



FINANCE COMMITTEE MINUTES

Regular Meeting
December 16, 2008

Chair Morton called the meeting to order at 7:07 p.m. in the Council Conference Room, 250 Hamilton Avenue, Palo Alto, California.

Present: Burt, Morton (chair), Schmid, Yeh

Absent: None

1. Oral Communications

Chair Morton opened the floor to public comment for items not appearing on this evening's agenda. No comments were offered.

2. 2007-2008 Year End Capital Improvement Program (CIP) Projects Status Report.

Director of Administrative Services, Lalo Perez presented the staff report. He commented on Project No. TE-95016, stating that the City has a business license software program used to create building permits called Accella. He stated that there was no activity on this account related to the potential business license tax initiative.

Council Member Yeh requested a status report on the Enterprise Application Infrastructure Upgrade Project (Project No. TE-07000).

Mr. Perez indicated that the City is in the integration, discovery, and testing phase of Project No. TE-07000. He stated that it was City Staffs' intention to bring this project back with a comprehensive update on the system and its progression.

Council Member Yeh requested an update on the budgeted Information Technology (IT) management position.

Mr. Perez stated that the IT management position had been filled; further indicating that the individual hired has extensive experience and will be

responsible for assisting with the IT Master Plan, and assisting with CIP Projects.

Council Member Burt recalled the Adamson Study's finding that the cost of construction is exceeding anticipated project costs. He questioned how the rapidly accelerating cost of construction is affecting current CIP Projects. He requested an update on the Kitchell Study.

Mr. Perez highlighted the Kitchell Study, stating that its guidelines state that for the next five years the City should spend roughly \$155 million on CIP Projects. He indicated that the City has a plan to cover approximately 1/3 of the proposed CIP Projects. He addressed an outstanding audit recommendation, regarding a funding plan, to increase investment and replacement of the City's infrastructure. The report proposes that the City should double what it is currently spending. It suggests raising the funds on construction projects and looking at current staffing levels.

Assistant Public Works Director, Mike Sartor summarized the forecasted trends of construction costs. He indicated that City Staff has experienced a change in construction bids due to the economy. He indicated that a lack of work in the private sector is driving the public sector bid prices down. On a weekly basis, City Staff is researching, tracking, and looking closely at trends and their impact on current and future CIP Projects. It is not known how long this trend will last.

Council Member Burt asked what the current bid data shows in regards to what City Staff is projecting.

Mr. Sartor shared a finding from the fire station renovation bid, stating that the lowest bidders were fifty percent below the estimator's assessment. He indicated that bids received for the street maintenance program were ten to fifteen percent lower than the engineer's estimate.

Chair Morton stated that the information provided is a good reference for the Council; however, the Council should keep in mind the focus is on the 2007-2008 CIP Project status report.

Council Member Schmid complimented City Staff on the comprehensiveness of the report. It was his belief that the Council has been receiving CIP budget adjustments on the City Council Agenda Consent Calendar. He questioned what this is doing to the City's General Fund. He inquired if there was a way to alert Council on how much these adjustments are increasing the budget.

Mr. Perez stated that City Staff can include a report that identifies the balances of CIP funds when there are changes to contracts and/or budget adjustments.

He stated when budget amendments are needed on projects, the funds are taken out of the infrastructure reserve and not the General Fund.

City Manager, Jim Keene stated that City Staff can generate a document that highlights financial changes to the CIP Projects; further stating that this document can highlight the budget amendment changes, allocations, and updates.

Council Member Yeh inquired on whether the School Site Irrigation Project (PG-98001) is a shared cost with the School District.

Acting Open Space & Parks Division Manager for Community Services, Don Piana confirmed that the cost of this project is fifty percent shared with the School District. He stated that the program has been successful and included updates to two middle schools and nine elementary schools irrigation systems.

Council Member Burt questioned why the remaining surplus funds in completed projects could not help support projects on hold due to lack of funding. He was referring to the chart titled Total Adjusted Budget for Fiscal Year 2007-2008. He requested information on projects that were put on hold due to the lack of funding.

Mr. Perez acknowledged that projects are being deferred due to the lack of funding and budgetary constraints. He indicated that the Cubberely Bathroom Renovation Project has been impacted due to the prioritization of other projects.

Chair Morton stated that the Children's Theatre Fire/Life Safety Upgrade is on hold as well as other projects. He stated that within the list of CIP Projects, Staff can list the projects that have been impacted.

Mr. Perez stated that the Municipal Service Center (MSC) Feasibility Study has been on hold. The MSC project has implications and is not a small task.

Council Member Burt stated that this project totals almost 10 percent of the CIP budget. It was his belief that projects on hold, due to the lack of funding, should be delineated from the status report.

Mr. Keene was in favor of Council Member Burt's idea; further stating that characterizing the projects into two different categories would be beneficial to the public and to Council. Utilizing one list with projects on hold, and one list with projects that are being deferred.

Mr. Perez stated that most of the projects in this case are deferred.

Council Member Yeh questioned how the City can communicate new infrastructure projects with the community.

Mr. Perez indicated that informing both the community and the Council is a top priority. He indicated that the projects can be characterized in a more understandable way to the public, and can further be labeled as is the case with Council priorities.

