



OFFICE OF THE CITY AUDITOR

City and County of Honolulu
State of Hawai'i



Audit of the City's Debt Service Practices

A Report to the
Mayor
and the
City Council of
Honolulu

Report No. 06-03
February 2006

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Submitted by

THE CITY AUDITOR
CITY AND COUNTY
OF HONOLULU
STATE OF HAWAII

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Foreword

This is a report of our Audit of the City's Debt Service Practices. The audit was conducted pursuant to Section 3-502.1(c) of the Revised Charter of Honolulu and the Office of the City Auditor's Annual Work Plan for FY2005-06. The city auditor selected this audit due to longstanding concerns expressed by the Honolulu City Council and the public regarding the city's growing debt payments and their impact on the operating budget. This audit provides information on how the city incurs debt, what the responsibilities of various city agencies and outside firms are, and how the city's practices compare with industry best practices.

We wish to acknowledge the cooperation and assistance of the staff and management of the Department of Budget and Fiscal Services, the Department of Environmental Services and others who we contacted during this audit.

Leslie I. Tanaka, CPA
City Auditor

EXECUTIVE SUMMARY

Audit of the City's Debt Service Practices

Report No. 06-03, February 2006

This audit was initiated by the Office of the City Auditor pursuant to Section 3-502.1(c) of the Revised Charter of Honolulu and the Office of the City Auditor's Annual Work Plan for FY2005-06. The city auditor selected this audit due to longstanding concerns expressed by the Honolulu City Council and the public regarding the city's growing debt payments and their impact on the operating budget. This audit provides information in a consolidated form that has not been previously disclosed to the city council or the public on how the city incurs debt, what the responsibilities of various city agencies and outside firms are, and how the city's practices compare with industry best practices.

Background

As of July 1, 2005, the city has a total outstanding debt of \$2.9 billion. Thus far, the city has kept its debt within both the state's constitutional and the city's debt limit. Maintaining an "AA" bond rating has enabled the city to secure favorable interest rates for the city's capital projects. The city has also generated savings by refinancing debt to take advantage of low interest rates in recent years. Nevertheless, from FY2001-02 to FY2005-06, debt service has almost doubled, from \$137.7 million to \$235.1 million. Moreover, city budget documents indicate that total debt service could exceed 20 percent of the city's operating budget within two years, in FY2007-08. Because debt service is a fixed cost within the city's operating budget, these payments restrict the availability of funds for other programs. Left unchecked, the growth in debt service could limit the city's flexibility to meet both present and future needs.

Summary of Findings

The city administration has generally complied with the city's debt policies and has refunded bonds at lower interest rates to reduce future debt service. In recent years, the City and County of Honolulu's consistent "AA" bond ratings have benefited the city's bond issuances resulting in favorable borrowing terms. However, the availability of relatively low-cost financing over the past three years and the current

growth in property tax revenue have been tempered by the significant debt service burden on the city's operating budget. Debt service has grown by 71 percent from FY2001-02 to FY2005-06 compared to 26 percent growth in the operating budget as a whole. To its credit, the current administration has taken additional steps to address the issue, such as instructing agencies to reduce expenses by 2.5 percent, canceling \$12 million in unneeded capital projects and \$10.5 million in contract funds that were encumbered before 1996 but never paid out.

While these measures represent positive steps, comprehensive and strategic actions are needed to resolve the city's debt management problems. The city's current debt operation is fragmented, lacking comprehensive management, planning, and accountability. In addition, the city's use of the same professional advisors for non-competitive bond sales raises concerns about conflict-of-interest and unnecessary costs.

Finding 1: Responsibilities for the city's debt have become a fragmented operation overseen by two different departments. Each has serious resource constraints, of which little is reported and accountability is uncertain. The city has generally complied with the city's debt policies and has refunded bonds at lower interest rates to reduce future debt service. Nevertheless, the city anticipates exceeding 20 percent of its operating budget as early as 2008. The city has no comprehensive strategic plan to resolve its debt management problems.

- Current debt-related responsibilities are fragmented and geared toward making payments on existing debt rather than managing and controlling overall debt. Debt-related responsibilities are concentrated between two administrators in two different agencies, the Department of Budget and Fiscal Services and the Department of Environmental Services, and their staffs face considerable learning curves to match their administrators' debt knowledge and experience.
- There is limited accountability for exceptions to the city's debt policy, such as using bond funds for operational expenditures, including employee salaries. The policy also prohibits using bond funds for items costing less than \$5,000 each. However, we found purchases that included teak furniture for the Honolulu Zoo employee lounge that cost between \$170 and \$1,595 each, cleaning

supplies, equipment rentals, power tools, mountain bikes, and volleyball equipment.

Finding 2: The city's reliance on the same underwriters for the past three years of bond issuance, using the negotiated sales method raises concerns. Contrary to industry best practices, the city has continued to sell its bonds non-competitively, and has relied on its underwriters to function as financial advisors. This has left the city vulnerable to the interests of underwriters who may have a conflict of interest between obtaining the highest possible interest yields for bond purchasers (investors) and seeking the lowest interest rate cost of financing for the city selling the bonds (issuer).

- Contrary to industry best practices, the city has continued to sell its bonds using the negotiated method. Under this method, an issuer grants an underwriter the exclusive right to sell the issuer's bonds, before the city has full knowledge of the terms of the sale. The purchase price is negotiated with the underwriter at the time the bonds are sold.
- In a competitive sale, interested underwriting firms bid on the right to purchase and resell the city's bonds based on the most beneficial terms, such as low interest cost and other factors. Competition provides an incentive for underwriters to submit the most aggressive bid at which they can successfully market bonds to investors, and minimizes concerns regarding whether the best prices were obtained for bonds issued.
- Based on our interviews with other jurisdictions using both competitive and negotiated bond sales, and previous studies spanning 20 years, we found that the competitive method results in significant savings over the negotiated method. For example, a 2001 Missouri audit found that the state paid \$83.2 million in excess interest rate costs, based on a 0.38 percent (or 38 basis-point) difference in interest rates between competitive and non-competitively sold bonds. Studies in other states found differences of between 29 to 54 basis points between competitive and non-competitively sold bonds.
- As one justification for the city's use of the negotiated method, in which underwriters assist the city with preparing its bonds for sale,

the city has reported that its underwriters also function as financial advisors. An independent financial advisor represents only the city's interests by evaluating underwriters' bids and making recommendations regarding issues such as bond structure and timing of bond sales, based on an assessment of overall market conditions. However, an underwriter with a set of clients waiting to buy bonds could skew those recommendations to the issuer, in favor of higher returns for its own clients. According to the Government Finance Officers Association, bond issuers such as the city "must remember that underwriters sell bonds to another set of clients – investors. It is easier to sell bonds to investors if the investment yield is higher. Unfortunately, higher investment yields for investors mean higher borrowing costs for issuers, such as the city. When it comes to pricing bonds, the incentives for these two parties are in direct opposition."

Recommendations and Response

We recommended that the Department of Budget and Fiscal Services:

- Consider obtaining the services of an independent professional municipal debt organization to formally evaluate in-depth the city's current debt management program, practices, organization, resources, and staffing to develop an action plan with recommendations for a comprehensive, unified debt management program that addresses the city's overall fiduciary interests.
- Establish a formal succession plan to ensure that the staff members supporting the current debt managers receive cross-training in debt management functions so that the city's interests are not jeopardized should either manager leave city employment.
- Develop and take steps to issue an annual report on all of the city's debt for the city council and taxpayers.
- Establish practices to accurately identify and scrutinize low dollar value equipment purchases by city agencies and report on the city's compliance with the city's debt policy.
- Reconsider the city's use of underwriters as financial advisors due to the underwriters' potential conflict of interest between clients like the city, which sell the bonds, and the underwriter's investors who buy them.

- Reconsider its procurement practices which have consistently resulted in selecting the same underwriting and bond counsel firms.
- Consider competitively selecting an independent financial advisor to represent only the city's interests in bond sales transactions. The advisor could independently assess the feasibility and cost-benefit of using the competitive bond sales method compared to the current practice of negotiated bond sales.
- The department should make use of established training by independent, nationally recognized municipal finance and debt organizations such as the Government Finance Officers Association as sources for formal debt and finance training and professional development.

In its response, the Department of Budget and Fiscal Services provided some clarifying information, and changes to the draft were made in the final report where appropriate. However, despite the assertion of many inaccuracies and misrepresentations, none of the comments provided to us in the report changed the substance of our findings. Moreover, some aspects of the agency's response contradict information and statements provided to us during fieldwork.

The department suggested that the audit was not performed in accordance with Generally Accepted Government Auditing Standards (GAGAS). This highlights the department's lack of familiarity with GAGAS standards, since such conclusions cannot be reached by reading a draft report. The definitive test for compliance with GAGAS comes from a peer review of all government auditing standards—general, fieldwork and reporting standards—conducted by trained evaluators independent of the audit organization. The reviewer must assess the audit organization's policies and procedures, including internal quality controls, and review working papers for the respective audit project. Thus, the department has no basis for its conclusion, other than its disagreement with our findings.

The department states that our objectives and purpose for the audit were unclear, in light of our findings. While the department may not agree with how we performed our audit, our objectives, as stated in the report, were communicated to the department prior to fieldwork: to assess the city's debt service practices, specifically over the last three fiscal years. The impetus for the audit was a long-standing concern among city

officials and the public regarding the city's increasing debt service payments. In order to properly address these concerns and assess these practices, we determined that it was insufficient to limit our scope to the mechanics of debt service payments, but rather to determine how the city incurs debt, what the city has been doing and what it plans to do in the future to control this cost.

We found that while the city has reduced debt through refinancing and continues to enjoy favorable bond ratings, the city does not have a comprehensive plan to control debt over the long term. The department states that the responsibility for such a plan lies solely with policymakers. We disagree. While policymakers have the responsibility to enact appropriate legislation, their decision-making process would be well served by comprehensive annual reports from the appropriate government agency on factors and activities that are pertinent to making those decisions.

The department questioned the competency, lack of technical knowledge of the city auditor's staff, and skepticism regarding the reliability of our sources. In reality, our office staff has a combined experience of 60 years in the performance auditing profession. As in any audit, our sources range from published reports in mainstream media to industry journals and independent, respected professional organizations, as well as interviews with both private sector and public sector experts. In this audit, that included finance directors and debt managers who have had success with implementing specific best practices. We found administrators who developed tools and comprehensive reports that helped them to communicate to policymakers and the general public: the status of the city's debt, how debt was affecting their municipalities and what the city was doing to control it.

In comparison, we found that the information on the city's debt was presented in piecemeal fashion. We believe that developing a comprehensive, reader-friendly report that aids policy makers and informs citizens of its activities is within the responsibility of any government agency. The department's stated lack of time, staff and resources to implement such a plan within the agency led to our recommendations that the agency hire an independent consultant with the appropriate technical knowledge to do so.

While the city acknowledged that there is a need for a comprehensive debt management plan, the department disagreed with our interpretation that the city will exceed its debt service limit by FY2007-08, stating that

the debt policy excludes revenue bonds. We derived our figures from the city's budget documents, which do not specify debt service from general obligation and revenue bonds. If such data is pertinent, then this is an example of the information the department needs to provide within a comprehensive debt management report to the city council and the public on a regular basis. Nevertheless, we maintain that a single guideline is insufficient as the city's only measure for debt affordability, as other municipalities have used more than one indicator for managing debt.

The department also takes issue with our comparison of debt policies in other municipalities. The city points out that credit ratings are not dependent on a single factor. We agree. Nevertheless, the city had cited one reason, namely potential damage to the city's credit rating, as a rationale for opposing debt limits. We found, and the department now agrees in its response, that debt limits in and of themselves did not preclude other municipalities from having higher credit ratings.

The department also acknowledged that personnel changes were present at the Treasury Division during the time of our audit, and that position classifications are inconsistent with the actual duties of employees within that division. In addition, the department acknowledged that bond proceeds were used for items that did not comply with the debt policy. We are encouraged that the department plans to investigate this, as such occurrences can inappropriately increase the city's debt.

We are also encouraged that, despite its vigorous defense of its underwriter and bond counsel selection process, the department has changed its selection committee for FY2006-07 to include the Department of Environmental Services and the Board of Water Supply based on their bond issuance needs for the year.

The Department of Budget and Fiscal Services states that there are particular circumstances in which negotiated bond sales are appropriate. We agree; none of our sources, nor does our report, advocate using either the competitive or negotiated bond sale method exclusively. However, our research has also indicated that competitive bond sales are recommended by the Government Finance Officers Association when specific conditions are present, which we outlined in Exhibit 2.4. The widespread use of negotiated bond sales is a credit to the underwriting industry, which has successfully marketed its services to municipalities. However, when there is evidence that a more transparent, competitive process has the potential for substantial savings and greater

accountability, the city would do well to investigate whether this alternative method has merit, instead of dismissing it out of hand. While underwriters may possess the necessary expertise, it is the city's responsibility to exercise professional skepticism when it comes to the use of city funds.

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Chapter 1

Introduction

This audit was conducted pursuant to the Office of the City Auditor's (OCA) authority to self-initiate audits, as provided in the Revised Charter of Honolulu. "Debt service" refers to the principal and interest payments on funds borrowed by the city for capital projects. The impetus for this audit stemmed from longstanding concerns about the city's growing debt payments and their impact on the operating budget.

As of July 1, 2005, the city had a total outstanding debt of \$2.9 billion. Thus far, the city has kept its debt within both the state's constitutional and the city's own debt limit. Maintaining a bond rating of "AA" has enabled the city to secure favorable interest rates for the city's capital projects. The city has also generated savings by refinancing some of its debt to take advantage of lower interest rates in recent years. Nevertheless, from FY2001-02 to FY2005-06, the city's debt service has almost doubled, from \$137.7 million to \$235.1 million. Moreover, the city reports debt service will exceed 20 percent of its operating budget within two years, in FY2007-08. Because debt service is a fixed cost within the city's operating budget, these payments restrict the availability of funds for other programs. Left unchecked, the growth in debt service could limit the city's flexibility to meet both present and future needs.

This *Audit of the City's Debt Service Practices* provides information in a consolidated form that has not been previously disclosed to the Honolulu City Council or the public on how the city incurs debt, what the responsibilities of various city agencies and outside firms are, and how the city's debt practices compare with industry best practices.

Background

The majority of the city's debt is based on the city's capital improvement program (CIP), a financial planning and management tool that identifies public infrastructure, facility and equipment requirements; prioritizes these requirements; and schedules them for funding and implementation. The capital improvement program represents the city's multi-year budget plan for long-lived projects that are too expensive to fund from current operating revenues. The city lists capital projects by function, such as public safety or city department/agency, and estimates costs and funding requirements over a six-year period.

The city's debt is managed by two of its agencies, the Department of Budget and Fiscal Services and the Department of Environmental Services. As the central budgeting and accounting agency for the City and County of Honolulu, the budget and fiscal services department has the overall responsibility for the city's debt and is responsible for long-range fiscal planning and management of the city's operating and capital improvement budgets. Within this department, the following divisions have specific debt-related responsibilities:

- The Fiscal/Capital Improvement Program Administration Division prepares the capital program, budget and necessary budget ordinances. It also reviews the capital budget program schedules of each executive agency and makes budgetary allotments. The division also monitors the implementation of capital projects, related expenditures and allocation of funds.
- The Accounting Division plans, develops, directs and coordinates central accounting for the city; provides financial services to departments and agencies; reviews the manner in which public funds are received and expended; ensures that monies withdrawn from operating budgets are in accordance with operating budget ordinance and allotments; administers central preparation of payroll; liquidates claims under a centralized voucher system; and prepares financial statements and reports on city operations. This division issues financial statements and reports, including the city's Comprehensive Annual Financial Report (CAFR), the Finance Director's Quarterly Financial Reports, and the Statement of Funded Indebtedness Outstanding and Unpaid as required by Section 47-2, Hawaii Revised Statutes (HRS). This statement is prepared jointly with the Treasury Division.
- The Treasury Division plans, directs and administers the city's financial affairs, including managing cash, debt and investments. The division receives, disburses and transfers cash for the city in accordance with established policies and procedures; maintains custody of public funds and securities; determines investment policies and strategies for the city's funds; identifies investment vehicles and evaluates alternatives; invests city funds and manages investment portfolios for the city, the Board of Water Supply and other city agencies; and ensures proper collateralization for the protection of all city funds held by city depositories. The division also plans, markets, coordinates,

reviews, monitors and administers the city's general obligation, revenue and special purpose bond issues. It procures the services of bond professionals who assist the city with its debt issuances. The division also determines the timing, structuring and size of bond financing for the city and ensures compliance with the federal Securities and Exchange Commission and Internal Revenue Service's regulatory and disclosure requirements regarding municipal bond financing, as well as to state and city legal requirements. The division also administers the city's accounts receivable and collections program for real property taxes, special assessments, user fees and other revenues, and assists the director of the budget and fiscal services department in resolving major fiscal problems of the city.

The Department of Environmental Services takes an active role in managing the city's wastewater debt. In 1998, the city established its wastewater system as an enterprise, enabling the city to approach capital markets with revenue bonds to finance its wastewater capital needs. City Resolution 98-197, CD1, which established a separate set of debt and financial policies for this enterprise, stated that the intent of the policies was, in part, to "ensure that the wastewater system is managed [so as] to be self-sufficient, supported [by] user fees and not general property taxes [or] other city and county resources."

Understanding government debt

State and local governments issue debt for a variety of reasons. For example, bonds and other debt instruments are used to finance construction, major equipment and other long-lived assets. Debt service is the repayment of principal and interest on those debt instruments. In other words, bonds are debt instruments that enable governments to make large purchases, similar to mortgages; and debt service is analogous to mortgage payments made over time to repay the debt.

Long-term bonds have historically provided a major source of funding for capital needs. Due to the high cost of acquiring or replacing capital assets, governments are usually not able to accumulate enough cash from current receipts to pay for necessary improvements. Borrowing money permits governments to acquire assets as needed rather than waiting until enough cash is available. Issuing bonds also serves to spread the cost of a capital asset to those who benefit from it, both now and in the future.

Short-term financing is sometimes used to meet interim financing needs of construction projects when the full cost of a project is not yet known. Governments can borrow on short-term bases as needed and later refinance with long-term debt once a project is completed. Short-term financing is also used if an issuer believes market conditions are such that delaying the issuance of long-term bonds is more advantageous. For example, if long-term interest rates are falling, an issuer might prefer to initially borrow short-term and then refinance with long-term bonds when interest rates are more favorable. Bond anticipation notes, commercial paper and bank lines of credit are commonly used for this purpose. These instruments can provide immediate funding for a project until permanent financing is arranged.

General obligation bonds

General obligation bonds are typically issued to finance government improvements that benefit the community as a whole. These obligations are secured by full faith and credit through the taxing authority of the issuer (such as the city). The issuer pledges to levy the necessary taxes on all assessable property within its jurisdiction to provide timely repayment of the debt. This means that the city's collateral is its power and pledge to increase real property taxes as needed to ensure that payments on the debt are made as promised. Due to the strength of this pledge, general obligation bonds are readily accepted in the municipal marketplace and usually have lower interest rates than comparably rated revenue bonds. Consequently, general obligation bonds can be issued at a lower cost relative to revenue bonds.

Revenue bonds

Revenue bonds are issued to finance facilities that have a definable user or revenue base. These debt instruments are secured only by a specific source of funds (usually a dedicated revenue stream) rather than by the general taxing powers of a jurisdiction; hence, revenue bonds are considered less secure than general obligation bonds. Revenue bond issuers are customarily required to set reasonable rates and charges, thereby limiting the amount of debt service that can be incurred by a facility.

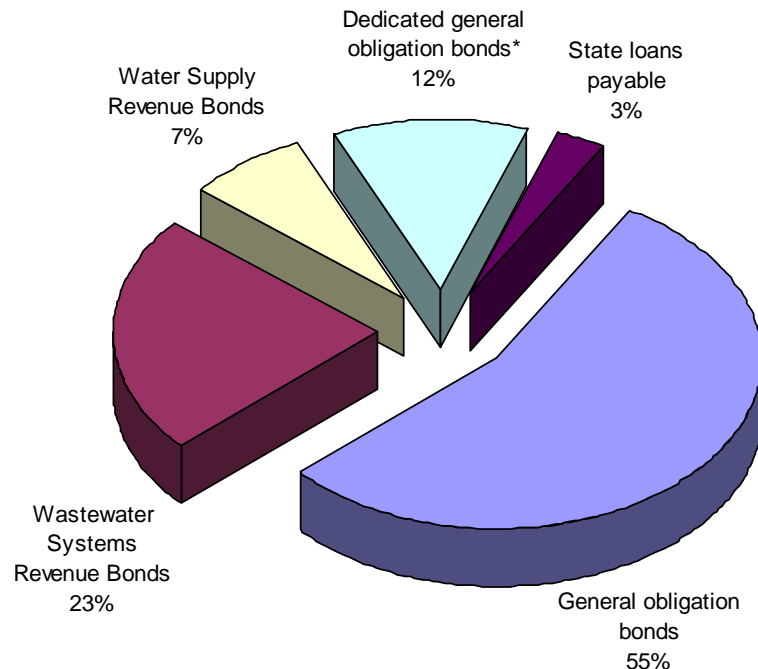
Since revenue bonds are secured only by the revenues pledged to pay the bonds, revenue bond documents generally require issuers to make many more promises about the operation of the facilities intended to provide the revenues. General obligation bond documents typically do not include such promises. Revenue bond promises, or "bond

covenants”, usually include rate covenants, an additional bonds test, and operation and maintenance requirements that must be met by the issuer. For example, the city’s wastewater revenue bonds are paid out of revenues generated by sewer service charges, which must be reviewed annually and adjusted as needed to ensure the enterprise meets its debt obligations.

Honolulu’s debt profile

As of July 1, 2005, the city had a total outstanding debt of \$2.9 billion. The largest components were general obligation bonds of \$1.6 billion (55 percent) and wastewater systems revenue bonds of \$669.6 million (23 percent). Other debts included water supply revenue bonds (\$216.0 million), dedicated general obligation bonds for housing (\$104.4 million), H-Power (\$83.7 million), solid waste (\$83.7 million), sewer projects (\$58.4 million); state loans payable (\$77.6 million), other notes payable (\$3.0 million) and special assessment bonds (\$645,000).

Exhibit 1.1
Chart of the City's Debt



Source: Summary of Total Funded Indebtedness Outstanding and Unpaid as of July 1, 2005

*Note: Dedicated general obligation bonds refer to the sum of such bonds specified for housing, H-Power, solid waste and sewer projects.

Based on U.S. Census population estimates and on gross debt and net debt figures from the city's CAFR from FY2000-01 to FY2003-04, the city's per capita gross debt has increased by 19 percent, from \$1,846 to \$2,194. Per capita net debt has increased by 34 percent, from \$1,263 to \$1,694.

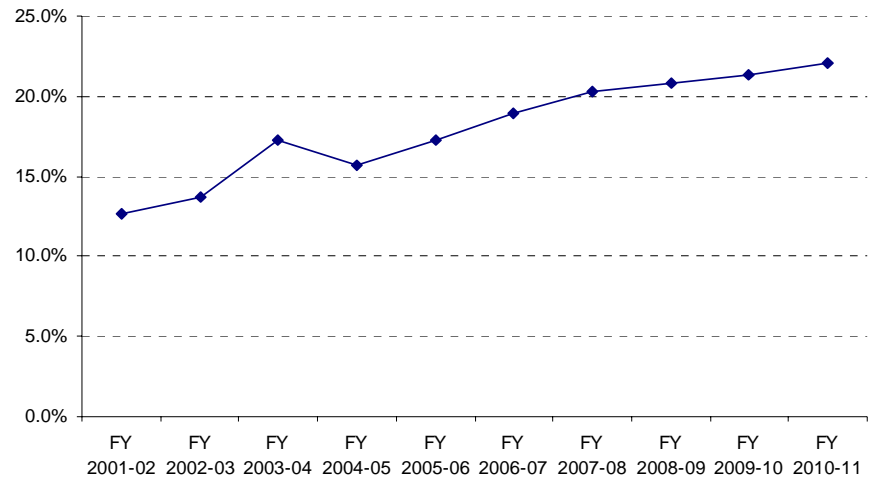
State and county debt service limits

Limits on debt provide both elected officials and taxpayers with guidance on acceptable levels of indebtedness and indicate a community's commitment to prudent borrowing practices so that essential public services are not jeopardized. The City and County of Honolulu must abide by both state constitutional requirements and city debt policies. The city's total debt of \$2.9 billion is only 3 percent of the \$92.4 billion in net tax-assessed real property value for FY2005-06, far below the Hawaii State Constitution's debt limit of 15 percent for each county. The state constitutional limit also excludes bonds that have matured, revenue bonds, special purpose revenue bonds, special assessment bonds, reimbursable general obligation bonds issued for specific purposes, bonds guaranteed by the state, and bonds issued in anticipation of specific revenues. Thus, while the city has \$2.9 billion in total debt, only \$1.62 billion of this – the general obligation bonds plus \$3 million in other notes payable – are subject to the state's constitutional debt limit. The city complies with this method of calculating net outstanding debt.

