March 17, 2011

Subject: Report to Mayor and Council: Commission Comments on City of Tucson's Comprehensive Annual Financial Report (CAFR) for Fiscal Year Ending June 30, 2010

Honorable Mayor and Council:

During January, members of the City's Independent Audit and Performance Commission (IAPC) read the City's CAFR for the fiscal year ending June 30, 2010. Following their review, questions were asked of City staff. Those questions and staff responses are attached.

The Commission recommends that Mayor and Council read the City's CAFR, especially the *Management's Discussion and Analysis* and *Notes to Basic Financial Statements* sections. These sections provide significant discussion and details on the City's finances.

The following areas should be issues of interest to the Mayor and Council:

1. Despite difficult economic times, the City's General Fund assigned/unassigned fund balance increased during FY 2010:

	Balance at June 30, 2009	Balance at June 30, 2010
Assigned Fund Balance	$ -	$ 11.5 million[1]
Unassigned/Unreserved	17.0 million	22.8 million[2]
Total	$ 17.0 million	$ 34.3 million

2. Ratings from the three major bond rating agencies (Moody's, Standard & Poor's, Fitch) for the City's General Obligation Bonds remained unchanged from the prior year (obligations judged to be of high quality and subject to very low credit risk).

[1] $11.1 million of the $11.5 million assigned at June 30, 2010 was assigned for FY 2011 deficit mitigation.

[2] At June 30, 2010 the City's goal was to increase the General Fund unassigned fund balance to 10% of fund expenditures. For FY 2010, 10% of fund expenditures would have been $37.9 million. During January 2011, Mayor and Council adopted *Comprehensive Financial Policies* (Resolution 21676) containing new Fund Balance policies.

3. Several funds' year end unrestricted net asset deficits grew in FY 2010 and had the following balances at June 30, 2010:
    a. Golf Course $ (6.8 million)
    b. ParkWise $ (1.5 million)
    c. Self Insurance $ (52.7 million)

4. The following funds continued to require interfund loans from the General Fund to eliminate negative year-end cash balances[3]:
    a. Golf Course $ (6.3 million)
    b. ParkWise $ (1.5 million)
    c. Self Insurance $ (11.3 million)

5. The City's Self Insurance Fund and the Golf Course Fund had FY 2010 income losses of $10.4 million and $1.6 million, respectively.

6. The funded ratio for the Tucson Supplemental Retirement System decreased from 77% at June 30, 2009 to 71% at June 30, 2010. Funding ratios for the Police and Fire retirement systems remained constant at 66%. Employer contributions rates, based on actuarial analysis, for all three retirement systems were increased for the current fiscal year. Additional increases for FY 2012 have been adopted by the City's Pension Board and included in preliminary budgets for FY 2012.

The Commission would like to acknowledge Mike Mason, Accounting Administrator, for presenting information on the CAFR and coordinating responses to the Commission questions.

Commission members appreciate the opportunity to provide the Council with review of relevant issues. Please contact your appointee to the Commission, or the City Manager, should you have topics you would like the Commission to review.

Respectively Submitted,

David Cormier

David Cormier
IAPC Chair

Attachment

[3] Funds participate in the City's investment pool. Individual fund cash overdrafts are covered by funds with positive cash balances. Funds with overdrawn cash are charged interest at the investment pool's earnings rate. Cash overdrafts are converted to interfund loans for year-end statement presentation purposes.

The following information was provided to the Independent Audit and Performance Commission (IAPC) in response to questions submitted during a review of the FY 2010 Comprehensive Annual Financial Report (CAFR).

1. *The Letter of Transmittal references a 5-Year Financial Model created for the General Fund. Can a presentation of this model be scheduled for a future Commission Agenda item?*

   A demonstration took place at the March 2, 2011 IAPC meeting.

2. *Bond Ratings are listed in the Management's Discussion and Analysis (page 13). Request a short summary of the underlying factors that contributed to changes in rating (and description of ratings).*

   The rating agencies evaluate a variety of factors when determining the rating level to apply to an entity. These factors include economic and demographic factors of the community; financial and management issues; and issues related to the structure of the particular transactions. A change in one factor, such as the use of fund balance, may or may not result in a rating adjustment up or down, as each factor is not considered in isolation. Additionally, a rating agency may consider the use of fund balance differently depending on the purpose of the drawdown of the fund balance. However, the continued use of fund balance to balance a structural deficit reflects poorly on the financial position as well as the management factors that are evaluated.

   One of the reasons for Mayor and Council to adopt the Comprehensive Financial Policies was to illustrate strong management and provide a framework to improve the financial position of the City. The rating agencies rely on strong management to make decisions that are appropriate for the operations of the City as well as maintaining a strong financial position; keeping debt at affordable levels is part of that evaluation.

   The most commonly cited bond rating agencies are Standard & Poor's, Moody's, and Fitch. These agencies rate an entity's ability to repay its obligations. Ratings of 'AAA' to 'Aaa' are for high grade issues that are very likely to be repaid. Bonds rated 'BBB' to 'Baa' or above means they are unlikely to default and tend to remain stable investments. Bonds rated 'BB' and below are more speculative and more likely to default.

3. *What makes up the Assigned/Management contingencies portion of the General Fund fund balance (page 38) of $11.1 million?*

The $11.1 million was assigned for deficit mitigation to help avoid issuing a sale/leaseback financing during FY 2011. The $11.1 million resulted from 1) FY 2010 total revenues less expenditures and other financing source/uses, which totaled $7.4 million and, 2) a reduced FY 2010 debt service payment due to a previous reserve setup with Certificate of Participation proceeds of $3.7 million.

4. *Has the $1.7 million Rio Nuevo receivable been written off post June 30, 2010?*

As soon as the IGA between Rio Nuevo and the City has been signed, the receivable will be written off.