Council Member Yeh stated that the CNG Gas Station has had ongoing public interface and requested a status on the project.

Mr. Sartor stated that the CNG Gas Station is on the last phase of construction. He indicated that there will be a public facility located at the site. The anticipated opening for the new facility is scheduled for March 2009.

Council Member Yeh inquired on whether there was an ongoing public-serving resource system that could explain CIP Projects, status, and anticipated completion dates.

Mr. Perez welcomed ideas on new communication channels to filter information to the community.

Chair Morton suggested devising headlines in the media.

Council Member Burt stated that significant projects can be summarized on the City's website; further stating that illustrations would be beneficial.

Mr. Perez stated that City Staff is exploring the possibility of utilizing its GIS Program to enhance project images posted on the City's website.

Chair Morton indicated that this item was an informational item and no action was requested.

3. Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2008 and Management Letter.

City Auditor, Lynda Flores Brouchoud presented the staff report. She indicated that as required in the City's Municipal Code, the Office of the City Auditor coordinated the City's Annual Financial Audit with the assistance of Maze & Associates. Maze & Associates reviewed the City's Fiscal Year 2007-2008 Financial Statement and provided recommendations on the City's internal control practices.

Maze & Associates Staff Member, Cory Biggs stated that the opinions in the financial statement are referred to in the report as unqualified opinions; further stating that these are the highest quality of assurance the City can receive. He indicated that City Staff was prepared, knowledgeable, and provided all data in a timely manner. He overviewed the numerous reports that were provided to the City Council as follows: 1) the Memorandum of Internal Control and Required Communications document that his office produced; 2) retiree healthcare (GASB 45); 3) unusual transactions in regards to the credit risks and the credit crisis in the current economy; and 4) estimates, including cash investments and portfolios. He overviewed the management comments including material weaknesses and significant deficiencies seen in the IT Division and utility billing system.

Council Member Yeh referencing the Data Security Standard (PCI/DSS), from the Memorandum of Internal Control Structure, inquired whether this is driving the SAP interface for utility billing services.

Mr. Perez stated that the current configuration complies with the FACT Act. He stated that City Staff will be looking into on-line payment feature upgrades (e.g., bank account auto deductions, credit cards accounts) that will comply with governmental regulations and standards.

Council Member Yeh inquired whether an upgrade to the system would change the level of merchant status the City is regulated under.

Mr. Perez's understanding, from a utilities standpoint, was that the City would not move into a different category of merchant regulations in regards to an increase in on-line payments.

Council Member Schmid questioned whether an individual would be responsible for fraudulent signatures. He addressed a detrimental situation that took place with cash transactions and advances within the City.

Mr. Biggs stated that Council Member Schmid was referring to what is called the auto opinion; further indicating the scope of work provided by Maze & Associates assures that the data presented is materially accurate. He stated that a complex calculation is used to determine the materiality.

Council Member Schmid inquired about the Council's responsibility in regards to an audit oversight. He asked if the Council could claim non-materiality in such cases.

Mr. Biggs stated that the key to a successful governmental organization is to set up enough internal controls to minimize the occurrence of fraudulent issues, yet still conducted business efficiently.

Council Member Schmid questioned how the City rated in regards to cash control.

Mr. Biggs confirmed that the City currently has good cash control based on the tests performed. He indicated that cash balances are audited 100 percent for accuracy. Further stating that random or judgmental sampling is used for receipt transactions. He stated that agencies can institute oversight procedures. He provided two examples of procedures as follows: 1) good balance of internal control to safeguard funds; and 2) internal audit functions to zero in on smaller areas that do not receive good coverage from the audit process.

Council Member Schmid suggested a follow up discussion with the City Auditor to fill any overlooked areas in the audit process. He referred to the section in the report titled "Allowing for Doubtful Account" which refers to the Below Market Rate (BMR) housing liabilities. He inquired on a possibility of writing off these loans in the future.

Mr. Biggs stated that the BMR loans are long term notes which were set up to finance housing programs to low income families. He indicated that there is some opportunity to collect the loans. He reiterated that the objective of the program is to encourage housing and not to make a profit; therefore the payment of said loans is structured with the expectation that the loans may not be repaid.

Council Member Schmid stated that these loans total several million dollars.

Mr. Biggs stated that this amount can be seen in the Notes and Loans Receivable section of the City's budget. He stated that municipalities utilize a modified accrued accounting system. He stated that accounting policies requires that governmental organizations be very conservative with expectations of receivables. He indicated that these funds are tied up in long term receivables and can not be spent.

Council Member Burt questioned why there was a \$50,000 threshold set for an accounting manager to review a journal entry. He felt that was a large number.

Mr. Biggs stated that Maze & Associates recommends this threshold in place to detect material errors that may otherwise go undetected.

Mr. Perez stated that a lot of the journal review activity happens at a lower level by accounting clerks and senior accountants; he further stated that the City will implement a procedure for monthly spot checks performed from the accounting manager.

Council Member Burt questioned if an accounting manager would ever look at journal entries below \$40,000 which is below the \$50,000 threshold.