In 1996, the city council adopted Resolution 96-26, *Establishing the City's Debt and Financial Policies* in response to bond rating agencies' concerns about the impact of the city's "aggressive debt plans" and their impact on credit quality. At the time, 15 percent of the city's non-federal fund appropriations were tied to debt service requirements. To preserve credit quality, the policy established affordability guidelines capping debt service for general obligation bonds at 20 percent of the operating budget, and debt service on direct debt (excluding self-supporting bonds) at 20 percent of general fund revenues.

While the city currently complies with this limit, the city's budget documents report debt service as an aggregate amount instead of distinguishing debt service from general obligation and revenue bonds. As a result, total debt service is reported as exceeding 20 percent of the operating budget as early as FY2007-08 (see Exhibit 1.2).

Exhibit 1.2
Debt Service as Percentage of Operating Budget



<i>Fiscal Year</i>	<i>Debt Service</i>	<i>Executive Operating Budget</i>	<i>Debt Service as a Percentage of the Operating Budget</i>
2001-02	\$137,666,838	\$1,083,962,152	12.7%
2002-03	153,168,219	1,116,000,464	13.7%
2003-04	201,899,027	1,169,082,681	17.3%
2004-05	193,413,088	1,228,961,020	15.7%
2005-06	235,100,413	1,361,210,036	17.3%
2006-07	270,400,000	1,425,300,000	19.0%
2007-08	302,800,000	1,495,900,000	20.2%
2008-09	323,100,000	1,555,900,000	20.8%
2009-10	346,000,000	1,620,100,000	21.4%
2010-11	362,100,000	1,644,000,000	22.0%

Sources: Executive Capital and Operating Budget adopted ordinances from FY2001-02 to FY2005-06, projections from FY2006-07 to FY2010-11 from Executive Program and Budget for FY2005-06

Note: These budget documents do not distinguish between general obligation and revenue bond debt service.

Wastewater revenue system debt service limits

The wastewater system enterprise has its own set of debt and financial policies, established in 1998 in preparation for funding wastewater system capital projects with revenue bonds instead of general obligation bonds. These policies state that wastewater user rates:

“Will be set . . . to ensure that the revenues generated by Sewer Service Charges are sufficient to pay all operating, maintenance, debt service, and capital costs, and to maintain sufficient operating reserves, without reliance on the City and County’s general taxes and other revenues.”

The policies also state that:

“To provide for the generation of adequate revenues to fund all debt service payments as well as to meet all pay-as-you-go capital needs and to provide internal guidelines to ensure the enterprise’s ability to meet its debt service requirements, the city intends to maintain target revenues (excluding Wastewater System Facility Charge revenues) of 1.6 times (160 percent of) senior revenue bond debt service and 1.25 times (125 percent of) debt service for all revenue bonds.”

According to audited sewer fund financial statements for the year ending June 30, 2004, debt service coverage exceeded the requirements of bond covenants and city policies: it totaled 471 percent on senior revenue bonds, 203 percent on revenue bonds and 147 percent on all debt.

Objectives of the Audit

The audit objectives were to:

1. Review and assess the city’s debt service practices.
2. Make recommendations as appropriate.

Scope and Methodology

To assess the City’s debt services practices, we reviewed the Hawaii State Constitution; Chapter 47, HRS, *County Bonds*; Chapter 47C, HRS, *Indebtedness of Counties, Exclusions from the Funded Debt*,

and Certification Thereof; Chapter 49, HRS, *Revenue Bonds*; the *Hawai'i Public Procurement Code*, Chapter 103D, HRS; the Revised Charter of Honolulu; the Revised Ordinances of Honolulu; debt and financial policies for the city; Resolution 03-59, CD1, the city's current amended debt and financial policy; and Resolution 98-197, CD1, the debt and financial policies for the city's wastewater system enterprise.

Our review of the city's debt service practices for the three most recent fiscal years of debt issuance included documenting the debt process for general obligation and wastewater revenue bonds, which constitute the majority of the city's debt. Our review did not include other debt such as water supply revenue bonds, dedicated general obligation bonds, state loans payable, and special assessment bonds. The review also examined the debt-related roles of participating agencies: for general obligation debt, the Department of Budget and Fiscal Services' Treasury, Fiscal/CIP Administration, and Accounting divisions; and for wastewater revenue bonds, the Department of Environmental Services. We interviewed departmental and divisional administrators and staff whose position descriptions entailed debt-related analysis and monitoring. We reviewed reports on the city's debt, budget documents, department communications, and related documents. We also reviewed transcripts for the city's three most recent bond issuances.

To identify pertinent issues, we reviewed media coverage of Honolulu's debt in particular and of municipal debt generally, as well as published academic studies pertaining to debt management practices. Our assessment of best practices included research of municipal debt practices from the Government Finance Officers Association (GFOA); National Advisory Council on State and Local Budgeting; National Association of Counties; National Association of Local Government Auditors; and the Municipal Securities Rulemaking Board. We also reviewed general criteria published by the bond rating agencies Fitch, Moody's and Standard & Poor's as well as their reports on specific ratings given to Honolulu bonds issued over the last three years.

We also interviewed municipal debt and finance officials who are members of GFOA's Governmental Debt and Fiscal Policy Committee from Montgomery County, Maryland; Portland, Oregon; and San Jose, California. In addition, features of Honolulu's debt policies were compared to debt policies and reports from these same municipalities, and other cities whose bond ratings were equivalent to or better than Honolulu's "AA" rating: Denver, Colorado; Seattle, Washington; and Scottsdale, Arizona.

Our work was performed in accordance with generally accepted government auditing standards.

Chapter 2

The City's Management of Debt is Fragmented and Some Practices May Be Contrary to the City's Fiduciary Interests

City administration has generally complied with the city's debt policies and refunded bonds at lower interest rates to reduce future debt service. In recent years, the City and County of Honolulu's consistent "AA" bond ratings have benefited its bond issuances, resulting in favorable borrowing terms. However, the availability of relatively low-cost financing over the past three years and the current growth in property tax revenue has been tempered by the significant debt service burden on the city's operating budget. Debt service has grown by 71 percent from FY2001-02 to FY2005-06, compared to 26 percent growth in the operating budget as a whole. To its credit, the current administration has taken additional steps to address the issue, such as instructing agencies to reduce expenses by 2.5 percent and canceling \$12 million in unneeded capital projects and \$10.5 million in contract funds that were encumbered before 1996 but never paid out.

While these potentially cost-saving measures represent positive steps, comprehensive and strategic actions are needed to resolve the city's debt management problems. The city's current debt operation is fragmented, lacking comprehensive management, planning, and accountability. In addition, the city's use of the same professional advisors for non-competitive bond sales raises concerns about conflicts of interest and unnecessary costs.

Summary of Findings

1. Responsibilities for the city's debt have become a fragmented operation, overseen by two different departments. Each has serious resource constraints, of which little is reported and accountability is uncertain. The city has generally complied with its debt policies and refunded bonds at lower interest rates to reduce future debt service. Nevertheless, the city's budget documents indicate that debt service could exceed 20 percent of its operating budget as early as FY2007-08. The city has no comprehensive strategic plan to resolve its debt management problems.

2. The city's reliance on the same underwriters for the past three years of bond issuance, using the negotiated sales method, raises concerns. Contrary to industry best practices, the city has continued to sell its bonds non-competitively and relied on its underwriters to serve as financial advisors. This has left the city vulnerable to the interests of underwriters who may have a conflict of interest between obtaining the highest possible interest yields for their bond purchasers (investors) and seeking the lowest interest rate cost of financing for the city selling the bonds (issuer).

The City Lacks a Comprehensive Debt Management Program

Responsibilities for the city's debt are fragmented between two departments, of which little is reported and accountability is uncertain. The city administration has generally complied with the city's debt policies and has refunded bonds at lower interest rates to reduce future debt service. Nevertheless, city budget documents indicate that total debt service could exceed 20 percent of the operating budget as early as FY2007-08. Administrators overseeing the city's debt reported having other significant departmental responsibilities, with staff facing considerable learning curves to match the administrators' debt knowledge and experience. Lacking a comprehensive, unified debt management program and a strategic plan to provide future direction, the city council cannot effectively oversee the city's debt program.

Best practices in governmental debt management and planning

According to the Government Finance Officers Association (GFOA), a debt management policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning. Debt levels and their related annual costs are important long-term obligations that must be managed within available resources. As such, GFOA recommends all state and local governments adopt comprehensive written debt management policies, review them at least annually and revise them as necessary. A debt management policy should address debt limits, use of derivatives, debt structuring practices and debt issuance policies, as described in the table below.

**Exhibit 2.1
GFOA Recommended Practice for Debt Management Policies**

Policy	Characteristics – policy defines:
Debt limits	<ul style="list-style-type: none"> ▶ specific limits or acceptable ranges for each type of debt. Limits are generally set for legal, public policy, and financial reasons.
Use of derivatives	<ul style="list-style-type: none"> ▶ how derivatives fit within the overall debt management program, ▶ conditions under which derivatives can be utilized, ▶ types of derivatives allowed and prohibited, ▶ approaches for measuring, evaluating and managing derivative risk, and ▶ methods for procuring and selecting derivative products
Debt structuring practices	<ul style="list-style-type: none"> ▶ maximum term for debt instrument, ▶ average maturity, ▶ debt service pattern, such as equal payments or equal principal amortization, ▶ optional redemption features, ▶ use of variable or fixed rate debt and limitations of use, ▶ other structuring practices, such as capitalized interest, deferral or principal or other internal credit support, including general obligation pledges
Debt issuance practices	<ul style="list-style-type: none"> ▶ criteria for determining sale method (competitive, negotiated, private placement) and investment of proceeds, ▶ criteria for issuance of advance and current refunding bonds, ▶ selection and use of professional service providers, ▶ comparative bond pricing services or market indices to be used as a benchmark in negotiated transactions and to evaluate final pricing results, ▶ use of credit ratings, ▶ minimum bond ratings allowable, ▶ determination of the number of ratings, and ▶ selection of rating services
Debt management practices	<ul style="list-style-type: none"> ▶ guidance for ongoing administrative activities, including: <ul style="list-style-type: none"> • investment of bond proceeds, • primary and secondary market disclosure practices, including required annual certifications, • arbitrage rebate monitoring and filing, • federal and state law compliance practices, and • market and investor relations efforts

Source: Government Finance Officers Association

To its credit, in 1996 the Honolulu City Council adopted Resolution 96-26, establishing the city's debt and financial policies. In 2003, anticipating upcoming increases in debt service payments, two bills were introduced: one to limit the city's overall annual operating budget

expenditures, and another to limit debt service expenditures specifically. These bills were opposed by the Department of Budget and Fiscal Services, citing fears that bond rating agencies might interpret debt expenditure limits as a negative action that could damage the city's bond ratings and impair its flexibility to manage its financial affairs. Instead, the department recommended that debt be limited during the budgeting process, by curtailing capital improvement projects.

Although the administration feared that further restricting debt service limits would damage the city's bond ratings, a comparison of similarly rated municipalities shows that four out of five limit their debt to ten percent or less of general fund revenues, compared to Honolulu's 20 percent.

Exhibit 2.2
Comparisons of Debt Service Limits in Other Municipalities

City/County (GO Bond Rating)	Debt Service Limits Based on Revenue	Outstanding Debt Limit	Voter Approval Required ?	GO Debt Principal Repayment Target	Net Present Value* or Other Savings Target for Refunding
Honolulu (AA)	20% of general fund revenues on direct debt; 20% of operating budget for GO bonds, including self-supporting bonds	15% of taxable assessed value	No	None; GO bonds limited to 25 years	2% NPV savings
Portland, OR (AAA)	10% of general fund revenues	0.75% - 1% of city's taxable assessed value	No	Repayment of principal on long-term general obligation debt: 20% in five years, 40% in ten years	5% NPV savings on advance refundings, and \$100,000 or more in NPV savings for current refundings
Denver, CO (AA+)	5% of general fund revenues	3% of taxable assessed property value	Yes	GO bonds limited to 15-year terms	5% NPV savings
Seattle, WA (AAA)	9% of total general fund budget; city will seek to reduce to 7% or less	1.5% of city-wide assessed value	No	18% of principal of total GO debt within five years; at least 35% within ten years	NPV savings of 5% on both advance and current refundings
Scottsdale, AZ (AAA)	25% of operating revenue	20% of assessed valuation	Yes	No, but policies limit average maturity of all outstanding bonds to 10 years or less	NPV target established at the start of each budget cycle, depending on market conditions
Montgomery County, MD (AAA)	10% of general fund operating budget	1.5% of full market value of taxable real property	No	60%-75% within 10 years	2% NPV savings

Sources: Bureau of Financial Services, Portland, Oregon; Department of Revenues, Denver, Colorado; Department of Finance, Seattle, Washington; Department of Financial Services, Scottsdale, Arizona; Department of Finance, Montgomery County, Maryland

*Note: Net Present Value refers to the future stream of benefits and costs converted into equivalent values today by assigning monetary values to benefits and costs, discounting future benefits and costs using an appropriate discount rate, and subtracting the sum total of discounted costs from the sum total of discounted benefits.

Denver, Colorado and Scottsdale, Arizona both require voter approval before issuing general obligation bonds. Honolulu requires only a city council vote. Three of the five municipalities specified payout ratios or repayment targets of 10 years or less, and three also had higher thresholds for bond refunding or refinancing than Honolulu – five percent in net present value savings compared to Honolulu’s two percent. Denver, Colorado, which shares a similar bond rating to Honolulu, not only restricts debt service but also the city’s ability to generate revenue, via the Taxpayer’s Bill of Rights (TABOR) amendment to the Colorado State Constitution. According to Denver’s financial policies, “TABOR limits the growth of revenue to the rate of inflation plus a local growth factor. If revenue exceeds this limitation, the city is required to reimburse the citizens or ask the citizens [for permission] to retain revenue through voter approval.” As Exhibit 2.2 shows, these municipalities’ debt restrictions have not kept them from earning bond ratings equal to or higher than Honolulu’s.

In fact, the bond rating agency Standard & Poor’s *Public Finance Criteria* states that it:

“looks for realistic debt limitations that permit the issuer to meet its ongoing financial needs. A city near its debt limit has less flexibility to meet future capital needs, but more importantly, may be unable to meet its needs in the event of an emergency.”

Standard & Poor’s also says that a debt burden is usually considered high when debt service payments represent 15 to 20 percent of combined operating and debt service fund expenditures. Thus, Honolulu’s 20 percent debt service threshold is high, both in policy and in practice.

Similarly, the bond rating agency Fitch IBCA’s *Local Government General Obligation Rating Guidelines* states:

“In recent years, more municipalities have implemented debt affordability policy guidelines establishing debt issuance limitations within existing legal limits... Principal indicators that have been used to limit debt or guide issuance includes debt service as a percentage of operating revenues or expenditures and direct debt as a percentage of the property tax base or personal income base. Where such guidelines are adhered to over time and broadly used in the budget, planning, and general decision-making processes, they are viewed favorably as one of

the best practices an issuer can employ to strengthen its credit position.”

Fitch adds that management practices are important to predicting favorable credit performance. They can also add stability to weak credits, maximizing credit potential. Conversely, weak financial management can negatively affect even the strongest economies and local government structures.

For example, California’s bond rating increased from A to AA due to improved debt management practices, since every bond proposal is accompanied by a formal analysis of debt affordability. In recent years, such programs have earned praise from bond-rating agencies as being fiscally prudent. A number of states have also analyzed the long-term fiscal impact of adding new debt. For instance, faced with a decade-long growth in debt, Florida’s legislative and executive officials worked with outside experts to develop a 10-year revenue and expenditure outlook against which the advisability of new debt is weighed. Their plan is to review and update the 10-year outlook annually. Similarly, Maryland and Virginia have been preparing formal debt analysis studies for decades and have enjoyed continuous AAA ratings since ratings were first instituted, according to Standard & Poor’s.

Thus, Honolulu should be commended for having debt and financial policies in place, and for complying with the letter of these policies thus far. However, fulfilling the city’s original intent of greater efficiency and accountability remains elusive.

The city’s current debt operations are fragmented

Current debt-related responsibilities are fragmented and geared toward making payments on existing debt rather than managing and controlling overall debt. While major responsibilities rest within the Department of Budget and Fiscal Services, administrators in the Fiscal/Capital Improvement Program (CIP), Treasury and Accounting divisions were quick to identify the boundaries of their particular responsibilities. For example, the Fiscal/CIP Division evaluates and prioritizes capital projects, but its administrator says that actual debt is ultimately determined by the financing developed by the Treasury Division. In turn, the Treasury Division monitors cash accounts and estimates bond issues based on the city’s cash needs. However, the treasury administrator reports it is inappropriate for the division to estimate future bond issuance amounts because the Fiscal/CIP Division does not provide information on upcoming capital projects. Thus, bond amount estimates

are based on those issued in the past, which may not be accurate for future needs. Accounting Division administrators may question expenditures that appear to be exceptions to the debt policy. A letter from the department's director with appropriate justification is filed with individual requests, but such exceptions are not routinely monitored or reported. Thus, no single entity claims ultimate responsibility for managing the city's debt.

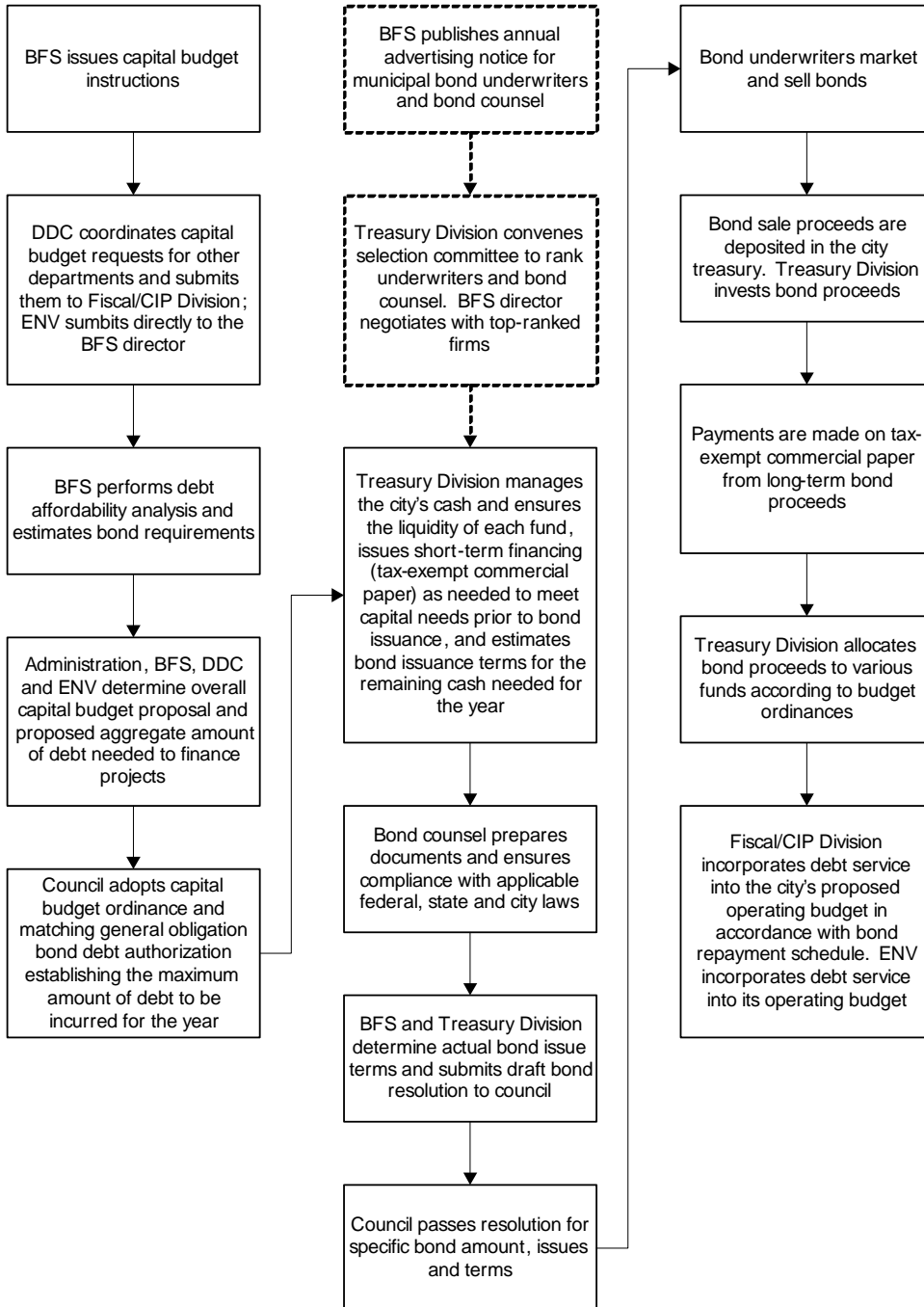
The roles of the various departments, as illustrated in Exhibit 2.3, are as follows:

- The Department of Design and Construction coordinates capital budget requests from various city agencies and submits them, along with supporting cost calculations and alternatives, to the Department of Budget and Fiscal Services' Fiscal/CIP Division.
- The Department of Environmental Services' executive assistant prepares, manages and updates long-range capital improvement project costs and estimates the timing of expenditures over a 20-year period according to its capital improvement plan and based on inflation, capital outlays and debt service projections. The department submits its capital budget directly to the budget and fiscal services department director.
- The Department of Budget and Fiscal Services issues budget instructions to the various city agencies according to the mayor's priorities. Once agency requests are received from the Department of Design and Construction:
 1. The Fiscal/CIP Division evaluates the requests and recommends capital project priorities to the director of budget and fiscal services. This division also evaluates information from bonds issued to determine deviations from projected and budgeted amounts, which are taken into account in the next bond issue.
 2. The Treasury Division manages the city's cash and arranges short-term financing as needed to meet liquidity needs, thereby determining the amount of debt needed to meet obligations in the upcoming fiscal year. Once the city council adopts the capital budget ordinance and resolution authorizing the bond issuance for the total amount needed,

the Treasury Division executes the bonds with assistance from contracted financial firms.

3. After bond proceeds are received, the Treasury Division deposits bond proceeds into the appropriate funds, and the Accounting Division posts the appropriate amounts within the accounts, as well as recording expenditures from those accounts.

Exhibit 2.3
The City's Debt Process—Where Debt Service Comes From



Source: Dept. of Budget and Fiscal Services and Dept. of Environmental Services

Note: Dashed lines indicate contracting process for bond counsel and underwriters overseen by Treasury Division
 DDC = Department of Design and Construction, BFS = Department of Budget and Fiscal Services,
 ENV = Department of Environmental Services

Operations focus on day-to-day, not comprehensive, debt management

Administrators responsible for debt from budget and fiscal services and environmental services cite the city's debt policies as the only policies and procedures guiding departments on the city's debt management. Both Resolution 03-59 CD1, *Amending the Debt and Financial Policies of the City*, and Resolution 98-197 CD1, *Establishing Debt and Financial Policies Regarding the Wastewater System Enterprise*, state that the policies were established as guidelines under which "the city shall manage... its debt program". However, the policies have no provisions for overall administration, operations, duties and responsibilities for data gathering, debt analysis, planning, reporting or monitoring.

Without specific parameters regarding acceptable exceptions, the city leaves itself open to treating cash shortages as "emergencies" or "unusual circumstances", thereby allowing liberal use of CIP funds for salaries and equipment. Financing such items with bonds roughly doubles the cost of such items compared to paying with cash. In addition, budgeting for such expenditures under the guise of a capital project enables them to undergo less scrutiny than if they were paid for with operating funds.

Debt-related responsibilities are concentrated between two administrators with inexperienced staff

According to the Treasury Leadership Council, the nature of the treasury function makes it inherently vulnerable to risks, increasing the need for internal controls. Contributing to the vulnerability of the treasury's functions are: transactions involving large sums of money, decisions made in and affected by volatile financial markets, time-critical transactions, and complex financial instruments. When managing debt and interest rate risk management, dependence on a limited number of personnel constitutes an operational risk.

At the city, only two administrators have comprehensive institutional knowledge, direct experience and a concentration of responsibilities with regard to the city's largest bond issuances: the chief of the Treasury Division for general obligation bonds and the executive assistant for the Department of Environmental Services for wastewater revenue bonds. Although the city relies heavily on these two administrators and has a significant investment in the appropriate execution of their duties, there is

no formal succession plan or continuity provision should either of these administrators cease their employment with the city.

According to the Department of Human Resources' class specifications, the treasury chief is responsible for overall activities of the city treasury involving:

- centralized cash management;
- investment and portfolio management;
- debt management and financing;
- accounts receivables programs;
- the city's insurance needs;
- planning, directing and coordinating activities of subordinates involved in a variety of functional areas;
- making decisions and taking administrative actions;
- developing, evaluating and implementing operating standards, policies, procedures and methods;
- preparing prospectuses for the sale of bonds;
- preparing, analyzing and maintaining financial reports and records;
- developing and maintaining effective working relationships with governmental agencies;
- preparing correspondence and reports; and
- preparing annual budget reports.

