policy guidance needed for treatment of excess reserves

In some cases, the City identified excess reserves and used this money for other purposes, yet its policies do not discuss the treatment of excess reserves. It is important that the reserves are not built up excessively or unnecessarily, and when conditions warrant, reserves should be appropriately reduced or liquidated. However, the City does not have guidance on how excess reserves are treated, if not applied towards debt repayment. For example, which stakeholders are involved, how to determine the appropriate reserve level, whether money should be returned to contributors, and how to communicate these decisions. Without this guidance, there is a potential for overspending reserves, and reducing financial ability to respond to other unexpected situations related to debt repayment.

Some other cities include reserves in debt management policy

City Financial Services conducts various activities related to debt reserves management, but the City's debt management policy does not explicitly address debt reserves. While there are best practices over reserves generally, there are no identified best practices specific to debt reserves. We researched debt management policies available online and found practices varied across the 11 cities reviewed (see p. 25 for a list of cities). Some cities chose to include debt reserves in their debt management policies. For those cities, their policies provide a framework over the use of debt reserves and recognize the need for flexibility to meet emerging needs from investors, policy-makers and program managers. For example, the City of Scottsdale, Arizona – which has the same general obligation bond credit rating as the City of Portland – had the most detail about debt reserve levels for General Fund debt. Specifically, it requires reserve levels equal to one month of repayment for general obligation bond debt, and half a year of annual debt repayment for other debt secured by the General Fund.

Chapter 3 **Recommendations**

In order to improve the accountability over the use of internal debt reserves to ensure they are consistently used as intended, we recommend the Commissioner-in-charge direct the Bureau of Financial Services within the Office of Management and Finance to:

1. Work with Council to ensure current and future funds have ordinances that meet City policy requirements, including the purpose of any reserves and transfer activity.
2. Work with stakeholders from appropriate debt-issuing bureaus to obtain any Council action needed to adequately protect internal reserves, and ensure sufficient guidance exists to manage these reserves and permitted use(s) of any excess.
3. Better document how internal reserve use has complied with any restrictions, the reserve's purpose, and the rationale for and implications of the City's decisions when it chooses not to follow the reserve's stated purpose.
4. Improve communication about planned internal reserve use to the public, property owners and other stakeholders responsible for debt repayment.

Chapter 4 **Objective, Scope and Methodology**

We conducted this audit to review the City's approach to debt reserves. We identified this topic because of the City's growing debt reported in our *Portland's Fiscal Sustainability and Financial Condition: Actions now can reduce risk of future problems* (Report #399) audit released in 2011. Our audit objective was to determine whether City practices related to debt reserves aligned with best practices and applicable requirements.

In order to accomplish our objective, we reviewed various resources related to the City's financial management. We reviewed pertinent sections of City Charter and Portland City Code. We also reviewed the Comprehensive Financial Management Policies, Accounting Administrative Rules, and other Citywide, bureau or program-specific policies, procedures or practices relevant to the audit. We analyzed the City's Comprehensive Annual Financial Reports (CAFRs) as well as the annual Adopted Budget and relevant supplemental budgets for multiple years. We reviewed the Public Finance and Treasury Division's *Annual Debt Report for Fiscal Year 2011* as well as an example of debt management reporting used by Financial Services. We generated various reports from SAP, the City's Enterprise Resource Planning system, to identify legal funds, subfund reserves, and transaction-level detail relevant to the audit. We also reviewed past reserve studies by outside consultants and an internal review by the Financial Planning Division.

We focused on the City's outstanding bonds because they constitute a material portion of the City's outstanding debt. We identified the bond population by reviewing information in the City's CAFR for Fiscal Year 2011, and verified its completeness with the Municipal

Securities Rulemaking Board's Electronic Municipal Market Access system. We selected a non-statistical sample of bond issues based on risk, coverage across stratified bond type categories and dollar amount, and our results are not projectable to the full bond population. During testing, we reviewed official bond statements, bond declarations, City ordinances, and continuing disclosures. Since the City uses a software application to determine the amount of any legally required debt reserves, we analyzed the computer-processed information and determined the calculations were sufficiently reliable for our audit purposes. We compared the reserve amounts required as of June 30, 2011, to the City's actual cash reserves or, if the City used reserve equivalents, independently verified information with the reserve insurance policy provider.

We conducted interviews to gain an understanding of City operations, perspectives of managers and staff, and the management of debt-related funds. Our interviews at the Bureau of Financial Services included managers and staff across Accounting, Financial Planning, and Public Finance and Treasury divisions. Due to information shared by Financial Services staff in preliminary interviews, we obtained advice from the Office of the City Attorney about the City's legal requirements related to two debt funds. We also expanded our discussions about these specific funds to other officials in the Office of Management and Finance, as well as the Office of the City Attorney, Office of the City Auditor, Portland Bureau of Environmental Services, Portland Bureau of Transportation and Portland Water Bureau.