Mr. Perez stated that the accounting manager looks at journal entries below the \$50,000 threshold if the entry showed discrepancies.

Council Member Yeh inquired on activity regarding the funding plan for the Public Safety Building which included prefunding the Pension Plan.

Mr. Perez indicated that pre-paying CalPers pension has been done; however, he stated that the City is not locked into this process. This issue can be assessed and shifted as necessary based on market conditions.

Council Member Yeh questioned what protections would municipalities have against investing in an uncertain market.

Mr. Biggs stated that in any market investment strategies should be practiced; further stating that there will be good and bad investment years. He stated that successful investment strategies include the following: 1) choosing the right timeframe to lock funds; 2) knowing your risk tolerance threshold; and 3) possessing a good asset allocation.

Council Member Yeh stated that if there are losses to an investment, the unfunded liability can potentially grow, creating a double-payment for current and retired workforce. He questioned how are governments looking at down years in the economy and efficiently using public funds.

Mr. Biggs stated that the funding of retired healthcare is completed using an actuary. The actuary analyzes data and determines the unfunded liabilities (growth liability net investment balances). The actuary will amortize this amount to determine the level of funding to appropriate annually. This is the annual retired contribution. As long as the City pays the retired annual contribution, the City will have sufficient funds to pay the benefits. Premiums are typically a very small part of this proportion of the entire actuary of liability.

City benefits pay insurance premiums; further stating that over the long term the premiums will continue to escalate. He stated that financial planning and leveling of funding is achieved by setting aside more benefits in the early years so there are additional reserves to draw upon in the later years. This is a long

term liability and should be strategized through in a long term perspective scope.

Chair Morton stated that the City has prefunded retirement medical benefits; further stating that \$29 million is listed as a prepaid asset. He indicated that the health care benefits equal \$9 million annually; further stating that the City has prepaid for roughly 3 years. He had a concern on the earning of the funds.

Mr. Perez stated that the fund is in a separately managed fund, in a trust. He stated when the City receives the long range financial plan from Public Employees' Retirement System (PERS) City Staff will provide a scenario on their assumptions and impact in the future.

MOTION: Council Member Yeh moved, seconded by Schmid that the Finance Committee recommends to the City Council approval of the Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2008.

MOTION PASSED: 4-0

4. Recommendation Regarding Adoption of Ordinance Authorizing Closing of the Budget for the Fiscal Year Ending June 30, 2008, including Reappropriation requests, closing completed capital improvement projects, Authorizing transfers to reserves and Approval of Comprehensive Annual Financial Report (CAFR).

Administrative Services Department Accounting Manager, Trudy Eikenberry provided a brief overview of the financial statements. She stated the General Fund ended with an operating gain of \$3.3 million. She overviewed the Capital Projects Fund. She stated that once the Capital Projects funds are assigned to a project they are moved from infrastructure reserves to the commitment reserves. She indicated that at this point funds are ready to be spent and the service contracts have been executed.

Chair Morton stated that the fund balance is made up of two parts, the committed and non-committed funds.

Ms. Eikenberry reviewed the Enterprise Funds shedding light on the various fund balances.

Chair Morton requested an update regarding the Water Fund Upgrade System.

Director of Administrative Services, Lalo Perez stated that the City is addressing land matters with Stanford regarding the Water Fund Upgrade System.

Council Member Burt requested clarification on why a \$4.5 million loss goes to a \$9.8 million decrease in the Electric Fund.

Ms. Eikenberry's believed that other reserves in this fund were used or there was an increase in capital reserves.

Mr. Perez stated that the simplistic view is that it was separated by distribution and public benefits. He stated that re-appropriations can change from year to year.

Ms. Eikenberry stated that re-appropriations are fund carryovers of CIP Projects that were not completed and the funds are automatically carried forward; or unspent money maybe re-appropriated from another project. Re-appropriations are a legal obligation due to project commitments. She completed the overview of the Staff report; including the Gas Fund, Wastewater Collection Fund, Wastewater Treatment Fund, and the Storm Drain Fund.

Council Member Yeh questioned the Enterprise Funds from the Storm Drain Fund of the report. Because the reserve is negative \$3.6 million, he inquired when the anticipated year that this fund would have a positive balance. Additionally, he inquired on the negative balance of the Wastewater Treatment Plant.

Mr. Perez stated that anticipated positive balances in these funds are based on future fee revenues. He indicated that all the funds did well and the City had a good balance budget year ending. He indicated that there was one concern on the Enterprise Fund which was Storm Drain fund planned. Prior projects have exceeded the projected budgets. Currently projects may not have sufficient revenues to cover the costs of projects. The City is staying within its budget; however, policy choices will need to be made on how to go forward in an uncertain economy.

Chair Morton stated that past Finance Committee Members have looked at going back to the voters for an adjustment of monthly storm drainage rates based on the expectation that future projects may expand and cost more than what is available.

Council Member Burt recalled discussions regarding changing rates, due to the escalating costs in capital projects for storm drains. He questioned how many projects have not been approved and did City Staff anticipate lower bids in the future.

Mr. Perez stated that during the budget process, a status update will be presented.