Within the Treasury Division there is a funded position for an assistant chief of treasury that would oversee both accounts receivable as well as the cash and debt management branches. The position has been vacant

since 1998. In response to a city council inquiry about the position, the budget and fiscal services department director stated in April 2005 that:

“In assessing the needs of the division, it is apparent that the depth of knowledge and experience in the areas of bond issuance, debt management and investment are sorely lacking. The transactions are (1) complex, requiring highly specialized expertise, (2) of significant size, involving hundreds of millions of dollars, [and] (3) extremely time sensitive. Currently, the [treasury chief] independently performs or closely controls all of the activities in these areas due to the critical nature of the work. Attempts to delegate all or a portion of these responsibilities to existing staff have been unsuccessful. Without adequate backup, the city exposes itself to possible disruption in operations and potential costly delays. Lack of qualified applicants has made the filling of this vacancy difficult.”

During the budget process, the Department of Design and Construction coordinates capital project requests from various departments and submits them to the budget and fiscal services department's Fiscal/CIP Division, which evaluates and prioritizes the various projects before submitting them to the mayor's office. While the Department of Environmental Services relies on the design and construction department for project planning, design and construction, the environmental services department bypasses the Fiscal/CIP Division and submits its budget for wastewater projects directly to the budget and fiscal services department director.

One reason for this separation is the wastewater system's enterprise status. Established in 1998, its status enables the wastewater system to issue its own revenue bonds to fund its \$2 billion, 20-year capital program and pay for them through sewer fund revenues. Prior to 1998, these projects were financed through general obligation bond funds. Another reason for the separation of processes is that a number of environmental services' wastewater projects are dictated by federal consent decrees. If wastewater projects were funded with bonds, the Fiscal/CIP Division would evaluate environmental services' projects to determine whether they follow the debt policy. However, Fiscal/CIP's evaluations and subsequent analyses have been compromised in the past by lack of timely and complete information from the environmental services department.

The administrator in charge of environmental services' budget and debt states that the department prepares its own debt affordability analysis before the budget process and incorporates debt into its operating budget. Currently, the department works mostly with the Fiscal/CIP Division regarding general obligation debt incurred before the wastewater system became an enterprise. However, the division contends that because the mayor makes the ultimate decision to increase revenue by proposing higher sewer rates, the wastewater enterprise should not consider itself totally independent from other city departments.

The concentration of responsibilities is exacerbated by a lack of debt expertise within the Treasury Division and environmental services department staff. Three positions with nominal responsibilities for debt analysis have recently been filled, but none of the new employees have received formal training on debt since their arrival. Both treasury and environmental services department administrators report their support staff members are learning about debt issuances and finance through on-the-job training, as none have prior direct experience in either private sector finance or governmental debt. To date, no formal training has been planned.

The Treasury Division has two branches: cash and debt management, and accounts receivable. The latter administers the city's real property tax program and performs billing and collection activities.

The Cash and Debt Management Branch:

- receives all monies due to the city, including real property taxes;
- deposits collections;
- maintains records of all bank deposits, withdrawals, debit memorandums and cash transfers;
- controls activities related to the issuance of all city checks;
- maintains records of authorizations relating to the disbursements of checks;
- invests city funds and manages investment portfolios for the city and the Board of Water Supply;

- analyzes cash balances and cash flow projections;
- determines amounts to be invested in various vehicles;
- determines the timing and terms of investments;
- maintains centralized accounting records for cash, debt and receivables;
- prepares related financial statements and reports;
- accounts for and processes adjustments related to tax appeals and claims filed under the City's Real Property Tax Relief Program;
- maintains custody of public funds and securities;
- ensures proper collateralization for the protection of all city funds held by depositors;
- participates in the sale of bonds;
- prepares and maintains detailed records related to each bond issue;
- arranges for debt service payments;
- services bondholders and paying agents;
- ensures compliance with federal Securities and Exchange Commission, Internal Revenue Service, and state and city regulatory requirements; and
- prepares necessary reports.

Turnover among experienced staff and recent hiring exacerbate the disparity in bond and debt knowledge and experience between the city debt administration and their staffs. The newly-hired treasury debt analyst is assigned to the cash and debt management branch. The position was filled in June 2005 but not staffed full-time until September.

The city's minimum qualifications for the treasury debt analyst position, which include the following:

- a combination of education and experience substantially equivalent to graduation from an accredited college or university with major work in business administration, finance, or a closely related field;
- three years of professional experience in researching, compiling and analyzing financial information in support of an extensive fiscal program, supplemented by one year of professional financial management experience in the evaluation, purchase and sale of bonds and securities, or managing a diverse investment portfolio; and
- the ability to gather, analyze, interpret and prepare financial data; evaluate information, apply problem-solving techniques and make sound decisions relating to the city's bond and securities program; analyze statistical tables, graphs, charts and accounting reports and statements; understand and interpret laws relating to the sale of securities and government bonds; analyze and monitor bond issuances for compliance with laws, rules and regulations; and establish and maintain effective and cooperative working relationships with bond counsels, investments banks, bond insurers, consultants and rating agencies.

The new analyst has an accounting background and experience wiring payments to banks when general obligation and revenue bonds are sold, but will need additional training in other aspects of the bond process, as part of the responsibilities of the treasury debt analyst position. Similarly, the new cash and debt manager, who will supervise the treasury debt analyst, needs training and experience in the city's bond issuances. The employee currently occupying this position has been in place since January 2005 but continued to perform previous duties as revenue collection administrator until June 2005. Similar to the treasury debt analyst, this employee was not involved with bond issues as of the date of our audit; but instead monitored and carried out transactions related to principal and interest payments on bonds already issued.

Within the Department of Environmental Services, the executive assistant has responsibilities that involve projecting expenditures for capital needs, related financing, and assessing the impact of financing on prices charged to customers. His staff includes an administrative assistant who heads

the management and budget section, handles the department's operating budget and helps prepare bond documents. The administrative assistant supervises a management analyst, who has been in the position since April 2005.

No comprehensive debt management program is planned

The U.S. Government Accountability Office (GAO) defines internal control as a major part of managing an organization, comprising the plans, methods and procedures used to meet the missions, goals and objectives of performance-based management. Internal control monitoring should assess the quality of performance over time and generally be designed to assure that ongoing monitoring occurs in the course of normal operations.

Resolution 03-59 CD1 states that the original intent of the city's first formal debt and financial policies was to "reengineer city government to make it more efficient, responsive, and accountable," and Resolution 98-197 CD1, *Establishing Debt and Financial Policies Regarding the Wastewater System Enterprise*, says that policies are intended in part to "identify potential financial risks and mitigate against them." However, none of the city administrators we interviewed articulated that the city has established or plans to establish a comprehensive debt management program concerned with the impact of debt on current operations, debt planning and assessment, or accountability for the use of monies obtained from bond issuances.

Debt-related reports are inadequate and hinder accountability

The city's FY2005-06 Executive Program and Budget reports that total debt service payments are expected to exceed 20 percent of the operating budget by 2007-08. The threshold is cited within the city's debt policies as a debt affordability measure, but in effect caps payments for debts already incurred, rather than acting as a tool with which to measure and manage the city's entire debt. In the absence of periodic reporting and analyses containing other benchmarks, the city cannot reliably determine whether it is managing its debt beyond this measurement. Without a comprehensive debt management program, the city's focus is limited to maximizing annual spending without exceeding debt limits.

Existing debt-related communications provide no framework for reporting progress toward achieving specific goals or future plans to address concerns. Information and communication are considered part of the GAO's Internal Control Standards, which state that:

“Pertinent information should be identified, captured, and distributed in a form and time frame that permits people to perform their duties efficiently. Effective communications should occur in a broad sense with information flowing down, across, and up the organization. In addition to internal communications, management should ensure that there are adequate means of communicating with, and obtaining information from, external stakeholders that may have a significant impact on the agency achieving its goals.”

Currently, the Department of Budget and Fiscal Services issues a number of separate reports with respect to the city's debt:

- an annual summary of total indebtedness required by Section 47C-2, Hawaii Revised Statutes (HRS), and updates each time the city issues bonds, as required by Section 47C-3, HRS;
- official statements presented to potential investors for each bond offering;
- tabulations within the Comprehensive Annual Financial Report, including ratio of direct bonded debt to assessed value and population; computation of legal debt margin and authorized but unissued bonds; and ratio of debt service to general government expenditures; and
- *ad hoc* reports as requested by the city council, such as the impact of additional CIP requests on long-term debt.

While the department develops a number of reports, its own staff members recognize that not all reports are reader-friendly. In addition, they acknowledged that the various reports are delivered in such piecemeal fashion that they do not appear to facilitate the city council's decision-making. In the absence of specific legislation pertaining to elements of a comprehensive debt report, the council can anticipate such piecemeal reporting will continue.

In contrast, the City of Portland, Oregon, which was praised by both the GFOA and the National Advisory Council on State and Local Budgeting for its debt management policies, generates reports from a centralized Debt Management Office. The office is responsible for all the city's bond issuances, from general obligation to sewer revenue bonds, and has three full-time staff members who manage the city's \$2.2 billion in

outstanding debt. Aside from debt information submitted for budget purposes, the office issues a monthly debt management report regarding various aspects of the city's debt. In addition to total outstanding debt by various categories, the 22-page report for October 2005 includes the percent of debt maturing in the next 5 to 25 years for each type of bond, historical outstanding debt for the past 10 years, debt activity in the past 12 months in terms of additions (new money bonds, refunding bonds, notes, and line of credit draws) and reductions (bonds matured, bonds redeemed prior to maturity, bonds refunded, and line of credit reductions), debt service payments for the next 12 months on each bond issued, future debt service and current ratings on the city's bonds.

Similarly, the City of San Jose, California has prepared annual debt reports for the past 14 years, separate from various summaries and schedules included in the city's CAFR and budget documents. According to the San Jose debt administrator, the reports are written in plain language to clarify debt jargon, thereby communicating to city council members and the general public various aspects of the city's debt, debt activities, and future plans so they can better understand how their money is being spent. San Jose also issues updated quarterly debt reports to the city council and the "Making Government Work Better" committee.

Accountability for practices that violate the city's debt policy is limited

The GAO states that internal controls should provide reasonable assurance of compliance with applicable laws and regulations, meaning the prevention or prompt detection of unauthorized acquisition, use or disposition of an agency's assets. The city's debt policies stipulate that debt should not be used to finance ongoing operational costs; and that whenever possible, the city must pursue alternative sources of funding in order to minimize the level of debt. The policies do not require reporting of individual or aggregated instances; nor do they require the city to track actual expenditures of "operational costs", such as personnel costs. This makes it difficult to detect and monitor the prevalence and fiscal impact of using debt financing for operating expenditures. However, we found that like Honolulu, other municipalities allow certain salaries to be included in capital costs.

In April 2002, the city council adopted Resolution 02-101 CD1, revising the city's debt policy to allow contracts to hire engineering and design professionals under personal services contracts with definite termination dates to be included within the capital budget. In July 2002, corporation

counsel determined that other related services, such as technicians, clerks and draftsmen who work under engineering and design management services personal services contracts could also be included in capital costs. From FY2002-03 to FY2004-05, two city agencies (design and construction and transportation services) reported they paid a total of 21 employees on personal services contracts using capital funds. The departments reported the total cost of these salaries was approximately \$1,706,349 — including \$6,654 for a senior clerk typist. For FY2005-06, the Department of Environmental Services sought and received approval to use revenue bond funds totaling \$156,672 for the salaries of three of its permanent engineers who work on the department's capital programs, as well as 66 of the Department of Design and Construction's wastewater engineers, inspectors, technicians and three secretaries for FY2005-06, totaling \$3,434,693. For FY2005-06, a combined total of \$3,591,365 in city salaries will be paid with wastewater revenue bond funds.

The administrator estimated that salaries financed with funds from a 30-year bond cost double what they would cost in cash. However, this type of financing also affects rate increases charged to customers. For example, financing a project with cash could result in a rate increase of 30 cents a month, while borrowing and paying the cost of the project over a 30-year period could reduce that increase to 3 cents a month. In keeping with principles of intergenerational equity, if the useful life of a project is 50 years, then spreading out the costs over time may be more appropriate rather than overburdening current customers.

While the administrator initially stated that a debt service cost analysis was performed for the salaries of the anticipated city employees financed with sewer revenue bond funds, we were later told this analysis was an internal document and could not be found. The environmental services department indicated it plans to go back to paying those salaries with cash by FY2008-09 or FY2009-10. None of the budget and fiscal services department administrators indicated any future plans to return to paying any or all salaries with operating funds. Neither budget and fiscal services nor the Department of Design and Construction mentioned any plan to return to using operating funds for salaries once the city's economic condition improves. We maintain that while allowable under the city's debt policy, the city should work toward alternatives to funding salaries with bond funds and thus limit unnecessary additions to the city's debt service.

The city's debt and financial policy also specifically limits capital costs to those that do not recur annually. It advises that equipment having a unit cost of \$5,000 or more and an estimated service life of five years or more, except for equipment funded with cash from the Sewer Fund, should be included in capital costs. Items whose individual cost is less than \$5,000 may be funded in the capital budget if they are aggregated and made an integral part of a project costing \$25,000 or more, and the estimated service life of every major component is 5 years or more. The example cited in the policy is a project to replace all of the light poles in a neighborhood or a project to replace a park's facilities, including playground equipment.

The city's current recordkeeping and tracking system makes it difficult to identify whether expenditures comply with these policies. During our audit, the Department of Budget and Fiscal Services' Accounting Division created a customized computer program to extract information from the city's accounting system, showing that expenditures below \$5,000 are not routinely monitored for compliance with the debt policy. We found that expenditure reports lacked the necessary detail to identify what was actually purchased with the funds. Reporting on standard forms was inconsistent, with some recording dollar amounts per item and others merely aggregate totals.

We examined various records, including the city's CIP equipment journal, CIP liquidated encumbrance reports, and unbudgeted equipment requests, and found that some of the appropriations for major equipment during FY2002-03 to FY2004-05 were expended on equipment valued at less than \$5,000 and for equipment rentals. These included:

- teak furniture for the Honolulu Zoo employee lounge valued between \$170 and \$1,595 each, \$140 for 10 packages of teak cleaner;
- various power tools ranging from an impact wrench (\$233), 29-piece socket wrench set (\$770), cordless drill (\$161), and a one-half inch drill (\$125);
- 20 mountain bikes that cost \$1,132 each for the Honolulu Police Department;
- volleyball equipment, including 10 carts at \$260 each, 11 sets of volleyball equipment – including nets, pads, boundary tape,

antennas, aggregated with referee stands for district parks totaling \$55,076 for the Department of Parks and Recreation; and

- quarterly payments for Pitney-Bowes machines of \$353 and \$363.

The use of CIP funds for equipment — particularly expenditures for unbudgeted equipment, those with no description listed, and those categorized as “equipment not classified” — needs to be addressed. To reduce unnecessary additions to the city’s debt service, equipment purchases warrant further review.

The treasury chief said the cost of debt service resulting from financing salaries or equipment is not communicated to the executive agencies. Furthermore, the decision to use cash or borrowed funds depends on prioritization of needs and is ultimately made by the mayor and the budget and fiscal services director. If they determine that a project or equipment is needed, the treasury chief said it would be prudent to provide the funding for it. This rationale minimizes departments' input in discussions regarding what the city can afford prior to deciding whether to build projects or acquire specific equipment. In contrast, the City of San Jose, California's Debt Management Program serves in a financial advisory role to other city departments.

The City’s Reliance on the Same Underwriters for Negotiated Sales Raises Concerns of Conflict of Interest and a Potentially Costly Impact

The city has relied on its underwriters, with whom it has a longstanding relationship, to provide various services such as negotiated bond sales, financial advice, and information. Inexperienced Treasury Division staff have also received training materials from investment professionals. While these services may be conveniently obtained from known firms, the practice of obtaining such services from the underwriters is potentially contrary to the city’s fiduciary interests. The budget and fiscal services department’s administrators have justified the use of non-competitive *negotiated* bond sales as cost-effective due to 1) the services provided by underwriters; 2) greater flexibility in timing bond sales; and 3) greater control over selecting underwriters familiar with Hawai’i’s economy. However, both the Government Finance Officers Association and independent academic researchers recommend the use of competitive sales because they provide greater accountability and cost-effectiveness than negotiated sales. Moreover, the practice of using underwriters as

financial advisors presents a conflict of interest according to the Municipal Securities Rulemaking Board (board).

The board is a self-regulatory organization created by Congress in 1975 that writes rules regulating the behavior of bank and securities firm dealers in the municipal securities market to protect investors and public interest. The board is subject to oversight by the Securities and Exchange Commission (SEC) and its rules have the force and effect of law once they are approved by the SEC. The rules are enforced by the National Association of Securities Dealers for securities firms and by various bank regulatory agencies for bank dealers and by the SEC.

The board's Rule G-23, established in 1977, precludes underwriters from simultaneously serving as financial advisors in order to prevent conflicts of interest. As a financial advisor, a municipal securities professional acts in a fiduciary capacity as an agent for the governmental unit issuing bonds, and would normally seek to achieve the lowest possible interest cost for the issuer. An underwriter, on the other hand, acting as principal for its own account, would normally want to establish higher interest-rate yields which make the securities attractive for resale to others.

The Department of Budget and Fiscal Services states that it has never used underwriters hired for a negotiated sale as financial advisors on that same sale. Thus, its relationship with its underwriter does not constitute a financial advisory relationship. While this may conform to the letter of the law, we maintain that the department's independence on its underwriters risks violating the intent of Rule G-23.

In a competitive sale, an issuer (the city) solicits bids from underwriting firms to purchase its bonds, and sells its bonds to the firm or bond syndicate offering the most beneficial terms — e.g., the bid with the lowest true interest cost, and other factors. True interest cost is defined as the rate, compounded semi-annually, which is necessary to discount principal and interest payments on their payment dates back to the purchase price of a bond issue. The true interest cost takes into account the time value of money by giving greater weight to earlier debt payments. The competitive process affords an issuer some assurance that bonds are sold at the lowest interest cost given its bidders' assessments of market conditions on that particular day. Competition provides an incentive for underwriters to submit the most aggressive bid at which they expect to be able to successfully market bonds to investors. The competitive process results in an outcome that is

defensible for public officials and can minimize concerns regarding whether the best price was obtained for bonds issued.

Bonds are also sold on a non-competitive, *negotiated* basis. Under this method, an issuer grants an underwriter the exclusive right to sell the issuer's bonds. Negotiated sales are recommended when an issuer is selling bonds that are not readily accepted or have security risks or structural features not commonly found in the marketplace. Examples include variable rate debt issuances and large, complicated issuances in which more details need to be explained to potential investors, such as a \$400 million solid waste resource recovery bond or tax-increment bond tied to complex property laws.

Interviews with industry professionals revealed that the frequency of Honolulu's twice yearly bond issuances, general obligation bonds backed by unlimited taxing ability, and wastewater revenue bonds backed by revenues from an essential service in which the city has a virtual monopoly, are neither rare nor unfamiliar to the municipal bond market, neither risky nor complicated as to require extensive education of potential investors. One finance director said that even a smaller locality that issues bonds every six or seven years could use a competitive sales method and still educate the market prior to a sale using conference calls (for example) to disclose needed information and allow potential investors to ask questions.

Hawai'i County recently completed its first competitive bond sale since 1996. It provided positive results in that it received ten bids for its \$50 million bond offering on February 8, 2006. The county reported that it paid lower fees to the banks that won the right to underwrite the debt by offering the lowest interest cost at the auction. While the county's final analysis of savings is pending, they believe that the sale went well enough to consider competitive sales for future issuances.

In a negotiated sale, an underwriting firm is selected early in the bond issuance process, before the issuer has full knowledge of the terms of the sale. Once selected, the underwriter assists the issuer in all tasks necessary to prepare for the sale, including developing a structure that meets investor needs, preparing bond documents, undertaking pre-marketing activities to build investor interest in the bonds, and selling the bonds to investors. The issuer negotiates a purchase price for the bonds with the underwriter at the time the bonds are sold.

The treasury chief said that one factor in Honolulu's use of the negotiated method for bond issues in FY2004-05 was due to refinancing existing debt, or refunding, which is a more complicated process than issuing new debt. However, members of the Government Finance Officers Association (GFOA) debt committee whom we interviewed disagree that refunding is too complicated for a competitive sale. One finance director said that all eight refunding issues his county has done over the last six years had been done competitively, and the county exceeded its savings targets every time. A debt manager said that while their county had used negotiated sales for bonds that were tied to complex property tax laws needing more detailed explanation to investors, a recent first attempt at using the competitive method for the same type of complicated bond had been successful.

The city's use of non-competitive bond sales is potentially costly

The GFOA recommends that the competitive method of sale be chosen when conditions favoring this method are present, such as the market's familiarity with the issuer; a credit rating of A or better; and debt backed by the issuer's full faith and credit (i.e., general obligation bonds) are present. Based on research and interviews with administrators both in Honolulu and other municipalities, we found that the city meets all of these conditions, as shown by Exhibit 2.4.

Exhibit 2.4
Seven Conditions Favoring Competitive Bond Sales

Condition	<i>Has Honolulu Met This Condition For The Past 3 Years of Bond Issuance?</i>
1. The market is familiar with the issuer, and the issuer is a stable and regular borrower in the public market	Yes. Honolulu has issued one general obligation bond per year and one wastewater revenue bond every two years
2. There is an active secondary market with a broad investor base for the issuer's bonds	Yes. Administration has reported a strong demand for Honolulu's bonds among both local and institutional investors
3. The issue has an unenhanced rating of A or above or can obtain a credit enhancement prior to competitive sale	Yes. Honolulu's credit rating has been A or better
4. The debt structure is backed by the issuer's full faith and credit or a strong, known, or historically performing revenue stream	Yes. General obligation bonds are backed by the city's full faith and credit. Wastewater revenue bonds are backed by an essential service for which the city has a virtual monopoly
5. The issue is neither too large to be easily absorbed by the market nor too small to attract investors without a concerted sales effort	Yes. Bond sales have ranged from \$152.8 million to \$371.8 million per year. Total municipal bond market is \$2 trillion
6. The issue is not viewed by the market as carrying complex or innovative features or requiring explanation as to the bond's soundness	Yes. General obligation bonds and wastewater revenue bonds are common to the market
7. Interest rates are stable, market demand is strong, and the market is able to absorb a reasonable amount of buying or selling at reasonable price changes	Yes. Interest rates on municipal bonds have fluctuated within 78 basis points for the past three years; 100 basis points equals one percent

Sources: Government Financial Officers Association, Official Bond Statements from FY2002-03 to FY2004-05
 City and County of Honolulu press release November 4, 2005, *Bond Buyer* Bond Index

In both interviews with our office and subsequent media articles, the city's administration has defended its use of non-competitive bond sales by citing the statistic that 81 percent of municipal bond sales nationwide are conducted through negotiated means. However, far from being an acceptable justification, the head of public finance at the U.S. Securities and Exchange Commission has expressed concern in the media over decreasing competitive sales within the municipal bond market.

In addition, a 2001 Missouri audit found that, of the state's \$1.7 billion in bond sales, 87 percent were sold non-competitively. This resulted in \$83.2 million in excess interest costs (based on 0.38 percent difference in average interest rates between privately sold bonds and competitively sold bonds multiplied by total bond sales and an average life of the bonds of approximately 10 years). Thus, what appears to be a small difference in interest rates over a period of time could result in substantial savings.

Due to differences in state laws and economic factors such as state income tax levels, these types of comparisons are more accurate when conducted within the same state. Thus, the Missouri study methodology could not be duplicated in this audit due to the absence of competitively sold bonds in Hawaii.

However, academic studies spanning 20 years of research have shown that competitive sales resulted in cost savings over negotiated sales in terms of basis points, or changes in interest rates based on 1/100 of 1 percent. As illustrated in the Missouri audit, a difference of 0.38 percent, or 38 basis points, multiplied by \$1.7 billion over an average of 10 years, added up to significant savings.

- In Oregon, in a study of 210 general obligation bonds sold both competitively and through negotiated means, competitive bids resulted in a true interest cost that was 29 basis points lower than negotiated sales. The more bids received, the higher the savings: four to five bids resulted in 32.9 basis point savings, while six to seven bids resulted in savings of 52.6 basis points.
- In New Jersey, after allegations that an underwriter funneled money from a refunding issue to a company owned by an ally of the governor, the governor required that most state bond issues be sold through competitive bidding, and encouraged similar actions for all issuing localities. After a subsequent policy restricted negotiated sales, a study of 148 bonds showed that

competitively sold revenue bonds had an average cost advantage of 35 basis points over negotiated sales. As in Oregon, the study found that interest cost savings increase with the number of bids received, averaging 4 basis points per bid. On average, competitive sales were no more costly to issuers than negotiated sales.