In order to identify some of the legal restrictions imposed on the City, we reviewed a variety of resources at the state level. These included the Oregon Constitution, Oregon Revised Statutes, Oregon Department of Revenue's *Local Budgeting Manual* and Oregon State Treasury's *Oregon Bond Manual: An Information Manual for Oregon Municipalities*. We also spoke with officials at the Oregon Department of Revenue, Oregon State Treasury, Multnomah County Tax Supervising and Conservation Commission, as well as an attorney with expertise in special assessment (Bancroft Bond) financing that also serves as the City's Bond Counsel.

As part of our analysis, we also reviewed various industry-specific standards, reports and best practices relevant to the topic. Sources for this information included the Government Finance Officers Association, Internal Revenue Service, International City/County Management Association, FitchRatings, Moody's, Municipal Securities Rulemaking Board, National Advisory Council on State and Local Budgeting Practice, and Standard and Poor's. We also obtained information for 11 other cities to determine whether these governments have a specific debt reserve policy. These cities include Alexandria (VA), Bellevue (WA), Chicago (IL), Columbus (OH), Everett (WA), Las Vegas (NV), Missoula (MT), Palo Alto (CA), Salem (OR), Scottsdale (AZ), and Seattle (WA).

We reviewed information for reasonableness and consistency. We questioned or researched information that needed additional explanation. We did not audit the accuracy of source documents or the reliability of data in computer-based systems except as described earlier. For information referenced in the City's CAFRs, we relied on the work performed by the City's external financial auditors and, whenever possible and relevant, we compared information provided by management to audited information in the City's CAFR. We relied on management's representations about information provided about specific transfers out of debt funds. If supporting documentation was available, we reviewed these documents for reasonableness, but our reviews are not intended to provide assurance about the reliability of the Financial Services' documents or information provided by management is free from error, or fraud, waste and abuse.

Auditing standards require auditors to be structurally independent of the audited organization to avoid any actual or perceived relationship that could impair the audit work performed or findings reported. The City Auditor is responsible under City Charter to conduct audits of the City, and under City Code to manage the City's financing of special assessments. Because the City Auditor did not play a role in determining the objective, audit scope, or the information presented in this report, we do not believe her responsibility over managing the special assessment debt reserve constitutes a threat to our independence.

The Audit Services Division of the Office of the City Auditor developed this report independently for the public as well as for City officials. This report is the result of a performance audit, and was not part of the City's annual financial audit on the City's financial statements. Expressions of opinion in the report are not intended to guide prospective investors in securities offered by the City and no decision to invest in such securities should be made without referencing the City's audited CAFRs and official disclosure documents relating to a specific security.

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

APPENDIX

Overview of City bonds

The City issues many different types of bonds, and uses various resources to secure or repay the bonds. Figure 8 presents characteristics related to the City's bonds, such as bond type and whether bonds are secured by the General Fund or other sources. Typically, the City has a lower cost of borrowing when it uses its General Fund to secure debt.

A majority of the City's bond debt (79 percent) is for core activities (i.e. utility services) or urban renewal, where there is no direct legal claim on the City's General Fund. About 21 percent of City debt is backed by the General Fund.

Just because a bond is secured by the General Fund does not mean the General Fund is used for debt repayment. Financial Services officials told us that the General Fund has not been used to repay the City's debt except for the Non Self-Supporting bonds.

When the City issues "unlimited" bonds, it promises to authorize any voter-approved taxes needed to repay the debt. In contrast, when the City issues "limited" bonds, it will make cuts to existing services in order to repay the debt if money is not available.

Figure 8 Overview of City bonds

| Security | Bond type | Description | Activities | Percent of City outstanding bond debt | Underlying bond rating (Moody's) | Reserve practices per audit |
|---|---|---|---|---------------------------------------|----------------------------------|-----------------------------|
| Other sources | Revenue bonds | Supported by revenues from a specified project or enterprise | Gas, golf, hydro, parking, sewer, water | 65% | Varies | Legal Reserves |
| | Urban renewal and redevelopment bonds | Supported by expected growth in property tax revenues resulting from specified urban renewal improvements | Airport, Downtown, Oregon Convention Center, South Park Blocks, Central Eastside, Gateway, Lents, North Macadam, Interstate, River, and Willamette Industrial districts | 14% | Varies by district | |
| General Fund | Limited tax improvement bonds | Supported by special assessment contract payments from property owners specifically benefiting from local improvement | "Bancroft Bonds" issued for specific local improvements (e.g. Aerial Tram or Streetcar local improvement districts, system development charges, sidewalk repair) | 2% | Aa1 | Internal Reserves |
| | Limited tax and limited tax revenue bonds | May be paid from the General Fund (Non Self-Supporting) or other specifically identified non-General Fund resources (Self-Supporting) | Both Non Self-Supporting & Self-Supporting: Pension obligation | 8.5% | Aa1 | |
| | | | Non Self-Supporting: Headwaters Apartment Complex | | | |
| | | | Non Self-Supporting: Archives, CAD project, Emergency Operations Center, Enterprise Business Solutions project, housing projects, Integrated Regional Network Enterprise, Portland International Raceway, radio shop, 800 MHz | 8% | Aa1 | No debt reserves |
| Self-Supporting: Arena, Civic Stadium, North Macadam Investors, Oregon Convention Center, Portland Center for Performing Arts, Portland Mall, Streetcar | | | | | | |
| Unlimited tax general obligation bonds | Supported by a dedicated voter-approved property tax levy that can only be used to pay those specific bonds | Parks, emergency facilities, public safety | 2.5% | Aaa | | |