5. *Landfills closure/post-closure liability (page 59) of $37 million: What years are the actual cash flows estimated to be required? How are these cash requirements being accumulated and built into Environmental Services' (ES) rates?*

Landfill closure/post-closure care costs must be recognized over the useful life of a landfill even though such costs will only be incurred near or after the close of the landfill. An estimate of these costs is made annually to adjust the liability for any changes in regulations, inflation, or other factors.

Currently the ES operating budget is covering post-closure costs for three closed landfills. Los Reales is the remaining active landfill (estimated 60 year life). ES has various rates for residential, commercial, and disposal activities. Each of these rates includes a landfill closure/post-closure recovery portion. ES management has established a 'savings account' of $930,000 for FY 2010 and expects to increase this by similar amounts per fiscal year.

<u>Current Year - FY 2011</u>
Reserve amounts for future landfill closure and post-closure costs are only for Los Reales landfill as all other City landfills have now been closed and all related post-closure costs are paid for through ES' operating budget. The current year amounts are as follows:

Closure Costs = $0
Post-closure Costs Budget = $1,035,480
(note - this amount is the aggregate annual O&M for all closed landfills monitored by ES)
Closure Reserve = $416,937
Post-closure Reserve = $523,928

Future Years - 10 Year Plan

Closure costs - Based on current tonnage trends the Los Reales landfill is expected to be in service for approximately 60 years. Some intermediate closure work is expected to be performed at Los Reales and $800,000 has been budgeted for Westside closure in FY 2015 with other intermediate closure work currently scheduled for FY's 2017 and 2018 totaling $400,000. Both closure projects will be paid from ES' closure reserve.

Post-closure costs - The annual on-going post-closure costs for the other landfills that ES monitors is expected to be around $1.1 M for the next several years and will be paid for from ES' annual operating budget.

Reserves - the annual contributions to ES' Closure and Post-closure Reserves increases from the current year amount by about $5K to $7K, respectively; see attached spreadsheet for the specific annual amounts. ES is in the second year of a ten-year financial plan and will be requesting the reserve contributions be made as ES funds may be available. Periodically, ES' ten year financial plan will be re-evaluated to determine that the long term funding of ES' Landfill liability (approximately $32 M) remains on schedule.

6. *ParkWise-What makes up the long-term investment and Non-spendable Fund Balance of $1.6 million (page 74)? What is the plan to eliminate the $1.5 million fund deficit?*

The long term investment represents Certificate of Participation (COP) proceeds that are invested (and restricted) to cover the final debt service payment for that specific COPs issue. ParkWise's financial position has been improving. It no longer receives a General Fund subsidy and, over the last two fiscal years, its revenues have exceeded expenditures. This situation will gradually reduce its negative Unassigned Fund Balance. ParkWise is now under new management supervision, which will also benefit the management of this fund.

7. *The Golf Course Fund (page 91) continues to operate at a loss, what are plans to improve performance? What is the interfund payable of $6.3million?*

Parks and Recreation Administration have taken actions to reduce expenses. Other options to improve the financial position are being considered, but no decisions have been made at this time. The interfund payable represents the cash shortage as of June 30, which is the end of the fiscal year. This is an accounting entry accomplished for financial statement presentation purposes and is reversed on July 1 (new fiscal year).

8. *The Self Insurance Fund (page 93) operating loss was $10.4 million. Are rates to departments being held down to mitigate budget impacts? What is the $11.3 million interfund payable?*

The Self Insurance rates were not being held down due to budget impacts in FY 2010. Several new management actions have taken place or are in progress that will improve the financial position of this fund. The actions include:

- For FY 2011, an actuary will compute the estimated claim liabilities.
- For FY 2011, rates to Funds were increased to cover operations and include a component to recover prior year deficits over a 10-year period.
- Established a tort liability recovery through property tax based on claims expenses over $20,000. This recovery was $265,000 in FY 2011 and is estimated to be $2.4 million for FY 2012.
- Establishing a Self Insurance Trust that will align us with Industrial Commission preferred practices, which will provide a board to manage the assets in the fund. This will be briefed at a Mayor and Council Study Session on March 22, 2011.

For FY 2011, the operating income is estimated to be about $5 million as compared to a $10.4 million loss in FY 2010.

The interfund payable represents the cash shortage as of June 30, which is the end of the fiscal year. This is an accounting entry accomplished for financial statement presentation purposes and is reversed on July 1 (new fiscal year).

9. *The current employer contribution rate percentage for TSRS is 18.57%. What is the actuary's rate recommendation for FY 2012? Is this the rate being budgeted by the City for FY 2012?*

The employer contribution rates for TSRS for FY 2012 are:

- Hired prior to 7/1/06 24.05%
- Hired after 6/30/06 17.43%

These rates will be used in the FY 2012 budget.

Environmental Services Reserve Contributions - FY's 2010 through 2019

	Year 1 FY 10	Year 2 FY 11	Year 3 FY 12	Year 4 FY 13	Year 5 FY 14	Year 6 FY 15	Year 7 FY 16	Year 8 FY 17	Year 9 FY 18	Year 10 FY 19
Reserve Contribution - Capital	$ 860,000	$ 946,000	$ 1,040,600	$ 1,144,660	$ 1,259,126	$ 1,385,039	$ 1,523,542	$ 1,675,897	$ 1,843,486	$ 2,027,835
Reserve Contribution - Closure	412,061	416,937	421,886	427,758	433,714	439,755	445,882	452,097	458,400	464,794
Reserve Contribution - Post-Closure	517,801	523,928	530,147	537,526	545,010	552,601	560,301	568,110	576,031	584,066

Source: Environmental Services 10 Year Financial Model - April 2010.