- In the hospital bond market, a study of 4,576 bonds estimated that the true interest cost would decline by 54 basis points if the percentage of competitive issues rose from its current value of 7 percent to 100 percent.

While these studies also acknowledge there are special circumstances in which negotiated sales may be necessary, they conclude that the current prevalence of negotiated sales makes it unlikely that all such sales occurring today, which constitute the majority of the municipal market, are too risky or too unusual to be put out to bid. One reason cited for the increased use of negotiated sales is an “information asymmetry” between issuers and underwriters, with those in the markets on a daily basis possessing a potential advantage in their knowledge of prices and market conditions. Without a competitive means to balance out this information, issuers are at a disadvantage.

According to the Government Finance Officers Association (GFOA), issuers must decide which method of sale will result in the lowest cost for their debt and achieve other important policy objectives. The GFOA recommends that the competitive method of sale be chosen when conditions favoring this method of sale are present. This method of sale ensures that an underwriter has earned the job through a competitive process based upon an objective, mathematical calculation.

The Treasury Division has consistently identified the same underwriters as the best-qualified

One disadvantage of negotiated sales is the potential charge of favoritism toward particular firms chosen to underwrite the bond issue. This is of particular concern due to scandals in other states in the 1990s involving finance firms which illegally sought to obtain underwriter status for large bond issuances. We are neither alleging, nor did this audit uncover, any indications of illegal activity. Nevertheless, there should be concerns about propriety in the municipal bond market overall; those concerns should compel the city to balance the perspectives of its underwriter with those of other experts and independent sources of information.

A budget and fiscal services department administrator said that the city uses the negotiated method in order to have more control over selecting an underwriter with the right skills, service and expertise. In many cases, the administrator said, the underwriter knows more about the city's economy and operations than the administrator does. Another administrator said that underwriters used by the city know people within the rating agencies and can address concerns about the city's credit, for example. However, industry experts we interviewed said these types of sales pitches are commonly employed by underwriters nationwide. They cautioned issuers to remember that underwriters will structure deals to their own benefit. One finance director said it was inappropriate for underwriters to deal with rating agencies on the issuer's behalf.

For the past three years of bond issuances, the city has relied on the same underwriter (UBS Financial Services, as either senior manager or co-manager) and the same bond counsel (Orrick, Herrington & Sutcliffe LLP). Underwriters and bond counsel are selected by the budget and fiscal department using the request for qualifications or qualified list method pursuant to the *Hawaii Public Procurement Code*, HRS Section 103D-304(d) and Chapter 3-122, Subchapter 7 (*Source Selection and Contract Formation*), Hawaii Administrative Rules. The selection committee consisted of the treasury chief and two staff members, who ranked senior managers according to experience and professional qualifications, past performance on projects of similar scope, capacity to accomplish work in the required time, and subsequent support services.

For FY2004-05, the budget and fiscal services department's records show that the list of qualified firms for bond counsel includes four companies. Three were listed as qualified managing underwriters for both general obligation and wastewater revenue bonds: Citigroup, Merrill Lynch, and UBS Financial Services, Inc. The same three companies were also named, along with six other companies, as qualified co-managers (see Exhibit 2.5).

Exhibit 2.5

Underwriters and Bond Counsel Used for the Past Three Years of Bond Issuance

<i>Bond</i>	<i>Managing Underwriters</i>	<i>Bond Counsel</i>
Wastewater System Revenue Bonds Senior Series 2005A and 2005B (\$152,815,000)	<ul style="list-style-type: none"> • Citigroup • UBS Financial Services 	<ul style="list-style-type: none"> • Orrick, Herrington & Sutcliffe LLP
Honolulu General Obligation (GO) Bonds 2005A-D (\$371,770,000)	<ul style="list-style-type: none"> • UBS Financial Services • JP Morgan Securities • Merrill Lynch & Co. 	<ul style="list-style-type: none"> • Orrick, Herrington & Sutcliffe LLP
Honolulu GO Bonds Series 2004A, B, and C (\$321,620,000)	<ul style="list-style-type: none"> • UBS Financial Services 	<ul style="list-style-type: none"> • Orrick, Herrington & Sutcliffe LLP
Honolulu GO Bonds 2003A (\$250,000,000)	<ul style="list-style-type: none"> • Citigroup Global Markets Inc. • UBS Financial Services 	<ul style="list-style-type: none"> • Orrick, Herrington & Sutcliffe LLP

Source: Official Statements and Bond Transcripts from FY2002-03 to FY2004-05

Using underwriters as the city’s financial advisors creates a conflict of interest

The chief of the Treasury Division stated to us that, in the course of negotiated sales, the city’s underwriters also function as financial advisors. This creates a conflict of interest according to Rule G-23 of the Municipal Securities Rulemaking Board, the regulatory agency for firms involved in underwriting municipal bonds. In its 1977 notice of filing, the board stated:

“In a negotiated sale situation, the element of competition among prospective purchasers is absent, and the financial advisor who also acts as underwriter or purchaser in a private placement does so with substantial conflict of interest. The Board believes that the existence of this conflict is contrary to the fiduciary obligations of the municipal securities professional as a financial advisor to the issuer and is not consistent with the public interest.”

As mentioned earlier, one example of this conflict is that as an agent for the issuer, an independent financial advisor would normally seek to achieve the lowest possible interest cost to the issuer; but when acting as a principal for its own account, an underwriter would normally seek to establish higher yields to make the securities attractive for resale to others. In another example, if an underwriter has customers with large amounts of securities to be issued, the underwriter may be tempted to advocate a larger issue than what may be in the best interests of the issuer; conversely, an underwriter might advocate a smaller issue if its own customers' interest is not strong.

The Department of Budget and Fiscal Services states that it has never used underwriters hired for a negotiated sale as financial advisors on that same sale. Thus, its relationship with its underwriter does not constitute a financial advisory relationship. While this may conform to the letter of the law, we maintain that the department's dependence on its underwriters risks violating the intent of Rule G-23.

According to the Government Finance Officers Association (GFOA), issuers must remember that underwriters sell bonds to another set of clients – investors. It is easier to sell bonds to investors if the investment yield is higher. Unfortunately, higher investment yields for investors mean higher borrowing costs for issuers, such as the city. Issuers must understand that underwriters are working simultaneously with two different clients when underwriting a bond issue – the issuer and investors. When it comes to pricing bonds, the incentives for these two parties are in direct opposition.

The advantages cited by the budget and fiscal services department for negotiated sales are the heightened attention given to the issue by the underwriter, additional services and flexibility in the structure and timing of the sale. Because the underwriter knows in advance that it will obtain the bonds, the firm has a greater incentive to engage in extensive pre-sale marketing to assess demand for and promote the issuer's securities. Budget and fiscal services department officials have also said that negotiated sales are more cost-effective because the city does not have to hire a separate financial advisor for an additional cost. However, members of the GFOA debt committee we interviewed disagreed, saying that, when managed correctly, hiring an independent financial advisor reduces the scope of what an underwriter does, and thus should not constitute an additional cost.

In a competitive sale, the financial advisor works with the issuer to determine the structure and timing of the issue, to prepare bond documents and rating agency presentations, to evaluate and select the best bid, and to close the transaction. In a negotiated sale, the managing underwriter may provide many of these services. In this case, the financial advisor's vital role is to ensure the issuer's goals and interests are represented and protected when structuring the transaction and establishing the borrowing rates and yields on the bonds. Thus, the financial advisor must be a strong advocate capable of representing the interests of the issuer when potential disagreements with the underwriter arise regarding investor demand for bonds.

The Treasury Division has asked underwriters to develop training for its inexperienced staff

In light of the conflict-of-interest issues described in the previous section, involvement of underwriters outside of bond issuances warrants closer scrutiny. The treasury chief reports that, in response to the need to train the division's inexperienced staff, brokerage firms have offered basic investment modeling and asset allocation materials showing such areas as the difference between securities investment, and risk/return analysis.

When asked about this practice of relying on investment brokers to provide training materials, members of the Government Finance Officers Association (GFOA) debt committee told us this was an odd practice at best, particularly in light of materials and training sessions available from organizations serving government bond issuers. For example, the GFOA holds annual seminars on debt issuances for both beginner and intermediate levels, taught by government officials within the issuer community. One debt manager said that while anyone from outside the city would bring a certain bias to their training programs, there is a risk that an underwriter could exclude areas contrary to their own interests — such as the benefits of pursuing competitive bond sales.

Similarly, the services of an independent financial advisor should also be selected on a competitive basis. One municipality uses financial advisors who serve other municipal issuers and found that they provide a broad perspective of other municipal issuances and experiences.

Conclusion

The city administration has generally complied with the city's debt policies and refunded bonds at lower interest rates to reduce future debt

service. In recent years, the City and County of Honolulu's consistent "AA"-level bond ratings have benefited the city's bond issuances, resulting in favorable borrowing terms. The current administration has initiated potentially cost-saving measures to reduce rising debt costs by instructing agencies to reduce expenses and by canceling \$12 million in unneeded capital projects and \$10.5 million in contract funds encumbered before 1996 but never paid out. Despite these actions, the city projects that it will exceed its established debt limits as early as FY2007-08.

We found that the city has no comprehensive strategic plan to manage all its debt. Responsibilities for the city's debt have evolved into a fragmented operation managed by two different departments with serious resource constraints. Moreover, institutional knowledge of and experience with the city's debt are concentrated in only two city administrators, whose recently hired staff are in the process of learning their debt-related responsibilities through on-the-job training and for whom no formal debt-related training is planned. City reports are not reader-friendly and provide only limited information. Comprehensive and strategic actions are needed to obtain transparency and accountability over the city's debt operations and resolve its debt management problems.

We found that although the city's debt policy allows the use of capital funds for salaries, only the Department of Environmental Services reports that it plans to return to funding salaries with cash instead of revenue bonds. The Department of Budget and Fiscal Services has no such plans for the city's general obligation debt at this time. We found that city agencies use capital funds to purchase equipment costing far less than the \$5,000 limit, including items such as cleaning supplies and rental payments. Use of bond funds for such purchases results in unnecessary additions to the city's debt service and warrants further review to examine the extent and control mechanisms needed to restrict such practices.

Certain city practices raise concerns about conflict of interest and may result in unnecessary costs. The city has consistently evaluated the same underwriters as the best qualified for the past three years of bond issuance. The city's continued use of non-competitive negotiated sales methods, granting the underwriters the exclusive right to sell the city's bonds, raises concerns. Moreover, the city relies on its underwriters to function as financial advisors, creating a conflict of interest problem the Municipal Securities Rulemaking Board ruled against the practice in

1977. Future plans for the underwriters to provide staff training are also contrary to industry best practices. This has left the city vulnerable to underwriters who have conflicting interests between obtaining the highest possible interest yields for bond purchasers (investors) and seeking the lowest interest rate cost of financing for the city selling bonds (issuer).

Recommendations

The Department of Budget and Fiscal Services should:

1. Consider obtaining the services of an independent professional municipal debt organization to formally evaluate, in-depth, the city's current debt management program, practices, organization, resources, and staffing to develop an action plan with recommendations for a comprehensive, unified debt management program that addresses the city's overall fiduciary interests.
2. Establish a formal succession plan to ensure that staff members supporting the current debt managers receive cross-training in debt management functions so the city's interests are not jeopardized should either manager leave city employment.
3. Develop and take steps to issue an annual report on all of the city's debt for the city council and taxpayers.
4. Establish practices to accurately identify and scrutinize low dollar value equipment purchases by city agencies and report on the city's compliance with the city's debt policy.
5. Reconsider the city's use of underwriters as financial advisors due to the potential conflict of interest between clients like the city, which sells bonds, and the underwriter's investors, who buy them.
6. Reconsider its procurement practices, which have consistently resulted in selecting the same underwriting and bond counsel firms.
7. Consider competitively selecting an independent financial advisor to represent only the city's interests in bond sales transactions. The advisor could independently assess the feasibility and cost-benefit of using the competitive bond sales method compared to the current practice of negotiated bond sales.

8. The department should make use of established training by independent, nationally recognized municipal finance and debt organizations such as the Government Finance Officers Association as sources for formal debt and finance training and professional development.

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Response of Affected Agency

Comments on Agency Response

We delivered copies of our confidential draft of this report to the Department of Budget and Fiscal Services at the start of business on January 13, 2006. Copies were also provided to the mayor, managing director and members of the city council on the same day, due to the department's inability to accommodate our requests for an exit conference. We had initially contacted the department to schedule an exit conference on December 9, 2005. Within that one-month period, two previously scheduled meetings were cancelled. The department subsequently requested an exit conference on January 27, 2006, a total of six weeks since our initial request. Thus, we determined that, in the interest of timely reporting of our audit findings, the exit conference would be waived. The opportunity to comment on our draft was thus limited to a written response, as included in this report (see Attachment 1). The department was given until January 30, 2006, our standard ten-day response period. The department requested an extension, and was given until noon on February 6, 2006, another five working days to submit written comments for incorporation in the final report.

The department submitted its written response on February 6, 2006 (see Attachment 2). In its response, the Department of Budget and Fiscal Services stated that the purpose and objectives of our audit was unclear, and questioned the competency of the city auditor's staff. The department also suggested that the audit was not performed in accordance with Generally Accepted Government Auditing Standards (GAGAS). This highlights the department's lack of familiarity with GAGAS standards, since such conclusions cannot be reached by reading a draft report. The definitive test for compliance with GAGAS comes from a peer review of all government auditing standards—general, fieldwork and reporting standards—conducted by trained evaluators independent of the audit organization. The reviewer must assess the audit organization's policies and procedures, including internal quality controls, and review working papers for the respective audit project. Thus, the department has no basis for its conclusion, other than its disagreement with our findings.

Furthermore, the city auditor and his staff have extensive experience with the peer review process, both as reviewers of audits conducted by other

government audit organizations across the nation as well as successfully undergoing the peer review process every three years in their previous employment at the state auditor's office. The city auditor is an authority on GAGAS, having issued over 180 GAGAS reports in his previous position as deputy state auditor. There is *no* doubt that this audit was properly planned, conducted, and reported in accordance with government auditing standards.

The department's response provided some clarifying information, and changes to the draft were made in the final report where appropriate. However, despite the assertion of many inaccuracies and misrepresentations, none of the comments provided to us in the report changed the substance of our findings. Moreover, some aspects of the agency's response contradict information and statements provided to us during fieldwork. In the following sections, we address the significant issues of the department's response.

While the department may not agree with how we performed our audit, our objectives, as stated in the report, were officially communicated in writing to the department prior to fieldwork. The impetus for the audit was a longstanding concern among city officials and the public regarding the city's increasing debt service. In order to properly assess these practices, we determined that it was insufficient to limit our scope to the mechanics of debt service payments, but rather to determine how the city incurs debt, what the city has been doing and what it plans to do in the future to control this cost. We found that while the city has reduced debt through refinancing and continues to enjoy favorable bond ratings, the city does not have a comprehensive plan to control debt over the long term. The department states that the responsibility for devising such a plan lies with policymakers. We disagree. While policymakers have the responsibility to enact appropriate legislation, their decision-making process would be well served by reports from the appropriate government agency on activities that are pertinent to making those decisions.

The department questioned the competency and lack of technical knowledge of the city auditor's staff who conducted this audit. In reality, our office staff has a combined 60 years of performance auditing experience. We recognized the complexity of municipal debt and therefore examined practices of a non-technical nature. We maintain that the responsibility for mastering the nuances of performing specific tasks rightly belongs to those employed by the agency. Our job as auditors is to determine how the city's practices compare with the industry's best

practices, and report our findings accordingly. Our goal in every audit is to explain to citizens in a straightforward fashion how their government works and in what areas they can be improved. This was made clear to the agency during our entrance conference.

The agency expresses skepticism regarding the sources of our information. As in any audit, our sources range from published reports in mainstream media to industry journals and respected professional organizations, as well as interviews with both private sector and public sector experts. In this audit, we included the perspectives of municipal finance directors and debt managers who have had success with implementing best practices. We found administrators who developed tools, comprehensive plans and reports that helped them to communicate to policymakers and the general public: the status of the city's debt, how debt was affecting their municipalities and what the city was doing to control it.

In comparison, we found that the information on the city's debt was presented in piecemeal fashion. We believe that developing a comprehensive, reader-friendly report that aids policy makers and informs citizens of its activities is within the responsibility of any government agency despite the stated absence of time, staff and resources. To assist the department in accomplishing this goal, we recommend that the agency hire an independent consultant with the appropriate technical knowledge to do so.

While the city acknowledged that there is a need for a comprehensive debt management plan, the department disagreed with our interpretation that the city will exceed its debt service limit by FY2007-08, stating that the debt policy excludes revenue bonds. We derived our figures from the city's budget documents, which do not separately identify debt service from general obligation and revenue bonds. If such data is pertinent, then this is an example of the information the department needs to provide within a comprehensive debt management report to the city council and the public on a regular basis. Nevertheless, we maintain that the 20 percent threshold is insufficient as the only guideline for debt affordability, as other municipalities have used more than one indicator to manage their debt through prudent borrowing practices to ensure that essential public services are not jeopardized.

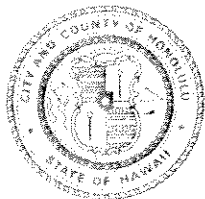
The department also takes issue with our comparison of debt policies in other municipalities. The city points out that credit ratings are not dependent on a single factor. We agree. Nevertheless, the city had

used one reason, potential damage to the city's credit rating, as a rationale for opposing debt limits. We found, however, that lower thresholds for debt did not preclude other municipalities from having higher credit ratings.

The department also acknowledged that personnel changes were present at the Treasury Division during the time of our audit, and that position classifications are inconsistent with the actual duties of employees within that division. In addition, the department acknowledged that bond proceeds were used for items that did not comply with the debt policy. We are encouraged that the department plans to investigate this occurrence.

We are also encouraged that, despite its vigorous defense of its underwriter and bond counsel selection process, the department has changed its selection committee for FY2006-07 to include the Department of Environmental Services and the Board of Water Supply based on their bond issuance needs for the year.

The department states that there are particular circumstances in which negotiated bond sales are appropriate. We agree; none of our sources, nor does our report, advocate using either the competitive or negotiated bond sale method exclusively. However, our research has also indicated that competitive bond sales are recommended by the Government Finance Officers Association when specific conditions favoring this method are present, which we outlined in Exhibit 2.4. The widespread use of negotiated bond sales is a credit to the underwriting industry, which has successfully marketed its services to municipalities. However, when there is evidence that a more transparent, competitive process has the potential for substantial savings and greater accountability, the city would do well to investigate whether this alternative method has merit, instead of dismissing it out of hand. While underwriters may possess the necessary expertise, it is the city's responsibility to exercise professional skepticism when it comes to the use of city funds.



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LESLIE I. TANAKA, CPA
CITY AUDITOR

January 13, 2006

COPY

Ms. Mary Patricia Waterhouse, Director
Department of Budget and Fiscal Services
530 South King Street, Room 208
Honolulu, Hawaii 96813

Dear Ms. Waterhouse:

Enclosed for your review are two copies (numbers 12 and 13) of our confidential draft audit report, *Audit of the City's Debt Service Practices*.

The Office of the City Auditor routinely conducts an in-person exit conference to inform agency heads of our findings prior to report issuance. However, more than one month has elapsed since our initial request to conduct an exit conference with your department. In light of the Generally Accepted Government Auditing Standards (GAGAS) requirement that reports be issued on a timely basis, the amount of time that has elapsed and two previously scheduled meetings cancelled by your office, we have determined that an exit conference will not be conducted for this audit.

If you choose to submit a written response to our draft report, your comments will generally be included in the final report. However, we ask that you submit your response to us no later than 12 noon on January 30, 2006.

For your information, the mayor, managing director, and each councilmember have also been provided copies of this **confidential** draft report.

Finally, since this report is still in draft form and changes may be made to it, access to this draft report should be restricted to those assisting you in preparing your response. Public release of the final report will be made by my office after the report is published in its final form.

Sincerely,

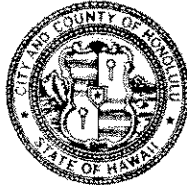
A handwritten signature in cursive script, appearing to read "Leslie I. Tanaka".

Leslie I. Tanaka, CPA
City Auditor

Enclosures

DEPARTMENT OF BUDGET AND FISCAL SERVICES
CITY AND COUNTY OF HONOLULU
530 SOUTH KING STREET, ROOM 208 • HONOLULU, HAWAII 96813
PHONE: (808) 523-4616 • FAX: (808) 523-4771 • INTERNET: www.honolulu.gov

MUFI HANNEMANN
MAYOR



MARY PATRICIA WATERHOUSE
DIRECTOR

PATRICK T. KUBOTA
DEPUTY DIRECTOR

February 3, 2006

'06 FEB -6 AIO 54

Mr. Leslie I. Tanaka, CPA
City Auditor
Office of the City Auditor
City and County of Honolulu
1000 Uluohia Street, Suite 120
Kapolei, Hawaii 96707

C & C OF HONOLULU
CITY AUDITOR

Dear Mr. Tanaka:

Subject: Draft Audit Report, *Audit of the City's Debt Service Practices*
Report No. 06-03, January 2006

A thorough review of your confidential draft audit report, *Audit of the City's Debt Service Practices*, Report No. 06-03, prompts us to raise serious concerns about the conduct of the audit and the veracity of your findings.

The audit, which was initiated at your behest rather than by the City Council, was conducted by members of your staff, whose inexperience and unfamiliarity with the subject matter have led to a draft report rife with errors, omissions, misrepresentations, unsubstantiated comments, and flawed conclusions.

While we have appreciated the opportunity to work with your office on management and financial audits of the Sunset on the Beach program and personal services contracts, those endeavors were confined largely to compliance with defined procedures and mandates. The highly complex and arcane field of debt service would, we contend, demand an audit conducted by impartial experts with the requisite knowledge and experience. Your failure to do so has led to findings and recommendations that call into question the validity of the entire report.

The audit also seemed to be conducted with little regard for key principles of the Generally Accepted Government Auditing Standards, which call for the conduct of audits by persons with the necessary qualifications, impartiality, and honest and open communication and constructive criticism based on factual analysis. Those qualities are noticeably absent in this audit.

Mr. Leslie I. Tanaka, CPA

February 3, 2006

Page 2

We believe the Office of the City Auditor makes a significant contribution to the City and we look forward to continuing to cooperate with you on improving our government.

Please call me at 523-4617 if you wish to meet and discuss the attached executive summary and detailed response to the draft audit report.

Sincerely,



Mary Patricia Waterhouse, Director
Department of Budget and Fiscal Services

MPW:sm

Attachments

cc: Mayor Mufi Hannemann
Wayne M. Hashiro, P.E., Acting Managing Director
Donovan M. Dela Cruz, Council Chair
Ann H. Kobayashi, Council Vice Chair
Romy M. Cachola, Council Floor Leader
Todd K. Apo, Councilmember
Charles K. Djou, Councilmember
Nestor R. Garcia, Councilmember
Barbara Marshall, Councilmember
Gary H. Okino, Councilmember
Rod Tam, Councilmember

EXECUTIVE SUMMARY

In Response to the City Auditor's Report No. 06-03 dated January 2006

CONCERNS RAISED AT THE ENTRANCE CONFERENCE:

Technical knowledge and competence of the audit staff

At the entrance conference, we expressed concerns about your staff's inexperience and apparent lack of knowledge about the highly specialized and complex subject of tax-exempt municipal bond financing. When we inquired about the hiring of an expert or specialist for this audit, you assured us that your staff was capable of performing the audit.

However, based on our review of the draft audit report and the plethora of errors, omissions, misrepresentations and unsubstantiated comments, it is apparent that your staff did not possess the necessary competencies. Many, if not all, of the deficiencies in the draft audit report can be attributed to that lack of expertise. For instance, failure to understand basic terminology led to your confusing investments with financing (bond and debt) activities. An inability to comprehend the significance of each bond rating category resulted in the inappropriate comparison of "triple-A" rated municipalities to "double- A" rated Honolulu.

Moreover, inadequate understanding about the examination and analysis performed by bond raters led to flawed conclusions. Bond raters assess a bond issuer's creditworthiness on four areas inclusively: an issuer's economy (the most critical area), administration, financial performance and flexibility, and debt burden. In contrast, the draft audit report determined that the "municipalities' debt restrictions have not kept them from earning bond ratings equal to or higher than Honolulu's" using one single aspect (debt limits) of a broader area (debt burden) in isolation as its basis.

Finally, the first recommendation made by the draft audit report that stated, "Consider obtaining the services of an independent professional municipal debt organization to formally evaluate, in-depth, the city's current debt management program, practices, organization, resources, and staffing to develop an action plan with recommendations for comprehensive, unified debt management program that addresses the city's overall fiduciary interest" can be interpreted as an admission that specialists were required for this subject matter. The City resources devoted to this audit may have produced greater value had an expert or specialist been hired at the start as we had requested during the entrance conference.

Defined audit objectives and scope

From the outset, we repeatedly asked your office for a definitive scope of the audit. None was ever provided. All we were ever told was what is stated in the draft audit report as, "review and assess the city's debt service practices."