Source: City of Portland's *Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2011* and *Annual Debt Report for Fiscal Year 2011*

RESPONSES TO THE AUDIT



OFFICE OF MAYOR SAM ADAMS
CITY OF PORTLAND

DATE: August 20, 2012

TO: Drummond Kahn, Director of Audit Services

FROM: Mayor Sam Adams, Commissioner-in-Charge of the Office of Management and Finance

SUBJECT: Debt Reserves: Legal reserves meet requirements, but internal reserves need more accountability

Dear Mr. Kahn:

I appreciate the opportunity to respond to the above-referenced audit. The report, *Debt Reserves: Legal reserves meet requirements, but internal reserves need more accountability*, provides insight regarding the City's debt reserve process and makes a valuable recommendation for continued communication regarding the creation and use of voluntary internal debt reserves.


I concur with OMF's letter of August 17, 2012, detailing their response to the above-referenced audit, and find their response to be sufficient. Thank you for your efforts.



CITY OF PORTLAND

OFFICE OF MANAGEMENT AND FINANCE

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Jack D. Graham, Chief Administrative Officer
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TO: Drummond Kahn, Director of Audit Services
CC: LaVonne Griffin-Valade, City Auditor
FROM: Jack D. Graham, Chief Administrative Officer 
DATE: August 17, 2012
SUBJECT: Response to 2012 Debt Reserves Report

Thank you for the opportunity to review and comment on your audit of the City's Debt Reserves (Audit). OMF appreciates the willingness of Audit Services staff to consider our feedback. The City has a long-standing national reputation for financial excellence, and upholding best practices related to debt management is a critical component of that assessment.

As described in the Audit, the City's debt reserves come in two flavors – reserves that are *legally required* by owners of specific series of bonds, and reserves that are *voluntarily created* by the City. In both cases, the purpose of a debt reserve is to provide protection against unanticipated declines in revenues used for repayment of debt and to ensure timely payment of debt service when due.

Nearly 80% of the City's outstanding debt has legally required debt reserves, and OMF agrees with the Audit finding that all legally required reserves remain fully funded and in compliance with provisions of the defining bond documents.

Three specific City bond programs maintain voluntary debt reserves as described in the Audit. Each of these bond programs is paid from defined revenue streams (housing project revenues, specific property assessments, or bureau pension contributions), but also has a legal claim on the City's General Fund. Maintenance of voluntary reserves mitigates risk that the City's General Fund could be called upon to make payment on these bonds. OMF recognizes it is important to continually monitor reserve levels and, when legally feasible, to adjust those levels to address changing risks. We believe that voluntary reserves are currently funded at appropriate levels.

While OMF recommends voluntary reserve funding levels, City Council ultimately has legal authority to direct the use of City resources. All prior actions to redirect voluntary debt reserves have been completed at the direction of City Council, in consultation with OMF, and were taken in the context of maintaining the City's overall financial stability and achieving the City's broader financial priorities.

OMF concurs with the Audit recommendations and will continue to work with Council, bureaus, and internal and external stakeholders to ensure appropriate communication related to the creation and use of voluntary debt reserves.

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Debt Reserves: Legal reserves meet requirements, but internal reserves need more accountability

Report #425, August 2012

Audit Team: Tenzin Choephel

This report is intended to promote the best possible management of public resources. This and other audit reports produced by the Audit Services Division are available for viewing on the web at: www.portlandoregon.gov/auditor/auditservices. Printed copies can be obtained by contacting the Audit Services Division.

LaVonne Griffin-Valade, City Auditor
Drummond Kahn, Director of Audit Services

Other recent audit reports:

A report to our community: from Portland City Auditor LaVonne Griffin-Valade (#431, July 2012)

Portland Fire & Rescue: More active management of overtime and call shifts needed for good stewardship of limited resources (#418, June 2012)

Residential Solid Waste: Customer rates accurate, but monitoring should continue (#429, June 2012)

Portland Water Bureau: Further advances in asset management would benefit ratepayers (#405, June 2012)