We describe in the attached detailed response the challenges that arose because the audit objective and scope were ambiguous and, understandably, the audit methodology may have been inappropriate. The discussions in the draft audit report alternated between "debt service practices" and "a comprehensive, unified debt management program and a strategic plan to provide future direction" or the "managing and controlling overall debt." The meanings of the latter two phrases were never explained. Your use of "debt service practices" may be construed as the procedures for principal and interest repayments based on the statement in the introduction of the draft audit report that "debt service refers to the principal and interest payments on funds borrowed by the city for capital projects." The methodology of only interviewing those employees assigned responsibilities related to the issuing, selling, paying interest on and redeeming bonds of the city fits an audit of "debt service practices" but not an

audit of “a comprehensive, unified debt management program and a strategic plan to provide future direction” or the “managing and controlling overall debt.”

As a result, the materials presented in the draft audit report were often inconsistent with the auditor’s comments. In addition, supporting evidence and information were deficient and unconvincing.

ACCURACY:

Generally Accepted Government Auditing Standards (GAGAS) require that evidence presented be true and that findings be correctly portrayed. The need for accuracy is based on the need to assure report users that what is reported is credible and reliable. In addition, a report must also be free of errors in logic and reasoning.

The draft audit report includes numerous errors and inaccuracies, a few of which are summarized below.

1. In Exhibit 1.2, Debt Service as Percentage of Operating Budget, the amounts used for debt service are incorrect because they should have excluded the debt service on revenue bonds. The City’s Debt and Financial Policies, Section III.G.1 of Resolution 03-59, CD1, states, “Debt service for general obligation bonds including self-supported bonds as a percentage of the City’s total operating budget, including enterprise and special revenue funds, should not exceed 20 percent.” Accordingly, the application of the policy confines the computation to debt service on general obligation bonds and reimbursable general obligation bonds as a percentage of the City’s total operating budget and excludes debt service on revenue bonds.
2. In Exhibit 2.2, Comparisons of Debt Service Limits in Other Municipalities, for Honolulu, the general obligation bonds are limited to a 25-year term, not 30 years.
3. Exhibit 2.3, The City’s Debt Process, contains numerous mistakes as noted in the detailed response attached.
4. Contrary to the draft audit report, the decision between the competitive bond sale method and the negotiated bond sale method does not have a right or wrong answer. The debate is decades long. Even the Government Finance Officers Association admits, “It is in the interest of the state and local government issuers to sell public debt using the method of sale that is expected to achieve the best sales results, taking into account both short-range and long-range implications for taxpayers and ratepayers. However, there is a divergence of views as to the relative merits of the competitive and negotiated methods of sale due to the lack of comprehensive, empirical evidence that would favor one method over the other” and goes on to advise issuers “to ensure that the most appropriate method of sale is selected in light of financial, market, and transaction-specific and issuer-related conditions.” Over time, the trend has been toward the negotiated bond sale method. Since 1990, negotiated sales have surpassed competitive sales by a large margin, with over 80 percent of all municipal issuers opting for the negotiated bond sale method. Can all of these issuers be doing it wrong?

While advocating the competitive bond sale method, the draft audit report fails to provide conclusive evidence to support the argument that it provides greater accountability and cost-effectiveness than the negotiated bond sale method.

5. The allegation that a Treasury Division employee's experience "falls short of the city's minimum qualifications" for the position is totally groundless. The City has strictly enforced recruitment and selection procedures in accordance with civil service laws. Any applicant for a civil service position must be examined and qualified by human resource specialists before interviews are held. Once a selection is made, human resource specialists conduct an evaluation to ensure compliance with all civil service rules and regulations. The City Auditor's staff was clearly not qualified to make such an assessment and should have refrained from comment. More importantly, the draft audit report misrepresents the facts by failing to disclose the City's recruitment and selection procedures that ensure an applicant meets minimum qualifications.
6. The audit comment, "This rationale excludes departments from being involved in discussions regarding what the city can afford prior to deciding whether to build projects or acquire specific equipment," is inconsistent with the fourth box under the first column in Exhibit 2.3, The City's Debt Process that states, "Administration, BFS, DDC and ENV determine overall capital budget proposal and proposed aggregate amount of debt needed to finance projects."
7. As explained in detail in our attached response, the draft audit report fallaciously contends that "triple-A" rated municipalities are similar to the "double-A" rated City and County of Honolulu. Bond raters consider the "triple-A" and "double-A" ratings two distinct and separate categories. Municipalities within each category may be considered comparable. However, comparisons of municipalities in different categories are invalid and futile. Although idiosyncrasies make comparisons between municipalities difficult, at a minimum, comparing municipalities with bond ratings within the same category is necessary for any analysis to be valid.
8. Under "The Treasury Division has asked underwriters to develop training for its inexperienced staff," the draft audit report mistakenly interprets remarks made about Treasury's investment activities as relating to the bond issuance function. Terms such as "brokerage firms," "investment modeling," "asset allocation," "securities investment," "risk/return analysis," and "investment brokers" clearly deal with the investment of monies to earn interest and not bond or debt transactions. There was obviously a misunderstanding by the City Auditor's staff that caused them to confuse comments made about investment activities with those relating to the issuance of bonds.

OBJECTIVE:

GAGAS require that the presentation of the entire report be balanced in content and tone. The report should be fair and not misleading and should place the audit results in perspective. This means presenting the audit results impartially and fairly. The tone should be balanced by requiring reports to present sound and logical evidence to support conclusions, while refraining from using adjectives or adverbs that characterize evidence in a way that implies criticism or unsupported conclusions.

A summary of some of the more glaring misrepresentations of facts and information is provided below.

1. In Exhibit 2.2, Comparisons of Debt Service Limits in Other Municipalities, most of the municipalities chosen to support the audit comments were considerably different from Honolulu. Municipalities with greater similarity to Honolulu exist and should have been selected, such as the County of Maui. Furthermore, the audit comment claims Exhibit 2.2 shows "a comparison of similarly rated municipalities" when four of the five are "triple-A"

rated as opposed to the City and County of Honolulu's "double-A" rating. Bond raters and other municipal finance professionals do not consider "triple-A" rated issuers similar to ones rated "double-A."

2. The draft audit report maintains that California's bond rating upgrade was "due to improved debt management practices." However, in the Tax Supported New Issue report dated February 18, 2000, Fitch Ratings stated, "The rating upgrade takes into account the fundamental strengths of California, buttressed by the sustained favorable economy and financial operations." Then, in its Global Credit Research New Issue report dated September 7, 2000, Moody's Investors Service wrote, "The upgrade reflects the strength and diversity of a state economy that continues to exceed consensus growth expectations and comfortably outpaces the nation in terms of personal income and employment growth." The upgrade also reflected California's increased fiscal conservatism, specifically, management's "ability to resist spending onetime revenues on recurring expenses despite a \$9 billion windfall." The debt management policy was ancillary to the other upgrade factors as the report mentioned that a debt management policy is anticipated to "potentially manage debt levels successfully" despite significant infrastructure needs and the state's inflexible budget structure. As indicated earlier, the most critical criterion for bond raters is the issuer's economy.
3. In the audit comment, "The threshold is cited within the city's debt policies as a debt affordability measure, but in effect places an annual cap on payments for debts already incurred, rather than acting as a tool with which to measure and manage the city's entire debt," the contention that the "threshold" is instead an "annual cap" is a misrepresentation. The debt and financial policies describe those ceilings as "guidelines."
4. Throughout the draft audit report, references are made to "industry professionals" and "industry experts" whose identities and occupations are never revealed. If these "industry professionals" and "industry experts" are in fact financial advisors, then their observations may be slanted and biased because they would be the beneficiaries if more issuers used the competitive sale method.
5. In Exhibit 2.4, Seven Conditions Favoring Competitive Bond Sales, the audit comments for conditions #2, #5, and #7 were based on faulty assumptions and a lack of technical knowledge, skills and experience about the municipal bond market. For Condition #2, the audit comment failed to differentiate between the "secondary market" and the "primary market" for municipal bonds. Under Condition #5, the audit comment mistakenly concluded that the bond issue's size alone determined the market's ability to absorb the bonds. A better determinant of whether an issuer's bonds can be "easily absorbed" by the municipal bond market is the appetite of the purchasers of those bonds. Condition #7 concerns market volatility and the audit comment erroneously determined that interest rates were stable because they ranged from 2 percent to 5 percent while most market participants would consider interest rate movements of 0.10 percent to 0.25 percent as constituting market volatility.
6. The material presented in the section entitled, "The Treasury Division has consistently identified the same underwriters as the best qualified," seems slanted and biased because it buries the finding of **no** wrongdoing among expressions of transgressions and corruption. It begins with a discussion about favoritism, and then talks about scandals. It acknowledges, "We are neither alleging, nor did this audit uncover, any indications of illegal activity." Yet, it proceeds to advise that "there should be concerns about propriety in the municipal bond market overall; those concerns should compel the city to balance

the perspectives of its underwriter with those of other experts and independent sources of information.”

7. The draft audit report uses adjectives and adverbs that characterize evidence in a manner that implies criticism or unsupported comments.
 - “Without specific parameters regarding acceptable exceptions, the city leaves itself open to treating cash shortages as ‘emergencies’ or ‘unusual circumstances’, thereby allowing **liberal** use of CIP funds for salaries and equipment.” The statement would have been more neutral if the word “liberal” were omitted.
 - “In addition, budgeting for such expenditures **under the guise of** a capital project enables them to undergo less scrutiny than if they were paid for with operating funds.” A more neutral approach would have been to replace the phrase “under the guise of” with “as.”
 - “While these services may be conveniently obtained from known firms, the practice of obtaining such services from the underwriters **is potentially contrary to the city’s fiduciary interests**.” A more neutral statement would have been, “Rather than obtaining such services from the underwriters, these services may be conveniently obtained from known firms.”
 - “The budget and fiscal services department’s administrators have **justified** the use of non-competitive *negotiated* bond sales as cost-effective due to 1) the services provided by underwriters; 2) greater flexibility in timing bond sales; and 3) greater control over selecting underwriters familiar with Hawaii’s economy.” Instead of “justified,” the statement would have been more neutral with the word “explained.”
 - “In both interviews with our office and subsequent media articles, the city’s administration has **defended** its use of non-competitive bond sales by citing the statistic that 81 percent of municipal bond sales nationwide are conducted through negotiated means.” The word “defended” could be replaced with “explained” for a more neutral tone.

COMPLETE:

GAGAS requires that the report contain all evidence needed to satisfy the audit objectives and promote an adequate and correct understanding of the matters reported. It also means the report states information and findings completely, including all necessary facts and explanations.

The audit comments below are only a few of the numerous assertions in the draft audit report that were unsubstantiated. Material was slanted and biased, providing only the information that supported the draft audit report’s perspective and omitted any facts that did not conform to its conclusions.

1. From the introduction of the draft audit report, the “impetus for this audit stemmed from longstanding concerns about the city’s growing debt payments and their impact on the operating budget.” However, the draft audit report does not discuss the cause of the “growing debt payments,” the capital budget. Financing decisions, whether to borrow or pay cash for capital improvement projects, are made during the capital budgeting process. If the capital budget appropriates bond proceeds, i.e., borrows to pay for capital

improvement projects, then “debt payments” will increase. The draft audit report ignores that entire aspect of the process by omitting discussions about the role the City’s executive and legislative bodies play in proposing, amending and adopting the capital budget thereby adding to the City’s debt burden.

2. Evidence in the draft audit report did not support the audit comment, “Lacking a comprehensive, unified debt management program and a strategic plan to provide future direction, the city council cannot effectively oversee the city’s debt program.” Furthermore, the meanings of “a comprehensive, unified debt management program and a strategic plan” were never explained.
3. The representation that, “Standard & Poor’s also says that a debt burden is usually considered high when debt service payments represent 15 to 20 percent of combined operating and debt service fund expenditures. Thus, Honolulu’s 20 percent debt service threshold is high, both in policy and in practice” included only a portion of Standard and Poor’s opinion of the City’s debt burden. It also omitted the analysis of Fitch Ratings and Moody’s Investors Service, the other two firms that rate the City.
4. For the audit comment, “In the absence of periodic reporting and analyses containing other benchmarks, the city cannot reliably determine whether it is managing its debt beyond this measurement. Without a comprehensive debt management program, the city’s focus is limited to maximizing annual spending without exceeding debt limits,” the draft audit report failed to demonstrate that the City’s focus is “limited to maximizing annual spending without exceeding debt limits” instead of other objectives such as maintaining and improving infrastructure.
5. The audit comment, “Moreover, the practice of using underwriters as financial advisors presents a conflict of interest according to the Municipal Securities Rulemaking Board (board)” and other audit comments related to the same matter uses the wrong source as its basis. It cites a 1977 notice of filing and not the authority, the Municipal Securities Rulemaking Board (MSRB) Rule G-23. As noted in our response, MSRB Rule G-23 specifically states, “Notwithstanding the foregoing, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities,” and clearly signifies that **no** conflict of interest exists. More importantly, despite discussing this matter at least three separate times, the draft audit report **does not present** any concrete evidence that the City ever used underwriters as financial advisors.
6. Under the heading, “The city’s use of non-competitive bond sales is potentially costly,” the draft audit report examines the competitive and negotiated bond sale methods. However, the material presented is limited to examples that the number of bids affected interest rates on a competitively sold bond issue and **not** whether negotiated sales are more costly than competitive.
7. In discussing the employee turnover and alleged lack of experience of certain employees, the draft audit report fails to provide perspective on the extent and significance of reported comments such as the frequency of occurrence relative to the number of cases or transactions tested. The situation described in the draft audit report was a rare, single occurrence as opposed to a persistent problem. At the time the audit was conducted, the Treasury Division was experiencing an unusual number of staffing changes and absences in its professional level positions.

EXIT CONFERENCE:

We believe that the exit conference is a vital component to the audit process. While we recognize that we were responsible for initiating the change to two previously scheduled exit conference meetings, unanticipated circumstances arose subsequent to the scheduling that necessitated the changes. It was always our intent to meet. We were never informed that you would be releasing the draft audit report to the Mayor, Managing Director and members of the City Council if an exit conference were not held by a certain date.

We do not understand the urgency to release the draft audit report prior to conducting an exit conference. The urgency to release the draft audit report seems inconsistent with the circumstances, especially since: (1) the audit was self-initiated, meaning neither the Administration nor the City Council are awaiting the results, (2) GAGAS recommends under Section 8.31 that "One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible officials of the audited entity and others, as appropriate," and (3) most importantly, there were no findings of wrongdoing.

In addition, the Department of Budget and Fiscal Services was given only nine-and-one-half working days from the date of your transmittal letter to respond to the draft audit report while it took your staff more than four months to conduct the audit. Then, when we requested additional time to February 10, 2006, to submit our response, you granted us an extension to February 6, 2006, maintaining that GAGAS requires timeliness.

While the timely release of the audit report is one component to consider under GAGAS, it also prescribes that timeliness should be weighed against other factors, such as accuracy, objectivity and completeness.

We believe that, through adequate communication during the audit, the issues raised regarding the draft audit report could have been addressed.

RESPONSE TO THE CITY AUDITOR'S REPORT NO. 06-03 DATED JANUARY 2006

CHAPTER 1 INTRODUCTION

Audit comments: Page 1: "Moreover, the city reports it will exceed its debt limit (20 percent of its operating budget) within two years, in FY2007-08."

Page 6: While the city currently complies with this limit, Exhibit 1.2 shows, as the city itself has reported, that it could exceed its own debt service limit as early as FY2007-08."

Page 27: "The city's FY2005-06 Executive Program and Budget reports that debt service payments are expected to exceed the city's affordability threshold of 20 percent of the operating budget by 2007-08."

Page 41: "Despite these actions, the city projects that it will exceed its established debt limits as early as FY2007-08."

Response: The audit comment is inaccurate and misleading.

The draft audit report omits the source of their statement that the "city reports it will exceed its debt limit (20 percent of its operating budget) within two years" given that the City did not make such a report.

Background

Audit comment: Page 6: "To preserve credit quality, the policy established affordability guidelines capping debt service for general obligation bonds at 20 percent of the operating budget, and debt service on direct debt (excluding self-supporting bonds) at 20 percent of general fund revenues. While the city currently complies with this limit, Exhibit 1.2 shows, as the city itself has reported, that it could exceed its own debt service limit as early as FY2007-08."

Response: The amount and percentages presented in the Exhibit 1.2, Debt Service as Percentage of Operating Budget, appears to be incorrect. Section III.G.1 of Resolution 03-59, CD1 amending the debt and financial policies states "Debt service for general obligation bonds including self-supported bonds as a percentage of the City's total operating budget, including enterprise and special revenue funds, should not exceed 20 percent." Accordingly, the application of the policy confines the computation to debt service on general obligation bonds and reimbursable general obligation bonds as a percentage of the City's total operating budget and excludes debt service on revenue bonds.

Our estimates can be found in the following table.

DEBT SERVICE POLICY
Resolution 03-59, CD1, adopted June 4, 2003

III.G.1 Debt service for general obligation bonds including self-supported bonds as a percent of the City's total operating budget, including enterprise and special revenue funds, should not exceed 20 percent.

FISCAL YEAR	DEBT SERVICE			OPERATING BUDGET	TOTAL %	GOB %
	GOB	REV	TOTAL			
2002	118,370,859	19,295,979	137,666,838	1,083,961,152	12.7%	10.9%
2003	128,942,979	24,225,240	153,168,219	1,116,000,464	13.7%	11.6%
2004	176,565,028	25,333,999	201,899,027	1,169,082,681	17.3%	15.1%
2005	167,074,298	26,338,790	193,413,088	1,228,961,020	15.7%	13.6%
2006	198,351,995	36,748,418	235,100,413	1,361,210,036	17.3%	14.6%
2007	219,800,000	50,600,000	270,400,000	1,425,300,000	19.0%	15.4%
2008	237,600,000	65,200,000	302,800,000	1,495,900,000	20.2%	15.9%
2009	244,300,000	78,800,000	323,100,000	1,555,900,000	20.8%	15.7%
2010	255,900,000	90,100,000	346,000,000	1,620,100,000	21.4%	15.8%
2011	262,200,000	99,900,000	362,100,000	1,644,000,000	22.0%	15.9%

Source: Department of Budget and Fiscal Services, Fiscal/CIP Division

Objectives of the Audit

Audit Objective: Page 8: "1. Review and assess the city's debt service practices."

Response: The objective and scope of the audit are not well defined.

From the outset, several requests were made to the City Auditor for a definitive scope of the audit. None was ever provided. All that was communicated was the objective stated above, "review and assess the city's debt service practices."

In the "Introduction," where the draft audit report states "'Debt service' refers to the principal and interest payments on funds borrowed by the city for capital projects," "debt service practices" would be construed to mean the procedures for principal and interest repayments. In addition, the manner in which the City Auditor's staff conducted the audit, by limiting their interviews to only the staff responsible for the issuing, selling, paying interest on and redeeming bonds of the city, would be consistent with that intention of "debt service practices."

However, the discussions in the draft audit report move back and forth between "debt service practices" and "a comprehensive, unified debt management program and a strategic plan to provide future direction" or the "managing and controlling overall debt." The meanings of the latter two phrases are never explained and remain vague and obscure throughout the entire draft audit report.

CHAPTER 2 THE CITY'S MANAGEMENT OF DEBT IS FRAGMENTED AND SOME PRACTICES MAY BE CONTRARY TO THE CITY'S FIDUCIARY INTERESTS

The City Lacks a Comprehensive Debt Management Program

Audit comment: Page 12: "Responsibilities for the city's debt are fragmented between two departments, of which little is reported and accountability is uncertain."

Response: Although it may appear to the City Auditor's staff that the responsibilities are fragmented, each department is acutely aware of their duties. The Department of Budget and Fiscal Services (BFS) has the responsibility under the City Charter Section 6-203(f) for "issuing, selling, paying interest on and redeeming bonds of the city." BFS interprets that to mean managing the process for the issuance of and the repayment of principal and interest on all City bonds including Wastewater System Revenue Bonds and Water System Revenue Bonds. Both the Department of Environmental Services (ENV) and the Board of Water Supply support BFS to issue and sell Wastewater System Revenue Bonds and Water System Revenue Bonds, respectively.

Therefore, the chief of the Treasury Division also has "comprehensive institutional knowledge, direct experience and a concentration of responsibilities" relating to the issuance and sale of Wastewater System Revenue Bonds and Water System Revenue Bonds.

Audit comment: Page 12: "Administrators overseeing the city's debt reported having other significant departmental responsibilities, with staff facing considerable learning curves to match the administrator's debt knowledge and experience."

Response: The audit comment is misleading.

Every employee in the City has numerous responsibilities and every agency in the City must deal with employee turnover and the need to train new employees. At the time the audit was conducted, the Treasury Division in particular was experiencing an unusual number of staffing changes and absences in its professional level positions.

Audit comment: Page 12: "Lacking a comprehensive, unified debt management program and a strategic plan to provide future direction, the city council cannot effectively oversee the city's debt program."

Response: The draft audit report fails to provide examples or evidence to support this finding.

It also neglects to explain the meaning of "comprehensive, unified debt management program and a strategic plan." The budget process provides a debt management program through the six-year capital program that includes the anticipated sources of funding for capital projects. Annually, the capital budget for the coming fiscal year and a six-year capital program are submitted to the City Council for review. The City Council may amend (add or remove projects and revise funding sources), and then must adopt, a capital budget. In doing so, the City Council appropriates funds (general obligation bond proceeds, wastewater revenue bond proceeds, other funds) to the projects contained in the capital budget.

Best practices in governmental debt management and planning

Audit comment: Page 12: "As such, GFOA recommends all state and local governments adopt comprehensive written policies, review them at least annually and revise them as necessary."

Response: The City adopted GFOA's recommendation for a comprehensive written debt and financial policies in 1996 by Resolution 96-26, CD1. Since then, the policies have been reviewed and revised in 1998 by Resolution 98-337, in 1999 by Resolution 99-46, in 2001 by Resolution 01-76, CD1, in 2002 by Resolutions 02-101, CD1 and 02-140, CD1, and in 2003 by Resolution 03-59, CD1.

There are plans to propose revising the policies again for the fiscal stability reserve fund, as the Administration continually seeks to strengthen and protect the City's financial position.

Audit comment: Page 14: "Although the administration feared that further restricting debt service limits would damage the city's bond ratings, a comparison of similarly rated municipalities shows that four out of five limit their debt to ten percent or less of general fund revenues, compared to Honolulu's 20 percent."

Response: The audit comment is inaccurate and misleading.

**Investment Grade Bond Ratings:
 Moody's/S&P/Fitch**

Aaa/AAA/AAA	}	Highest Quality
Aa1/AA+/AA+ Aa2/AA/AA Aa3/AA-/AA-	}	Very Strong Capacity
A1/A+/A+ A2/A/A A3/A-/A-	}	Strong Capacity
Baa1/BBB+/BBB+ Baa2/BBB/BBB Baa3/BBB-/BBB-	}	Adequate

Contrary to the audit comment's representation of "a comparison of similarly rated municipalities," a bond rating of "AAA" ("triple-A") is not similar to a bond rating of "AA" ("double-A"). Bond raters consider them two distinct and separate categories. "Triple-A" rated municipalities are quite rare. Generally, "triple-A" ratings are attributable to special circumstances where several features of the issuer contribute to its extremely strong creditworthiness. These features may be, but are not limited to, strong and stable economies, high wealth factors, high

cash reserves and low or rapidly amortizing debt. A "triple-A" rating may not be realistic for most major municipalities given the constraints required to maintain such a rating.

While there is value in examining the characteristics of municipalities with higher bond ratings than Honolulu for ways to improve, adopting stricter debt limits alone would not result in a "triple-A" rating. Policy decisions, such as the adoption of stricter debt limits, must be made with a broad, long-term perspective. Restrictive policies may ultimately hurt the City by leaving it without options and unable to access needed funds to maintain essential infrastructure during difficult financial times.

Four of the five municipalities chosen by the City Auditor's staff for their analysis are "triple-A" rated issuers as opposed to "double-A" rated Honolulu. Selectively presenting supportive data and slanting the investigation to produce the desired outcome can prove any hypothesis or theory. In order to be meaningful, comparisons should be made to municipalities as similar as possible to the City and County of Honolulu. If not, the resulting interpretation may be misleading.

Idiosyncrasies make comparisons between municipalities difficult. For example, many municipalities are responsible for schools but Hawaii counties are not. Some cities and counties rely on sales tax or other forms of revenue and others, like those in Hawaii, depend on real property taxes. Therefore, while it is difficult to completely remove all dissimilarities, at a minimum, comparing municipalities within the same bond rating category strengthens the validity of the analysis. There are numerous counties across the United States with a "double-A" rating, including one in the State of Hawaii. The County of Maui is a "double-A" rated credit and nearly identical to Honolulu. Yet, the draft audit report seems to have chosen "triple-A" rated municipalities with debt limits stricter than Honolulu.

The draft audit report also fails to distinguish between debt limits set by policy and those mandated by statute when comparing the various counties. Bond rating agencies view policies very differently from statutes or laws. In general, bond raters have greater comfort with debt limits set by policy than those mandated by law. Debt limits established by law are inflexible and may compel issuers to make imprudent costly financial decisions to avoid violating those limits.

Audit comment: Page 15: Exhibit 2.2, Comparisons of Debt Service Limits in Other Municipalities

Response: The Exhibit contains a conspicuous error.

Under the column titled "GO Debt Principal Repayment Target, Honolulu's GO bonds should be limited to 25 years in accordance with the Hawaii State Constitution and not 30 years.

Exhibit 2.2 is inaccurate and misleading.

Exhibit 2.2, Comparisons of Debt Service Limits in Other Municipalities, includes municipalities markedly different from the City and County of Honolulu not only in its bond rating but also in critical areas such as the economy and revenue structure.

For example, the City of Portland, Oregon's (AAA) revenue mix is different from Honolulu and the growth of property tax and revenues are limited by Measure Five. Its policies are significantly more flexible than the draft audit report purports them to be. While the debt limitation of 0.75% of taxable assessed valuation is a policy, the debt service limit of equal to no more than 10% of general fund revenue is worded such that Portland will "strive to limit annual debt service" rather than a policy that disallows debt service over 10%. Similarly, the GO debt principal repayment target is a goal rather than a policy and is worded as the "City will strive to repay the principal amount of its long term debt at least 20% in five years and 40% in 10 years." Finally, Section VIII of its debt policies manual outlines four permitted types of refunding of Portland's indebtedness. The draft audit report cites the two types geared towards savings but omits the other two types of permitted refunding issuances. Those are (1) restructuring debt (savings target can be waived by debt manager) and (2) defease existing debt with open market securities.

For the City of Seattle, Washington (AAA), the draft audit report indicates voter approval is not required. However, State law requires voter approval for general obligations but not for limited general obligations. As a result, Seattle typically issues limited general obligation (LTGO) debt, which is substantially different than the City and County of Honolulu's general obligation bonds. Where Honolulu's general obligation bonds are truly backed by the full faith and credit of the City (with the City having the ability to raise taxes to pay for debt service if necessary), Seattle's LTGO bonds have a limited pledge as Initiative I-747 limits the Seattle's tax levying authority making the debt limitation somewhat more meaningful since the growth of assessed value is limited and the City's ability to garner revenues is likewise limited.

The City of Scottsdale, Arizona (AAA) is not a good comparison because it is a natural "triple A. Scottsdale is a bedroom community with very pricey retail stores and hotels, very similar to Beverly Hills and Palm Beach. Further, it is a difficult comparison because it has a completely different revenue structure from Honolulu, relying largely on sales tax as a revenue source. According to its website, Scottsdale also limits its debt to 20% like Honolulu.

Montgomery County, Maryland (AAA) is not a good comparison because it is also a natural "triple A". It is a very wealthy county with a high concentration of federal entities and workers providing a highly stable economy.

Audit comment: Page 16: "As Exhibit 2.2 shows, these municipalities' debt restrictions have not kept them from earning bond ratings equal to or higher than Honolulu."

Response: The audit comment is inaccurate and misleading.

Comparisons between "triple-A" rated municipalities (Portland, Seattle, Scottsdale and Montgomery County) and "double-A" rated Honolulu are pointless because the disparity is considerable, as noted earlier.

More importantly, the presence or absence of debt restrictions is not the sole nor is it the most important determinant of an issuer's bond rating. Bond raters evaluate four basic analytical areas.

1. The most critical area is the issuer's economy including such factors as demographics, income level of its citizens, tax base, diversity of its economic base, and economic volatility.
2. The area of administration assesses adherence to long-range financial plans, financial management, annual budget, capital improvement program, pension and employee benefits policies, real property tax administration, labor settlements, and litigation.
3. The area of financial performance and flexibility evaluates the issuer's accounting and reporting, examination of operating trends focusing on the structure of revenue and expenditure items, and pensions and other long-term liabilities.
4. The area of debt burden analyzes the nature of the pledged security, debt repayment structure, current debt service burden, and future capital needs.

Source: Standard & Poor's Public Finance Criteria

The draft audit report itself acknowledges that bond raters examine more than just the issuer's debt policies and debt management practices. On page 17, the draft audit report writes, "Fitch adds that management practices are important to predicting favorable credit performance. They can also add stability to weak credits, maximizing credit potential. Conversely, weak financial management can negatively affect even the strongest economies and local government structures." Fitch's statement is referring to the second analytical area in the list above.

Audit comment: Page 16: "Standard & Poor's also says that a debt burden is usually considered high when debt service payments represent 15 to 20 percent of combined operating and debt service fund expenditures. Thus, Honolulu's 20 percent debt service threshold is high, both in policy and in practice."

Response: The audit comment is inaccurate and misleading.

The audit comment included only a portion of Standard and Poor's opinion of the City's debt burden. It also omitted the analysis of Fitch Ratings and Moody's Investors Service, the other two firms that rate the City.

In its latest credit report on the City and County of Honolulu dated October 27, 2005, Standard & Poor's stated, "The city's **debt burden is moderate**, at \$1,810 per capita and 2.0% of AV, excluding self-supporting GO debt. The current issuance will refund existing obligations, and the anticipated ongoing capital plan is manageable. Annual general fund-related capital expenditures over the past two years have been \$134 million and \$147 million, respectively, lower than in prior years. In practice, the city's capital plan has been between 4% and 20% cash-funded, and annual debt service carrying costs have been relatively high, at approximately 19% of total general fund expenditures." (Attachment I)

On October 27, 2005, Fitch Ratings reported, "Honolulu's credit strength rests in the sound fundamentals of its tourism-based economy, good financial operations and reserves, **low debt burden**, and strong fiscal management." The report went on to say, "Expected annual issuance will increase debt levels, although they will remain affordable." (Attachment II)

Moody's Investors Service, on October 27, 2005, stated "Moody's expects that **Honolulu's debt levels will continue to remain manageable given reasonable borrowing assumptions** and the expectation of continued tax base growth in the near term." The report added "**Debt burden measures compare favorably to other cities and counties in the U.S.** with overall debt representing only 1.4% of fiscal 2006 taxable values." (Attachment III)

Audit comment: Page 17: "For example, California's bond rating increased from A to AA due to improved debt management practices, since every bond proposal is accompanied by a formal analysis of debt affordability."

Response: The audit comment is inaccurate and misleading.

In a Tax Supported New Issue report dated February 18, 2000, Fitch Ratings stated, "The rating upgrade takes into account the fundamental strengths of California, buttressed by the sustained favorable economy and financial operations." (Attachment IV) Then, in its Global Credit Research New Issue report dated September 7, 2000, Moody's Investors Service wrote, "The upgrade reflects the strength and diversity of a state economy that continues to exceed consensus growth expectations and comfortably outpaces the nation in terms of personal income and employment growth." The upgrade also reflected California's increased fiscal conservatism, specifically, management's "ability to resist spending onetime revenues on recurring expenses despite a \$9 billion windfall." (Attachment V) The debt management policy was ancillary to the other upgrade factors as the report mentioned that a debt management policy is anticipated to "potentially manage debt levels successfully" despite significant infrastructure needs and the state's inflexible budget structure. As indicated earlier, the most critical area for bond raters is the issuer's economy.

Fitch Rating's reason for California's upgrade validates earlier comments that bond raters consider many factors in arriving at their credit decisions. Those factors are:

1. The most critical area is the issuer's economy including such factors as demographics, income level of its citizens, tax base, diversity of its economic base, and economic volatility.
2. The area of administration assesses adherence to long-range financial plans, financial management, annual budget, capital improvement program, pension and employee benefits policies, real property tax administration, labor settlements, and litigation.
3. The area of financial performance and flexibility evaluates the issuer's accounting and reporting, examination of operating trends focusing on the structure of revenue and expenditure items, and pensions and other long-term liabilities.
4. The area of debt burden analyzes the nature of the pledged security, debt repayment structure, current debt service burden, and future capital needs.

Audit comment: Page 17: "However, fulfilling the city's original intent of greater efficiency and accountability remains elusive."

Response: The draft audit report fails to provide examples or evidence to support this finding. Also, the source of the statement is not identified.

The city's current debt operations are fragmented

Audit comments: Page 17: "Current debt-related responsibilities are fragmented and geared toward making payments on existing debt rather than managing and controlling overall debt."

Page 18: "Thus, no single entity claims ultimate responsibility for managing the city's debt."

Response: Debt-related responsibilities are not fragmented. The Department of Budget and Fiscal Services has overall responsibility. Various components of BFS along with other City agencies provide specific functions in support of that responsibility, including the budget process where the management of debt is an integral part.

The audit comments may stem from inconsistencies between the objective and scope of the audit work, where both are not well defined, and the audit methodology used. There appears to be a stated audit objective of "review and assess the city's debt service practices" and an implied audit objective of examining "a comprehensive, unified debt management program and a strategic plan to provide future direction" and the "managing and controlling of overall debt." There is a clear difference between debt service practices that focus on issuing, selling, paying interest on and redeeming bonds of the city as opposed to managing and controlling the City's overall debt that involves policy-setting, planning and decision-making.

Audit comments and conclusions rely on the audit methodology to be consistent with the audit scope and objective. In the draft audit report, the manner in which the City Auditor's staff conducted the audit may not have been suitable to the audit objective. The City Auditor's staff only interviewed those employees assigned responsibilities related to the issuing, selling, paying interest on and redeeming bonds of the city. Understandably, those interviews would just disclose information on day-to-day operations such as "making payments on existing debt." Limiting interviews only to the employees assigned those responsibilities would have been congruent with the audit objective of reviewing and assessing the City's debt service practices.

However, if the audit objective of the City Auditor's staff was to examine "a comprehensive, unified debt management program and a strategic plan to provide future direction" or the "managing and controlling overall debt," then discussions with the policy-setters and decision-makers who manage and control the City's overall debt through the adoption of a capital budget that approves capital appropriations may have been more consistent.

As for the audit comment that "no single entity claims ultimate responsibility for managing the city's debt," if it is referring to debt service practices, then that entity is the Department of Budget and Fiscal Services where the City Charter Section 6-203(f) states the Department of Budget and Fiscal Services has the responsibility for "issuing, selling, paying interest on and redeeming bonds of the city." Then again, if it means "a comprehensive, unified debt management program and a strategic plan to provide future direction" or the "managing and controlling overall debt," the responsible parties would be the policy setters. The adoption of the capital budget approves the capital appropriations resulting in capital expenditures requiring bond proceeds that add to the City's debt and debt service payments.

Audit comment: Page 18: "Accounting Division administrators may question expenditures that appear to be exceptions to the debt policy. A letter from the department's director with appropriate justification is filed with individual requests, but such exceptions are not routinely monitored or reported."

Response: The Accounting Division routinely monitors expenditures for exceptions to the debt policy, takes the necessary action including disapproval of payment requests, and solicits advice from the Fiscal/CIP Administration Division when warranted.

Audit comment: Page 18: "The department submits its capital budget directly to the budget and fiscal services department director."

Response: More accurately, the department submits its capital budget to the Department of Budget and Fiscal Services in consultation with the Department of Design and Construction.

Audit comment: Page 18: "Once agency requests are received from the Department of Design and Construction:"

Response: The audit comment should include the Department of Environmental Services and the Department of Transportation Services in addition to the Department of Design and Construction.

Audit comment: Page 18: "1. The Fiscal/CIP Division evaluates the requests and recommends capital project priorities to the mayor's office. This division also evaluates information from bonds issued to determine deviations from projected and budgeted amounts, which are taken into account in the next bond issue."

Response: The audit comment is inaccurate.

The Fiscal/CIP Division receives, reviews and recommends capital projects for the Director of Budget and Fiscal Services who in turn evaluates, prioritizes and submits them to the Managing Director and the Mayor. In addition, the Fiscal/CIP Division analyzes information from bonds issued to determine deviations from projected and budgeted amounts, as well as indicates the sources of funding for each capital project in drafting the capital budget submitted to the City Council. The City Council reviews, amends and adopts the capital budget ordinance and the bond ordinance authorizing the issuance of general obligation bonds for the total amount identified in the capital budget as funded by general obligation bonds.

Audit comment: Page 18: "2. The Treasury Division monitors the city's cash needs and determines the amount of debt needed to meet obligations in the upcoming fiscal year. Once the city council passes the capital budget ordinance and resolution authorizing the bond issuance for the total amount needed, the Treasury Division executed the bonds with assistance from contracted financial firms."

Response: The audit comment is inaccurate.

First, the Treasury Division does **not** "determine the amount of debt needed to meet obligations in the upcoming fiscal year." The capital budget ordinance for

the fiscal year identifies the funding sources and appropriates funds for all of the capital projects contained in it.

Second, the city council adopts the capital budget ordinance and a bond authorization ordinance that authorizes the issuance of general obligation bonds for the projects in the capital budget with that particular funding source.

The Treasury Division manages the City's cash and ensures liquidity of the improvement bond funds by arranging short-term financing (tax-exempt commercial paper) as needed to meet liquidity needs. When the outstanding balance of tax-exempt commercial paper approaches the \$250 million program ceiling, a resolution to issue long-term bonds is submitted to the City Council for approval. Upon the approval of the resolution, long-term bonds are issued and the proceeds are used to refund the outstanding tax-exempt commercial paper.

Audit comment: Page 19: "3. After bond proceeds are received, the Treasury Division distributes the bond funds among the city's various accounts as appropriated, and the Accounting Division posts the appropriate amounts within the accounts, as well as recording expenditures from those accounts."

Response: The audit comment is inaccurate.

The Treasury Division deposits the bond proceeds into the appropriate funds, and the Accounting Division posts the appropriate amounts within the accounts, as well as recording expenditures from those accounts."

Audit comment: Page 20: Exhibit 2.3, The City's Debt Process

Response: Exhibit 2.3 is inaccurate.

It illustrates not only the City's debt process but also its capital expenditure process.

Fifth box in the first column

The City Council adopts a capital budget ordinance that appropriates funds to certain capital projects and a bond authorization ordinance that authorizes the issuance of general obligation bonds for those projects in the capital project funded by general obligation bonds.

Third box in the second column

The Treasury Division manages the City's cash and ensures liquidity of the improvement bond funds by arranging short-term financing (tax-exempt commercial paper) as needed to meet liquidity needs. When the outstanding balance of tax-exempt commercial paper approaches the \$250 million program ceiling, a resolution to issue long-term bonds is submitted to the City Council for approval. Upon the approval of the resolution, long-term bonds are issued and the proceeds are used to refund the outstanding tax-exempt commercial paper.

Fifth box in the second column

The Treasury Division of the Department of Budget and Fiscal Services determines the actual bond issue size and submits a bond resolution to City Council for approval.

Second box in the third column

If bond proceeds are deposited into the City Treasury, then the Treasury Division invests the funds.

Please note that if the bond issue is a refunding, proceeds are deposited with an escrow agent. Bond underwriters do not assist with the investment of bond proceeds deposited into the city treasury.

Third box in the third column

Tax-exempt commercial paper proceeds and bond sale proceeds (if available) are deposited in the City Treasury. Payments may be made from long-term bond proceeds to redeem outstanding tax-exempt commercial paper, if provided for in the bond resolution.

The sequence of the second and third boxes in the third column should be switched.

The fourth box in the third column should be deleted because Treasury does not allocate bond proceeds to various funds according to budget ordinances.

Audit comment: **Operations focus on day-to-day, not comprehensive debt management**
Page 21: "Administrators responsible for debt from budget and fiscal services and environmental services cite the city's debt policies as the only policies and procedures guiding departments on the city's debt management."

Response: The audit comment may stem from inconsistencies between the objective and scope of the audit work, where both are not well defined, and the audit methodology used.

As mentioned earlier, there appears to be a stated audit objective of "review and assess the city's debt service practices" and an implied audit objective of examining "a comprehensive, unified debt management program and a strategic plan to provide future direction" and the "managing and controlling of overall debt." There is a clear difference between debt service practices that focus on issuing, selling, paying interest on and redeeming bonds of the city as opposed to managing and controlling the City's overall debt that involves policy-setting, planning and decision-making.

Audit comments and conclusions rely on the audit methodology to be consistent with the audit scope and objective. In the draft audit report, the manner in which the City Auditor's staff conducted the audit may not have been suitable to the audit objective. The City Auditor's staff only interviewed those employees assigned responsibilities relating to the issuing, selling, paying interest on and redeeming bonds of the city. Understandably, those interviews would just disclose information on day-to-day operations such as "making payments on existing debt." Limiting interviews only to the employees assigned those responsibilities would have been congruent with the audit objective of reviewing and assessing the City's debt service practices.

However, if the audit objective of the City Auditor's staff was to examine "a comprehensive, unified debt management program and a strategic plan to provide future direction" or the "managing and controlling overall debt," then discussions with the policy-setters and decision-makers who manage and control the City's overall debt through the adoption of a capital budget that approves the capital appropriations may have been more consistent.

If by "comprehensive debt management" the audit report means the issuing, selling, paying interest on and redeeming bonds of the city, then the Department of Budget and Fiscal Services (BFS) continually evaluates the City's debt

portfolio seeking opportunities to reduce debt service expenditures. The Series 2004B and Series 2005BC&D bond issues refunded high interest rate bonds for lower interest rates generating present value savings of \$13 million. Furthermore, when interest rates were declining, BFS chose variable rate debt instruments for its Series 2000A&B (weekly reset) and Series 2001C (annual reset) bond issues, thereby lowering the City's debt service payments by an estimated \$44 million. The City benefited from extremely low variable rates where, on its Series 2000A&B bonds, weekly rates ranged from 0.60% to 5.00% as opposed to 5.78% if it had issued its customary long-term fixed rate bonds and, on its Series 2001C bonds, annual rates ranged from 1.18% to 2.85% as opposed to 4.80%.

In addition, through effective asset-liability management, BFS mitigated borrowing costs by using the tax-exempt commercial paper program for interim financing. Previously, the City issued long-term bonds for capital projects in design or construction and invested the proceeds in short-term securities until spent resulting in the City paying interest at the higher long-term rates while earning interest at the lower short-term rates. Generally, by improving the matching of maturities between investments (assets) and debt (liabilities), the City hedges itself against interest rate risk because as short-term rates on debt rise or fall so do short-term rates on investments.

Audit comment: Page 21: "However, the policies have no provisions for overall administration, operations, duties and responsibilities for data gathering, debt analysis, planning, reporting or monitoring."

Response: Resolutions 03-59, CD1 and 98-197, CD1 were meant to serve as general rules or guidelines and not intended to prescribe administrative procedures.

Audit comment: Page 21: "Without specific parameters regarding acceptable exceptions, the city leaves itself open to treating cash shortages as "emergencies" or "unusual circumstances", thereby allowing liberal use of CIP funds for salaries and equipment. Financing such items with bonds roughly doubles the cost of such items compared to paying with cash. In addition, budgeting for such expenditures under the guise of a capital project enables them to undergo less scrutiny than if they were paid for with operating funds."

Response: The draft audit report fails to provide examples or evidence to support this finding. Capital Improvement Program (CIP) funds for salaries and equipment are subject to appropriation by the City Council and, therefore, are not without oversight. It receives greater scrutiny because it is not part of regular expenditures.

Debt-related responsibilities are concentrated between two administrators with inexperienced staff

Audit comment: Page 21: "At the city, only two administrators have comprehensive institutional knowledge, direct experience and a concentration of responsibilities with regard to the city's largest bond issuances: the chief of the Treasury Division for general obligation bonds and the executive assistant for the Department of Environmental Services for wastewater revenue bonds."

Response: The Department of Budget and Fiscal Services (BFS) has the responsibility under the City Charter Section 6-203(f) for "issuing, selling, paying interest on and redeeming bonds of the city." BFS interprets that to mean managing the

process for the issuance of all City bonds including Wastewater System Revenue Bonds and Water System Revenue Bonds. Both the Department of Environmental Services (ENV) and the Board of Water Supply work with BFS to issue and sell Wastewater System Revenue Bonds and Water System Revenue Bonds, respectively.

Therefore, the chief of the Treasury Division also has "comprehensive institutional knowledge, direct experience and a concentration of responsibilities" relating to the issuance and sale of Wastewater System Revenue Bonds and Water System Revenue Bonds.

Audit comment: Page 21 to 22: "Although the city relies heavily on these two administrators and has a significant investment in the appropriate execution of their duties, there is no formal succession plan or continuity provision should either of these administrators cease their employment with the City."

Response: While portions of the audit comment may have merit, succession and continuity is a problem throughout the City and at other jurisdictions. The civil service system bars guaranteed succession, as it requires that all recruitment be competitive.

In addition, in the highly specialized discipline of tax-exempt bonds, the State of Hawaii has only three employees dedicated to this area and the other counties (Hawaii, Kauai and Maui) have only one employee each.

The City created the Treasury Debt Analyst classification in an attempt to provide more expertise in this area.

For the Department of Environmental Services (ENV), on-the-job training, written materials and offsite training when available are provided to two members of the ENV staff who support the Executive Assistant in financial matters.

Audit comment: Page 22 to 23: "Within the Treasury Division there is a funded position for an assistant chief of treasury that would oversee both accounts receivable as well as the cash and debt management branches. The position has been vacant since 1998. . . . Lack of qualified applicants has made the filling of this vacancy difficult."

Response: Investment and financing professionals are extremely well compensated in the private sector, making it difficult to attract qualified people especially when the City's salaries are far from competitive.

In addition, position classifications are not exactly appropriate for the assigned duties because accountant classifications, as opposed to finance classifications, are used for positions responsible for cash management, investments and debt administration. Accounting professionals and finance professionals are different in education, skills, experience, training and credentials. Accounting professionals do not necessarily convert well into finance professionals and vice versa.

Audit comment: Page 23: "While the Department of Environmental Services relies on the design and construction department for project planning, design and construction, the environmental services department bypasses the Fiscal/CIP Division and

submits its budget for wastewater projects directly to the budget and fiscal services department director.”

Response: The Department of Environmental Services (ENV) relies on the sewer funded staff in the Department of Design and Construction for project planning, design and construction and submits its capital improvement budget to the Department of Budget and Fiscal Services (BFS) in consultation with the Department of Design and Construction. The Fiscal/CIP Division of BFS receives, evaluates and recommends the ENV capital budget to the BFS Director.

Audit comment: Page 23: “If wastewater projects are funded with bonds, the Fiscal/CIP Division would evaluate environmental services’ projects to determine whether they follow the debt policy. However, Fiscal/CIP’s evaluations and subsequent analyses have been compromised in the past by lack of timely and complete information from the environmental services department.”

Response: The Fiscal/CIP Division and the Department of Environmental Services (ENV) evaluate ENV’s capital budget as part of the annual budget process to determine that it meets requirements of the Wastewater Financial Policy. The Fiscal/CIP Division is provided information, as it is available, mindful that all information, operating and capital, are being modified and revised during the budget process.

Audit comment: Page 23 to 24: “The administrator in charge of environmental services’ budget and debt states that the department prepares its own debt affordability analysis before the budget process and incorporates debt into its operating budget. Currently, the department works mostly with the Fiscal/CIP Division regarding general obligation debt incurred before the wastewater system became an enterprise. However, the division contends that because the mayor makes the ultimate decision to increase revenue by proposing higher sewer rates, the wastewater enterprise should not consider itself totally independent from other city departments.”

Response: As part of the budget process, the Department of Environmental Services works with the Fiscal/CIP Division to insure that data used on all debt is consistent and their understanding of compliance with debt policy are the same. It is true that the Mayor makes the final recommendation regarding budgets and sewer rate changes submitted to the City Council. The City Council has the final approval on both.

Audit comment: The last paragraph on page 25 of the draft audit report.

Response: There may be a possible legal problem with the audit comment on page 25 of the draft audit report. The City Auditor’s Office may wish to check with their attorneys.

Audit comment: Page 26: “This lack of experience falls short of the city’s minimum qualifications for the treasury debt analyst position.”

Response: The audit comment is inaccurate and misleading.

It may also raise labor relations issues due to the public discussion of the employee’s qualifications particularly since there is only one position within the entire City in that classification.

The allegation that a Treasury Division employee's experience "falls short of the city's minimum qualifications" for the position is totally groundless. The City has strictly enforced recruitment and selection procedures in accordance with civil service laws. Any applicant for a civil service position must be examined and qualified by human resource specialists before interviews are held. Once a selection is made, human resource specialists conduct an evaluation to ensure compliance with all civil service rules and regulations.

Audit comment: Page 26: "Exacerbating this shortage of expertise is a similar lack of experience in the cash and debt manager, who is supposed to provide general supervision to the treasury debt analyst. The employee currently occupying this position has been in place since January 2005 but continued to perform previous duties as revenue collection administrator until June 2005."

Response: The audit comment is inaccurate and misleading.

As previously explained, the lack of experience may be attributable to position classifications that are not exactly suitable to the assigned duties because accountant classifications are used for positions responsible for cash management, investments and debt administration. The inability to attract applicants with investment and financing experience, due to the disproportionate compensation between the public and private sector, coupled with the use of the accounting classifications results in the hiring of accounting professionals who demonstrate potential to perform the required duties.

More importantly, at the time the audit was conducted, the Treasury Division was experiencing an unusual number of staffing changes and absences in its professional level positions. Staffing shortages necessitated the prioritization of tasks to ensure that critical work was accomplished on time. The employee was trained on only essential, time-sensitive duties of the Cash and Debt Management Branch of the Treasury Division until June 2005, when a replacement was hired for the revenue collections administrator position.

No comprehensive debt management program is planned

Audit comment: Page 27: "However, none of the city administrators we interviewed articulated that the city has established or plans to establish a comprehensive debt management program concerned with the impact of debt on current operations, debt planning and assessment, or accountability for the use of monies obtained from bond issuances."

Response: Debt management is an integral part of the budget process with its multi-year projections and six-year capital program.

The draft audit report concluded that the City has not established and does not plan to establish a "comprehensive debt management program" because "none of the city administrators" articulated as much. However, no one interviewed by the City Auditor's staff was asked any questions about that topic.

In addition, the City Auditor's staff only interviewed those employees assigned responsibilities relating to the issuing, selling, paying interest on and redeeming bonds of the city. Understandably, those employees may not have been privy to such plans. However, discussions with policy-setters and decision-makers who

manage and control the City's overall debt by adopting the capital budget and making capital appropriations may have resulted in different conclusions.

Audit comment: **Debt-related reports are inadequate and hinder accountability**
Page 27: "The city's FY2005-06 Executive Program and Budget reports that debt service payments are expected to exceed the city's affordability threshold of 20 percent of the operating budget by 2007-08. The threshold is cited within the city's debt policies as a debt affordability measure, but in effect places an annual cap on payments for debts already incurred, rather than acting as a tool with which to measure and manage the city's entire debt."

Response: The audit comment is inaccurate and misleading.

Section III.G of Resolution 03-59, CD1 of the City's debt and financial policies, states "The City shall establish affordability guidelines in order to preserve the credit quality. Guidelines, which may be suspended for emergency purposes or because of unusual circumstances, are as follows:

1. Debt service for general obligation bonds including self-supporting bonds as a percentage of the City's total operating budget, including enterprise and special revenue funds, should not exceed 20 percent.
2. Debt service on direct debt, excluding self-supported bonds, as a percentage of General Fund revenue should not exceed 20 percent." (Attachment VI)

A guideline is defined as a statement of general policy. Contrary to the Audit comments, the "threshold" does not place "an annual cap on payments for debts already incurred." As a guideline, it is "a tool with which to measure and manage the city's entire debt."

Audit comment: Page 27: "In the absence of periodic reporting and analyses containing other benchmarks, the city cannot reliably determine whether it is managing its debt beyond this measurement. Without a comprehensive debt management program, the city's focus is limited to maximizing annual spending without exceeding debt limits."

Response: The draft audit report fails to provide examples or evidence to support this finding and it does not suggest what periodic reporting and analyses relating to specific benchmarks should be reported.

Audit comment: Page 27: "Existing debt-related communications provide no framework for reporting progress toward achieving specific goals or future plans to address concerns."

Response: The draft audit report fails to provide examples or evidence to support this finding.

Audit comment: Page 28: "While the department develops a number of reports, its own staff members recognize that not all reports are reader-friendly. In addition, they acknowledged that the various reports are delivered in such piecemeal fashion that they do not appear to facilitate the city council's decision-making."

Response: None of those involved in the audit from the Department of Budget and Fiscal Services and the Department of Environmental Services recalls making such an acknowledgement.

Audit comment: Page 28: "In the absence of specific legislation pertaining to elements of a comprehensive debt report, the council can anticipate such piecemeal reporting will continue."

Response: The audit comment is inaccurate and misleading.

The elements of a comprehensive debt report are not defined. Further, the council does not need legislation to request reports or information. Often, reports required by law continue to be prepared using valuable resources only to be filed without review or they lose their usefulness over time as priorities and circumstances change.

Audit comment: **Accountability for practices that violate the city's debt policy is limited**
Page 29: "The policies do not require reporting of individual or aggregated instances; nor do they require the city to track actual expenditures of "operational costs", such as personnel costs."

Response: The audit comment relates to budgetary appropriations. Reports on budgetary variances and expenditures are available. For example, the Finance Director's Quarterly Report is submitted to the City Council.

Audit comment: Page 30: "None of the budget and fiscal services department administrators indicated any future plans to return to paying any or all salaries with operating funds. Neither budget and fiscal services nor the Department of Design and Construction mentioned any plan to return to using operating funds for salaries once the city's economic condition improves. We maintain that while allowable under the city's debt policy, the city should work toward alternatives to funding salaries with bond funds and thus limit unnecessary additions to the city's debt service."

Response: No one interviewed by the City Auditor's staff was asked the question about "future plans to return to paying any or all salaries with operating funds" or "any plan to return to using operating funds for salaries once the city's economic condition improves" as described in the audit comment. Nevertheless, the draft audit report determined that such plans were not being contemplated because those interviewed did not talk about it.

Further, general obligation bond proceeds are only being used for the purpose provided for in Section II.A.1 of City's "Debt and Financial Policies" of Resolution 03-59, CD1, where it states "Contracts to hire engineering and design professionals under a personal services contract with a definite termination date may be included." (Attachment VI)

Audit comment: Page 31: "The city's current recordkeeping and tracking system makes it difficult to identify whether expenditures comply with these policies. During our audit, the Department of Budget and Fiscal Services' Accounting Division created a customized computer program to extract information from the city's accounting system, showing that expenditures below \$5,000 are not routinely monitored for compliance with the debt policy."

Response: The audit comment is inaccurate.

The recordkeeping and filing system used by the accounts payable and fiscal sections allow the Accounting Division staff to locate source documents such as contracts, requisitions and purchase orders.

Audit comment: Page 31 to 32: "These include:

- teak furniture for the Honolulu Zoo Employee Lounge valued between \$170 and \$1,595 each, \$140 for 10 packages of teak cleaner;
- various power tools ranging from an impact wrench (\$233), 29-piece socket wrench set (\$770), cordless drill (\$161), and a one-half inch drill (\$125),
- 20 mountain bikes that cost \$1,132 each for the Honolulu Police Department;
- volleyball equipment, including 10 carts at \$260 each, 11 sets of volleyball equipment-including nets, pads, boundary tape, antennas, aggregated with referee stands for district parks totaling \$55,076 for the Department of Parks and Recreation; and
- quarterly payments for Pitney-Bowes machines of \$353 and \$363."

Response: The Department of Budget and Fiscal Services will be reviewing the processes to procure equipment funded with capital budget appropriations to ensure compliance with the Debt and Financial Policies. Specific items, such as the HPD mountain bikes, were purchased in accordance with City Council approved changes to the list of equipment submitted by HPD. We consider changes approved by the City Council to the capital budget appropriations for equipment as authorization by them to purchase such equipment, albeit contrary to the Debt and Financial Policies.

Audit comment: Page 32: "Furthermore, the decision to use cash or borrowed funds depends on prioritization of needs and is ultimately made by the mayor and the budget and fiscal services director. If they determine that a project or equipment is needed, the city is obligated to provide the funding for it. This rationale excludes departments from being involved in discussions regarding what the city can afford prior to deciding whether to build projects or acquire specific equipment."

Response: The audit comment is inaccurate and misleading.

If a project or equipment is determined to be needed, the city is not "obligated to provide the funding for it" but it would be prudent to fund it. Also, the departments are involved in discussions regarding "what the city can afford prior to deciding whether to build projects or acquire specific equipment." Moreover, this audit comment contradicts the representations made in the fourth box under the first column in Exhibit 2.3, The City's Debt Process of the draft audit report that states "Administration, BFS, DDC and ENV determine overall capital budget proposal and proposed aggregate amount of debt needed to finance projects."

The City's Reliance on the Same Underwriters for Negotiated Sales Raises Concerns of Conflict of Interest and a Potentially Costly Impact

Audit comment: Page 32: "In the future, these services may extend to training for inexperienced Treasury Division staff."

Response: The audit comment is inaccurate and misleading.

The City Auditor's staff appears to have confused comments made about investment activities with those of bond and debt responsibilities. The two activities, investment versus bond and debt, are separate and distinct.

It was never Treasury's intention to have the underwriters train its staff.

Audit comment: Page 32: "However, both the Government Finance Officers Association and independent academic researchers recommend the use of competitive sales because they provide greater accountability and cost-effectiveness than negotiated sales."

Response: The audit comment is inaccurate and misleading.

The Government Finance Officers Association (GFOA) does not explicitly recommend the use of the competitive method of sale. GFOA states, "It is in the interest of state and local government issuers to sell public debt using the method of sale that is expected to achieve the best sales results, taking into account both short-range and long-range implications for taxpayers and ratepayers. However, there is a divergence of views as to the relative merits of the competitive and negotiated methods of sale due to the lack of comprehensive, empirical evidence that would favor one method over the other."

GFOA goes on to recommend "If state and local governments are able to choose their method of bond sale, the Government Finance Officers Association (GFOA) recommends that policies be adopted to ensure that the most appropriate method of sale is selected in light of financial, market, and transaction-specific and issuer-related conditions; the method of sale is evaluated for each bond issue, including an assessment of different risks associated with each method; and thorough records are kept about the process to demonstrate that it was equitable and defensible." (Attachment VII)

Clearly, GFOA does not definitively state that it "recommends the use of competitive sales because they provide greater accountability and cost-effectiveness than negotiated sales" as represented in the draft audit report.

Audit comment: Page 33: "Moreover, the practice of using underwriters as financial advisors presents a conflict of interest according to the Municipal Securities Rulemaking Board (board)."

Response: The audit comment is inaccurate, misleading and makes unsubstantiated representations. It fails to establish with evidence or examples that the City used underwriters as financial advisors.

The Municipal Securities Rulemaking Board (MSRB) Rule G-23 specifically states "For the purpose of this rule, a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services.

Notwithstanding the foregoing, a financial advisory relationship shall not

be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.”
(Highlighted for emphasis.) (Attachment VIII)

The City never used underwriters hired for a negotiated sale as financial advisors on that same sale. Based on MSRB Rule G-23, the underwriters hired by the City are clearly in the group where “a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.” Therefore, **no** conflict of interest exists.

Audit comment: Page 33: “The competitive process affords an issuer some assurance that bonds are sold at the lowest interest cost given market conditions on that particular day. Competition provides an incentive for underwriters to submit the most aggressive bid at which they expect to be able to successfully market bonds to investors.”

Response: The audit comment is misleading.

The competitive process merely assures the issuer that it received the lowest interest cost from among all of the bids received for its bonds and **not** the “lowest interest cost given market conditions on that particular day” as the audit comment maintains. The bids received by an issuer may not represent the market because not all market participants submit bids. With the competitive sale method, the number of bids and the type of bidders have a significant effect on the interest rates an issuer will pay on its bonds and the relationship of those rates to the market. Both the number of bids received and the type of bidders are beyond the control of the issuer in the competitive sale method.

One criticism of the negotiated sale method made by the draft audit report is that “underwriters sell bonds to another set of clients-investors. It is easier to sell bonds to investors if the investment yield is higher. Unfortunately, higher investment yields for investors mean higher borrowing costs for issuers, such as the city. Issuers must understand that underwriters are working simultaneously with two different clients when underwriting a bond issue-the issuer and investors. When it comes to pricing bonds, the incentives of these two parties are in direct opposition.” However, that same shortcoming is present in the competitive sale method as indicated by the audit comment that underwriters “submit the most aggressive bid at which they expect to be able to successfully market bonds to investors.”

Underwriters consider their ability to market the bonds to investors whether the bonds are purchased through a competitive or negotiated sales method. Therefore, the most “aggressive bid” does not necessarily translate into the lowest interest costs. In the competitive process, each underwriter will balance the interest rate at which it will be able to successfully market the bonds to investors with the interest rate at which it will be able to win the bid. Underwriters in the negotiated process have the same objective to achieve the lowest borrowing cost for the issuer while offering interest rates at which investors are willing to purchase the bonds.

Audit comment: Page 34: "Interviews with industry professionals revealed that the frequency of Honolulu's twice yearly bond issuances, general obligation bonds backed by unlimited taxing ability, and wastewater revenue bonds backed by revenues from an essential service in which the city has a virtual monopoly, are neither rare nor unfamiliar to the municipal bond market, neither risky nor complicated as to require extensive education of potential investors."

Response: The audit comment is inaccurate and misleading.

Throughout the draft audit report, references are made to "industry professionals" and "industry experts" whose identities and occupations are never revealed. If these "industry professionals" and "industry experts" are in fact financial advisors, then their observations may be slanted and biased because they would be the biggest beneficiaries if more issuers used the competitive sale method.

GFOA advises the issuer to ensure that the most appropriate method of sale is selected in light of financial, market, and transaction-specific and issuer-related conditions. (Attachment VII) Those considerations must be analyzed inclusively and not discretely as this and the following audit comment does.

In addition, the audit comment is concerned only with the obvious, ignoring other significant considerations. For example, it neglects the bond issue's size, timing and structural concerns, given that all of the bonds issued by the City during the period under audit had a refunding component and the municipal bond market was extremely volatile, with the Federal Reserve raising interest rates nearly monthly over the past 18 months or so.

Audit comment: Page 34: "One finance director said that even a smaller locality that issues bonds every six or seven years could use a competitive sale method and still educate the market prior to a sale using conference calls (for example) to disclose needed information and allow potential investors to ask questions."

Response: The audit comment is inaccurate and misleading.

Once again, the draft audit report focuses on a single aspect of an issue to the exclusion of all other facets and determines that the competitive sale method can be used because one of the seven conditions is met.

While any issuer can use the competitive sale method to sell its bonds, the overriding consideration is whether or not that approach is expected to achieve the best sales results in light of financial, market, and transaction-specific and issuer-related conditions. (Attachment VII) Further, the likelihood a "smaller locality" that "issues bonds every six or seven years" would possess the necessary knowledge and expertise to sell its bonds competitively is questionable.

Audit comment: Page 34: "The issuer negotiates a purchase price for the bonds with the underwriter at the time the bonds are sold."

Response: Negotiation with the underwriter is a dynamic and involved process that, for the City, generally begins with a pre-sale order period for retail buyers. During that period, retail buyers, particularly Hawaii residents, have an exclusive opportunity to buy bonds in advance. Typically, retail buyers are willing to accept a lower

yield than institutions and set the basis for the interest rate scale on the day of pricing usually held on the subsequent day.

Then, on the day of pricing, the underwriters offer the bonds to institutional buyers in the primary market at an interest rate scale agreed upon by the City. After a period of time, the City and the underwriters assess the orders and adjust the interest rates, if warranted, for over- and under-subscribed maturities. The underwriters return to the institutional buyers with the adjusted interest rate scales and again solicit orders. The process is repeated throughout the day until the City and the underwriters can agree to a purchase price.

In contrast, on the day of pricing, competitively sold bonds are put out to bid with the maturities, maximum coupons, maximum original issuer's discount or premium, ascending rate, bid date and time, and other relevant information. Interested underwriters submit their bids that are tabulated either by the issuer or the financial advisor. The bonds are awarded to the underwriter offering the lowest bid that meet the terms of the sale.

Audit comment: Page 34: "However, members of the Government Finance Officers Association (GFOA) debt committee whom we interviewed disagree that refunding is too complicated for a competitive sale."

Response: Generally, advance refundings, the type of refundings executed by the City in its last three issues, are done for savings. It is a complex transaction because it involves two fluctuating pieces; the tax-exempt municipal bond market and the securities market for either State and Local Government Securities referred to SLGS or U.S. Treasury securities. These SLGS or U.S. Treasury securities are placed in an escrow account that is used to redeem the refunded bonds. Both pieces have a direct effect on the present value savings of the refunding. If one or both pieces become unfavorable, then the savings target for the refunding may not be met.

Audit comment: Page 34: "One finance director said that all eight refunding issues his county has done over the last six years had been done competitively, and the county exceeded its saving targets every time."

Response: It is not clear if the unidentified finance director indicated that if the savings target could not be achieved the bonds would not have been sold. Also, there is no indication of how many times the bonds were put out for bid and not sold because the savings target could not be met.

Audit comment: Page 34: "A debt manager said that while their county had used negotiated sales for bonds that were tied to complex property tax laws needing more detailed explanation to investors, a recent first attempt at using the competitive method for the same type of complicated bond had been successful."

Response: The audit comment is inaccurate and misleading.

Once more, the draft audit report focuses on a single aspect of an issue to the exclusion of all other facets and finds that the competitive sale method can be used because one of the seven conditions is met.

While any issuer can use the competitive sale method to sell its bonds, the overriding consideration is whether or not that approach is expected to achieve

the best sales results in light of financial, market, and transaction-specific and issuer-related conditions. (Attachment VII)

It is unclear if the unidentified debt manager provided any basis for the determination that the bond sale was "successful." It could have been because he was able to sell all the bonds, or because the bonds were sold at low interest rates as compared to other sales of the day, or because numerous bids were received, or all of these factors.

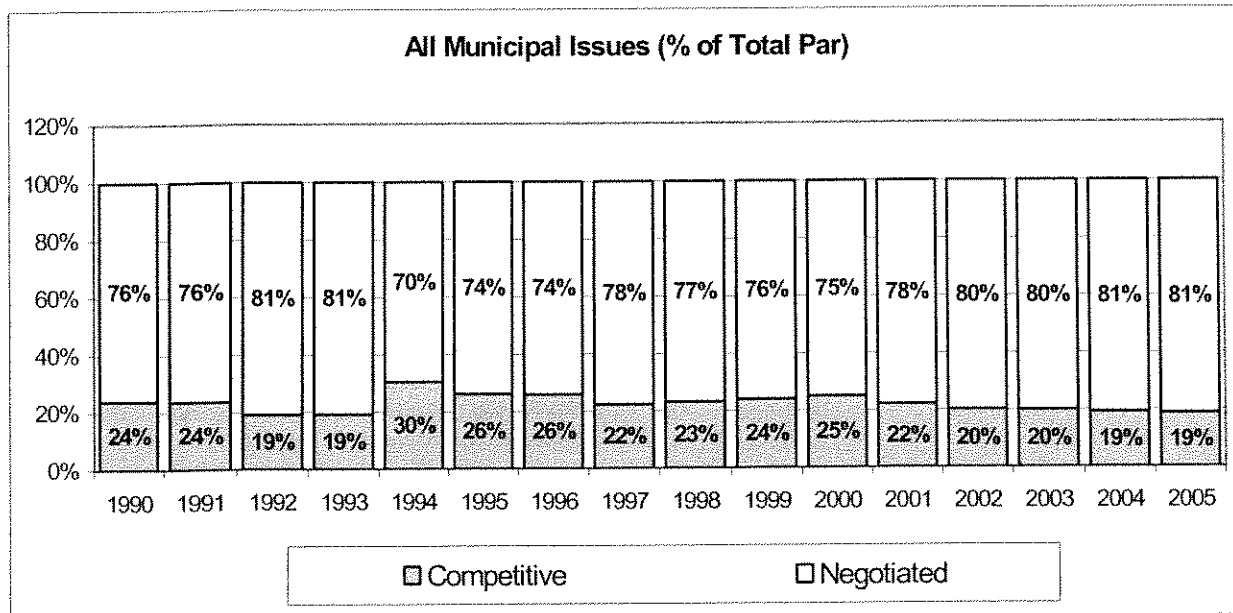
The city's use of non-competitive bond sales is potentially costly

Audit comment: Page 35: "The GFOA recommends that the competitive method of sale be chosen when conditions favoring this method are present, such as the market's familiarity with the issuer; a credit rating of A or better; and debt backed by the issuer's full faith and credit (i.e., general obligation bonds) are present."

Response: The audit comment is misleading and fails to provide evidence to support the conclusion that the City's use of non-competitive bond sales is potentially costly.

Contrary to the audit comment, the Government Finance Officers Association (GFOA), admits "It is in the interest of the state and local government issuers to sell public debt using the method of sale that is expected to achieve the best sales results, taking into account both short-range and long-range implications for taxpayers and ratepayers. However, there is a divergence of views as to the relative merits of the competitive and negotiated methods of sale due to the lack of comprehensive, empirical evidence that would favor one method over the other" and goes on to advise issuers "to ensure that the most appropriate method of sale is selected in light of financial, market, and transaction-specific and issuer-related conditions." (Attachment VII)

The debate over whether the competitive bond sale method is superior to the negotiated bond sale method has been going on for decades. Over time, the trend has been toward the negotiated bond sale method. As you can see, since 1990, negotiated sales have surpassed competitive sales by a large margin. Can all of these issuers be doing it wrong?



Source: Securities Database Company

Audit comment: Page 35: "Based on research and interviews with administrators both in Honolulu and other municipalities, we found that the city meets all of these conditions, as shown by Exhibit 2.4."

Response: The audit comment is inaccurate and misleading.

The administrators in Honolulu were never interviewed on the items in Exhibit 2.4.

Audit comment: Page 35: Exhibit 2.4, Seven Conditions Favoring Competitive Bond Sales

Response: The audit comment is inaccurate and misleading.

Condition 2: There is an active secondary market with a broad investor base for the issuer's bonds.

The condition refers to the "secondary market" while the Administration's statement relates to the "primary market."

Condition 5: The issue is neither too large to be easily absorbed by the market nor too small to attract investors without a concerted sales effort.

Absent absolute amounts that define "too large" or "too small," Condition 5 is nebulous and discretionary. In addition, the supposition that bond sales ranging from \$152.8 million to \$371.8 million can be "easily absorbed" because the municipal bond market is \$2 trillion is inaccurate. The tax-exempt municipal bond market's ability to absorb bonds offered for sale varies minute-to-minute, hour-to-hour, day-to-day. Instead of the size of the market, a better determinant of whether an issuer's bonds can be "easily absorbed" is the appetite of the purchasers of those bonds.

Condition 7: Interest rates are stable, market demand is strong, and the market is able to absorb a reasonable amount of buying or selling at reasonable price changes.

This condition concerns market volatility and is extremely subjective. Here again, the draft audit report focuses on a single aspect to the exclusion of all other facets and erroneously determines that interest rates were stable because they ranged from 2 percent to 5 percent. Most market participants would consider interest rate movements of 0.10% to 0.25% as constituting market volatility. Interest rates are not the only factor that affects the market nor do interest rates alone determine market stability. The tax-exempt nature of the municipal bond market causes yields to be highly sensitive to state and local supply and demand dynamics (the amount of the issuer's outstanding tax-exempt bonds to the amount available for investment in those bonds).

Audit comment: Page 36: "However, far from being an acceptable justification, the head of public finance at the U.S. Securities and Exchange Commission has expressed concern over decreasing competitive sales within the municipal bond market."

Response: The draft audit report fails to provide examples or evidence to support this finding.

Audit comment: Page 36: "The more bids received, the higher the savings. . .the study found that interest cost savings increase with the number of bids received."

Response: While the draft audit report reviews the competitive and negotiated bond sale methods, the material presented is limited to examples that the number of bids affected interest rates on a competitively sold bond issue and **not** whether negotiated sales are more costly than competitive.

The draft audit report advocates the competitive sale method. However, the City Auditor's staff is unable to determine with absolute certainty that the City's bonds will receive an adequate number of bids to ensure the lowest interest rates.

Audit comment: Page 37: "This (competitive) method of sale ensures that an underwriter has earned the job through a competitive process based upon an objective, mathematical calculation."

Response: Under the competitive sale method, all an underwriter has earned is the right to purchase the bonds.

Audit comment: Page 37: "In addition, the Municipal Securities Ratings Board (MSRB) has been working to increase price transparency in the municipal securities market in measured steps since 1995, culminating in the availability of real time transactions that allow issuers to view the progress of their bonds in the marketplace and compare them to those of other issuers."

Response: This audit comment is irrelevant to the competitive versus negotiated bond sale debate because both of those sales occur in the primary municipal bond market as opposed to the secondary municipal market where the MSRB is working to increase price transparency.

The Treasury Division has consistently identified the same underwriters as the best-qualified

Audit comment: Page 38: "One disadvantage of negotiated sales is the potential charge of favoritism toward particular firms chosen to underwrite the bond issue. This is of particular concern due to scandals in other states in the 1990s involving finance firms which illegally sought to obtain underwriter status for large bond issuances. We are neither alleging, nor did this audit uncover, any indications of illegal activity. Nevertheless, there should be concerns about propriety in the municipal bond market overall; those concerns should compel the city to balance the perspectives of its underwriter with those of other experts and independent sources of information."

Response: The audit comment is inaccurate and misleading.

The draft audit report made no findings of illegal activity as pointed out by the statement "We are neither alleging, nor did this audit uncover, any indications of illegal activity." Furthermore, it found that no laws or statutes were violated.

In fact, the draft audit report validates that underwriters and bond counsel were selected in accordance with the Hawaii Public Procurement Code, HRS Section 103D-304(d) and Chapter 3-122, Subchapter 7 (Source Selection and Contract Formation), Hawaii Administrative Rules.

The draft audit report fails to provide examples or evidence to support its assertion "Nevertheless, there should be concerns about propriety in the municipal bond market overall; those concerns should compel the city to balance the perspectives of its underwriter with those of other experts and independent sources of information."

Audit comment: Page 38: "A budget and fiscal services department administrator said that the city uses the negotiated method in order to have more control over selecting an underwriter with the right skills, service and expertise. In many cases, the administrator said, the underwriter knows more about the city's economy and operations than the administrator does."

Response: The audit comment is inaccurate and misleading.

The City Auditor's staff was told that the negotiated method allows the City to select an underwriter with the appropriate experience and qualifications who provide quality support services. In addition, it is helpful if the underwriters are familiar with the local economy and city operations.

Audit comment: Page 38: "However, industry experts we interviewed said these types of sales pitches are commonly employed by underwriters nationwide. They cautioned issuers to remember that underwriters will structure deals to their own benefit."

Response: The draft audit report fails to provide examples or evidence to support this finding.

Again, throughout the draft audit report, references are made to "industry professionals" or "industry experts" whose identities and occupations are never revealed. If these "industry professionals" and "industry experts" are in fact financial advisors, then their observations may be slanted and biased because

they would be the biggest beneficiaries if more issuers used the competitive sale method.

Audit comment: Page 38: "One finance director said it was inappropriate for underwriters to deal with rating agencies on the issuer's behalf."

Response: The audit comment is inaccurate and misleading.

It is common practice for underwriters to deal with rating agencies on the issuer's behalf. There is no rule against it. Underwriters provide an issuer with a depth of information on the examination and analysis performed by bond raters. With their extensive dealings with the bond raters, the underwriters offer valuable guidance in preparing the ratings presentation by ensuring that information is communicated in a manner that bond raters can easily relate to and comprehend.

Audit comment: Page 38: "For the past three years of bond issuances, the city has relied on the same underwriter (UBS Financial Services, as either senior manager or co-manager) and the same bond counsel (Orrick, Herrington and Sutcliffe LLP). Underwriters and bond counsel are selected by the budget and fiscal services department using the request for qualifications or qualified list method pursuant to the Hawaii Public Procurement Code, HRS Section 103D-304(d) and Chapter 3-122, Subchapter 7 (Source Selection and Contract Formation), Hawaii Administrative Rules."

Response: According to the Hawaii Administrative Rules, under the request for qualifications or qualified list method, "the selection criteria employed in descending order of importance shall be:

Experience and professional qualifications relevant to the project type (multiplier=4);

Past performance on projects of similar scope for public agencies or private industry, including corrective actions and other responses to notices of deficiencies (multiplier=3);

Capacity to accomplish the work in the required time (multiplier=2); and

Any additional criteria determined in writing by the selection committee to be relevant to the purchasing agency's needs or necessary and appropriate to ensure full, open, and fair competition for professional services contracts (multiplier=1)." (Attachment X)

For underwriters and bond counsel, the additional criterion was subsequent support services.

Based on the selection criteria and its mandated order of importance, underwriter and bond counsel firms with significant experience and suitable prior working relationships with the City or within the State of Hawaii would garner more points over firms without such a background.

The Treasury Division strictly adhered to the requirements of the request for qualifications or qualified list method as prescribed by the Hawaii Public Procurement Code, HRS Section 103D-304(d) and Chapter 3-122, Subchapter 7

(Source Selection and Contract Formation), Hawaii Administrative Rules. As it is written, weights for experience and professional qualifications and for past performance on projects of similar scope are specifically stated and applied exactly.

In addition to strictly adhering to the procurement laws and rules of the State of Hawaii, the City conforms to the GFOA's recommended practices as stated in their "Selecting and Managing the Method of Sale of State and Local Government Bonds (1994)." (Attachment VII) If using the negotiated sale method, GFOA suggests the following, all of which the City has adopted.

- "Promote fairness in a negotiated sale by using a competitive underwriter-selection process that ensures that multiple proposals are considered.
- Remain actively involved in each step of the negotiation and sale processes to uphold the public trust.
- Ensure that either the employee of the issuer or an outside professional other than the issue underwriters, who is familiar with and abreast of the condition of the municipal market, is available to assist in structuring the issue, pricing, and monitoring sales activities.
- Avoid using a firm to serve as both the financial advisor and underwriter of an issue because conflicts of interest may arise.
- Require that financial professionals disclose the name(s) of any person or firm compensated to promote the selection of the underwriter; any existing or planned arrangements between outside professionals to share tasks, responsibilities and fees; the name(s) of any person or firm with whom the sharing is proposed; and the method used to calculate the fees to be earned.
- Review the "Agreement Among Underwriters" and ensure that it governs all transactions during the underwriting period."

For bond counsel, in addition to strictly adhering to the procurement laws and rules of the State of Hawaii, the City complies with the Government Finance Officers Association's (GFOA) recommended practices in their "Selecting Bond Counsel (1998)." (Attachment IX) GFOA advises in making the final selection of bond counsel issuers should consider factors such as:

- "The selection should not be driven solely by proposed fee. The experience of the firm with the type of transactions contemplated by the issuer is the most important factor in the selection of bond counsel.
- For issuers that have ongoing needs of a similar nature, continuity is an important factor."

Audit comment: Page 38: "The selection committee consisted of the treasury chief and two staff members, who ranked senior managers according to experience and professional qualifications, past performance on projects of similar scope, capacity to accomplish work in required time, and subsequent support services."

Response: Under the Hawaii Public Procurement Code, HRS Section 103D-304(d) and Chapter 3-122, Subchapter 7 (Source Selection and Contract Formation), Hawaii Administrative Rules, members of the review and selection committee must have "sufficient knowledge" of the professional services being sought.

As the draft audit report determined on page 24, there is a "lack of debt expertise" within the City, thereby, limiting the availability of qualified individuals that can serve on the selection committee.

For Fiscal Year 2006, the selection committee included representatives from the Treasury Division, the Department of Environmental Services and the Board of Water Supply because all three agencies anticipated needing underwriting and bond counsel services during the year.

Audit comment: Page 38: "For FY2004-05, the budget and fiscal services department's records show that the list of qualified firms for bond counsel includes four companies. Three were listed as qualified managing underwriters for both general obligation and wastewater revenue bonds: Citigroup, Merrill Lynch, and UBS Financial Services, Inc. The same three companies were also named, along with six other companies, as qualified co-managers."

Response: You will note from the following table that the three firms qualified for managing underwriters were the three top-ranked firms in the nation for 2005. In addition, each firm served as a managing underwriter for the City within the last ten years.

Book Runner Full to Book Runner (Equal if Joint)	Par Amount (US\$ mil)	Rank	Mkt. Share	Number of Issues
Citigroup	62,645.4	1	15.4	896
UBS Financial Services Inc	45,755.3	2	11.3	818
Merrill Lynch & Co	31,486.1	3	7.8	408
Lehman Brothers	26,251.7	4	6.5	266
J P Morgan Securities Inc	23,840.5	5	5.9	374
Bear Stearns & Co	22,492.9	6	5.5	167
Morgan Stanley	20,534.3	7	5.1	245
Banc of America Securities LLC	19,833.7	8	4.9	438
Goldman Sachs & Co	19,387.9	9	4.8	179
RBC Capital Markets	18,007.6	10	4.4	692
Morgan Keegan & Co Inc	8,899.9	11	2.2	472
A G Edwards & Sons Inc	7,059.4	12	1.7	359
Piper Jaffray & Co	6,086.7	13	1.5	475
Wachovia Securities	5,521.6	14	1.4	244
George K Baum & Company Inc	4,897.1	15	1.2	274
Stone & Youngberg	3,960.1	16	1.0	231
First Albany Capital Inc	3,950.8	17	1.0	76
First Southwest Company	3,359.4	18	.8	236
Prager Sealy & Co LLC	3,317.2	19	.8	125
Seattle-Northwest Securities Corp	3,202.5	20	.8	167
City Securities Corporation	2,945.5	21	.7	166
Ziegler Capital Markets Group	2,880.5	22	.7	88
Roosevelt & Cross Inc	2,706.4	23	.7	371
ABN AMRO Incorporated	2,502.0	24	.6	128
Fifth Third Securities Inc	2,317.7	25	.6	185
Subtotal with Book Runner	406,077.7	-	100.0	13,745
Subtotal without Book Runner	.0	-	.0	
Industry Total	406,077.7	-	100.0	13,745

(*):tie

Source: Securities Database Company

Using underwriters as the city's financial advisors creates a conflict of interest

Audit comment: Page 39: "The chief of Treasury Division stated to us that, in the course of negotiated sales, the city's underwriters also function as financial advisors."

Response: The audit comment is inaccurate and misleading.

The City Auditor's staff was told that, with a negotiated sale, the City does not need to hire a financial advisor. In a negotiated sale, while the underwriter's primary role is as the purchaser of the bond issue, it is a common practice for the underwriter to also assist the issuer in performing origination tasks such as preparing the official statement, making presentations to rating agencies, and obtaining credit enhancement.

In contrast, for a competitive sale, the issuer must either perform the origination tasks themselves or pay for these services separately by hiring a financial advisor. Competitive sales are the primary source of revenue for financial advisors thus explaining their strong advocacy for that method of selling bonds.

Audit comment: Page 39: "This creates a conflict of interest according to Rule G-23 of the Municipal Securities Rulemaking Board, the regulatory agency for firms involved in underwriting municipal bonds."

Response: The audit comment is inaccurate, misleading and makes unsubstantiated representations. It fails to establish with evidence or examples that the City used underwriters as financial advisors.

The Municipal Securities Rulemaking Board (MSRB) Rule G-23 specifically states "For the purpose of this rule, a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services. **Notwithstanding the foregoing, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.**" (Highlighted for emphasis.) (Attachment VIII)

As previously stated, the City never used underwriters that were hired for a negotiated sale as financial advisors on that same sale. Based on MSRB Rule G-23, the underwriters hired by the City are clearly in the group where "a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities." Therefore, no conflict of interest exists.

Audit comment: Page 40: "Budget and fiscal services department officials have also said that negotiated sales are more cost-effective because the city does not have to hire a separate financial advisor for an additional cost. However, members of the GFOA debt committee we interviewed disagreed, saying that, when managed correctly, hiring a financial advisor reduces the scope of what an underwriter does, and thus should not constitute an additional cost."

Response: Generally, the underwriter's spread would not decrease with a reduction in scope. Therefore, the issuer's borrowing costs would increase because it would be hiring a financial advisor for a fee and also paying the underwriter's spread. In addition, recent experience of bond issuers has been for underwriter's spreads to be higher for competitive bond sales than negotiated ones.

The Treasury Division has asked underwriters to develop training for its inexperienced staff

Audit comment:

Page 41: "In light of the conflict-of-interest issues described in the previous section, involvement of underwriters outside of bond issuances warrants closer scrutiny. The treasury chief reports that, in response to the need to train the division's inexperienced staff, brokerage firms have offered basic investment modeling and asset allocation materials showing such areas as the difference between securities investment, and risk/return analysis. When asked about this practice of relying on investment brokers to provide training materials, members of the Government Finance Officers Association (GFOA) debt committee told us this was an odd practice at best, particularly in light of materials and training sessions available from organizations serving government bond issuers."

Response:

The audit comment is inaccurate, misleading and makes unsubstantiated representations. It fails to establish with evidence or examples that the City used underwriters as financial advisors.

The treasury chief was commenting on investment activities not the bond issuance function.

Clearly, terms such as "brokerage firms", "investment modeling", "asset allocation", "securities investment", "risk/return analysis", and "investment brokers", relate to investment activities and not bond or debt transactions. There was obviously a misunderstanding by the City Auditor's staff that caused them to confuse comments made about investment activities with those related to bonds.

As for the audit comment "In light of the conflict-of-interest issues described in the previous section," no conflict of interest existed. The City never used underwriters that were hired for a negotiated sale as financial advisors on that same sale nor does it intend to have underwriters train its staff.

The Municipal Securities Rulemaking Board (MSRB) Rule G-23 specifically states "For the purpose of this rule, a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services. **Notwithstanding the foregoing, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.**" (Highlighted for emphasis.) (Attachment VIII)

Based on MSRB Rule G-23, the underwriters hired by the City are clearly in the group where "a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities."

Audit comment: Page 41: "When asked about this practice of relying on investment bankers to provide training materials, members of the Government Finance Officers Association (GFOA) debt committee told us this was an odd practice at best, particularly in light of materials and training sessions available from organizations serving government bond issuers."

Response: The members of the GFOA debt committee may have thought it was an "odd practice" because the City Auditor's staff confused investment activities and investment terminology with bond underwriters and bond issuances.

Audit comment: Page 41: "One debt manager said that while anyone from outside the city would bring a certain bias to their training programs, there is a risk that an underwriter could exclude areas contrary to their own interests-such as the benefits of pursuing competitive bond sales."

Response: The draft audit report fails to provide examples or evidence to support this finding.

Audit comment: Page 41: "One municipality uses financial advisors who serve other municipal issuers and found that they provide a broad perspective of other municipal issuances and experiences."

Response: Underwriters also provide a "broad perspective of other municipal issuances and experiences." The breadth of the underwriters' knowledge would be larger than those of a financial advisor because underwriters are involved in 100% of the bonds issued (both competitive and negotiated). Consequently, underwriters would have relationships with a greater number of municipal issuers than financial advisors. National underwriting firms also have in-house specialists such as economists and attorneys that most financial advisory firms do not.

Conclusion

Audit comment: Pages 41 to 42: "The city administration has generally complied with the city's debt policies and refunded bonds at lower interest rates to reduce future debt service. In recent years, the City and County of Honolulu's consistent "AA"-level bond ratings have benefited the city's bond issuances, resulting in favorable borrowing terms. The current administration has initiated potentially cost-saving measures to reduce rising debt costs by instructing agencies to reduce expenses and by canceling \$12 million in unneeded capital projects and \$10.5 million in contract funds encumbered before 1996 but never paid out. Despite these actions, the city projects that it will exceed its established debt limits as early as FY2007-08.

We found that the city has no comprehensive strategic plan to manage all its debt. Responsibilities for the city's debt have evolved into a fragmented operation managed by two different departments with serious resource constraints. Moreover, institutional knowledge of and experience with the city's debt are concentrated in only two city administrators, whose recently hired staff are in the process of learning their debt-related responsibilities through on-the-job training and for whom no formal debt-related training is planned. City reports are not reader-friendly and provide only limited information. Comprehensive and strategic actions are needed to obtain accountability over the city's debt operations and resolve its debt management problems.

We found that although the city's debt policy allows the use of capital funds for salaries, only the Department of Environmental Services reports that it plans to return to funding salaries with cash instead of revenue bonds. The Department of Budget and Fiscal Services has no such plans for the city's general obligation debt at this time. We found that city agencies use capital funds to purchase equipment costing far less than the \$5,000 limit, including items such as cleaning supplies and rental payments. Use of bond funds for such purchases results in unnecessary additions to the city's debt service and warrants further review to examine the extent and control mechanisms needed to restrict such practices.

Certain city practices raise concerns about conflict of interest and may result in unnecessary costs. The city has consistently evaluated the same underwriters as the best qualified for the past three years of bond issuance. The city's continued use of non-competitive negotiated sales methods, granting underwriters the exclusive right to sell the city's bonds, raises concerns. Moreover, the city relies on its underwriters to function as financial advisors, creating a conflict of interest problem the Municipal Securities Rulemaking Board ruled against the practice in 1977. Future plans for the underwriters to provide staff training are also contrary to industry best practices. This has left the city vulnerable to underwriters who have conflicting interests between obtaining the highest possible interest yields for bond purchasers (investors) and seeking the lowest interest rate cost of financing for the city selling bonds (issuer)."

Response: Each of the findings described in the conclusion of the draft audit report have been addressed in the prior sections of this response.

Recommendations

Audit comments: Page 42 to 43: "Recommendation #1: Consider obtaining the services of an independent professional municipal debt organization to formally evaluate, in-depth, the city's current debt management program, practices, organization, resources, and staffing to develop an action plan with recommendations for comprehensive, unified debt management program that addresses the city's overall fiduciary interests.

Recommendation #2: Establish a formal succession plan to ensure that staff members supporting the current debt managers receive cross-training in debt management functions so the city's interests are not jeopardized should either manager leave city employment.

Recommendation #3: Develop and take steps to issue an annual report on all of the city's debt for the city council and taxpayers.

Recommendation #4: Establish practices to accurately identify and scrutinize low dollar value equipment purchases by city agencies and report on the city's compliance with the city's debt policy.

Recommendation #5: Reconsider the city's use of underwriters as financial advisors due to the inherent conflict of interest between clients like the city, which sells bonds, and the underwriter's investors, who buy them.

Recommendation #6: Reconsider its procurement practices, which have consistently resulted in selecting the same underwriting and bond counsel firms.

Recommendation #7: Consider competitively selecting an independent financial advisor to represent only the city's interests in bond sales transactions. The advisor could independently assess the feasibility and cost-benefit of using the competitive bond sales method compared to the current practice of negotiated bond sales.

Recommendation #8: The department should make use of established training by independent, nationally recognized municipal finance and debt organizations such as Government Finance Officers Association as sources for formal debt and finance training and professional development."

Response:

Given the significant level of errors, omissions, misrepresentations and unsubstantiated comments included in the draft report that were relied on to derive flawed audit conclusions, the recommendations are not credible and a detailed response is not appropriate until the underlying conclusions are remedied.

ATTACHMENT I

STANDARD & POOR'S	RATINGS DIRECT
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Research:

[Return to Regular Format](#)

Honolulu City And County, Hawaii; Appropriation, General Obligation Equivalent Security; Tax Secured, General Obligation

Publication date: 27-Oct-2005
Primary Credit Analyst: Robert Williams, San Francisco 415-371-5070; robert_williams@standardandpoors.com
Secondary Credit Analyst: Alexander M Fraser, Dallas (1) 214-871-1406; alexander_fraser@standardandpoors.com

Credit Profile

US\$147.66 mil GO bnds ser 2005 F due 07/01/2030 AA-
 Sale date: 01-NOV-2005
 US\$244.63 mil GO bnds due 07/01/2024 AA-
 Sale date: 01-NOV-2005

AFFIRMED

\$410.527 mil. Honolulu City & Cnty GO AA-
 \$275.460 mil. Honolulu City & Cnty GO (FGIC) AAA/AA-(SPUR)
 \$26.290 mil. Honolulu City & Cnty GO (FSA) AAA/AA-(SPUR)
 \$470.900 mil. Honolulu City & Cnty GO (MBIA) AAA/AA-(SPUR)
 \$91.255 mil. Honolulu City & Cnty go unlt'd tax imp rfdg bonds ser 2004A (MBIA) AAA/AA-(SPUR)
 \$192.850 mil. Honolulu City & Cnty go unlt'd tax imp rfdg bonds ser 2004B (MBIA) AAA/AA-(SPUR)

OUTLOOK: POSITIVE

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to Honolulu, Hawaii's series 2005E and 2005F GO refunding bonds and affirmed its 'AA-' rating on the city's outstanding GO debt.

The rating reflects:

- The city's role as the service, trade, and government center for the state of Hawaii;
- A strong tourism sector, with improving tourism statistics after some declines just after Sept. 11, 2001;
- Very strong increases in property values since fiscal 2001;
- Adequate financial performance, including a healthy surplus (unaudited) in fiscal 2005, despite steady declines in property values during much of the mid- to late-1990s; and
- A manageable debt burden with no additional debt plans until fiscal 2007.

Although Standard & Poor's expects that current increases in property values may be more sustainable than in previous cycles, a history of volatility prior to the current rebound continues to be a tempering factor. Demonstration of institutionalized financial reserve policies to formally control and anticipate the potential for revenue volatility may provide additional credit stability and lead to upward rating action.

The bonds are secured by the full faith, credit and unlimited ad valorem taxing authority of the City and County of Honolulu, and are being issued to refinance outstanding debt.

With 876,230 residents, or 72% of the state's total population, Honolulu is Hawaii's economic center and the center of government, transportation, finance, and education. Tourism accounts for about 25% of the gross state product, and Honolulu accounts for more than 50% of the state's hotel rooms. Waikiki, located on Oahu, remains the state's most visited destination. Honolulu's tourism market has rebounded strongly along with the rest of the state. The city and island are additionally anchored by the presence of the U.S. military; there are 33,799 active service men and women on the island, and nearly 15% of the total island population is either employed by or a direct dependent of one of the four branches of the armed services. Unemployment has been steadily declining and is currently at 3%, below the state level and one of the lowest rates for a U.S. city with a population above 750,000. Effective buying income levels are above the state but average overall, at 105% and 90% of the nation on a household and per capita basis, respectively.

The recent economic rebound on Oahu has been led by a strong real estate market, driven by strong appreciation in property values and new construction after an extended period of weakness during the mid- and late-1990s. Since 2001, total assessed value (AV) has increased a very strong 58%, to \$114.1 billion in 2006, a high \$130,000 per capita. Single-family homes and condominiums account for 56% of this valuation, followed apartments (22%), commercial (10%), industrial (5%), and hotel and resort properties (only 5%). Historic volatility prior to the recent strong recovery was due primarily to concentration of Japanese capital in the real estate market, which is now diminished, though tourism and second-home investment remain primary drivers for economic growth.

Financial performance has been strengthening with improvements in fund balances after a period of revenue contraction prior to fiscal 2001. At the end of fiscal 2004, the city reported a total general fund balance of \$62.3 million, or 8.5% of expenditures after transfers, with \$41.5 million, or 5.7% of expenditures, unreserved. For fiscal 2005 (unaudited), staff anticipates a healthy \$14.8 million general fund surplus, boosting the unreserved fund balance to \$57.4 million (7.9% of expenditures), not including an additional \$5.0 million reserve set-aside outside the general fund. The current and recent fund balance position is adequate, given historical revenue volatility and the need to reduce services historically without significantly increasing property tax rates. The new mayoral administration has stated its intent to tighten fund balance policies and other financial controls to provide additional stability during periods of potential economic or financial contraction, due to a potentially volatile tourism base. The unaudited 2005 fiscal year was the new administration's first year of financial results and represented a significant improvement over the original budget as well as May 2005 projections (which anticipated balanced performance) due to the administration's focus on expenditure control. In addition, financial staff has implemented monthly budgetary reviews with department staff to track expenditures to budget and generally tighten city budgetary practices, so that budgeted expenditures map more directly to actual costs at year-end. In practice, many departments had regularly delivered sizable positive expenditure variances, reducing budgeted-but-not-realized general fund deficits. Continued attention to such financial controls should provide increased transparency into and tighter control over budgets and reserves.

The city's debt burden is moderate, at \$1,810 per capita and 2.0% of AV, excluding self-supported GO debt. The current issuance will refund existing obligations, and the anticipated ongoing capital plan is manageable. Annual general fund-related capital expenditures over the past two years have been \$134 million and \$147 million, respectively, lower than in prior years. In practice, the city's capital plan has been between 4% and 20% cash-funded, and annual debt service carrying costs have been relatively high, at approximately 19% of total general fund expenditures. The city does not anticipate additional GO debt issuance until 2007.

■ Outlook

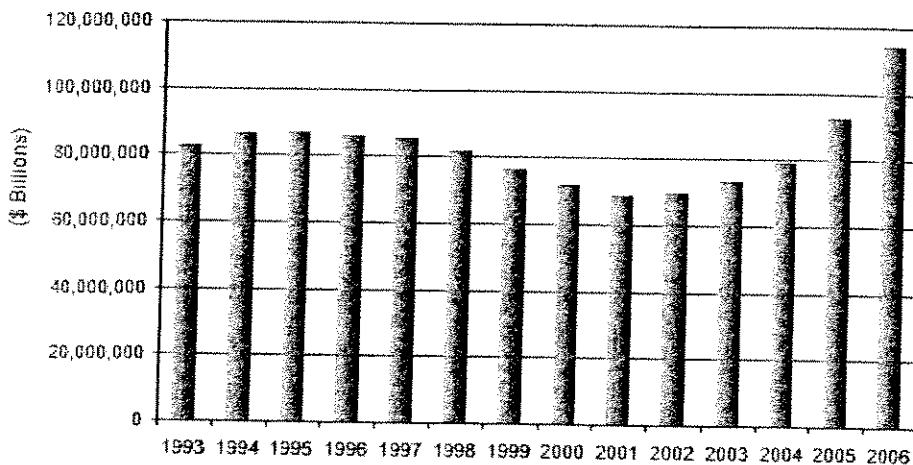
The positive outlook reflects Standard & Poor's expectation that the current administration will continue to implement formalized, conservative financial controls and reserve targets, in order to provide stability in case of future revenue volatility, given some continued reliance on tourism and rapid increases in property values. Currently, staff has begun the formalization of such policies and is in discussion with city council about how best to handle, and control, future expenditure of existing fund balances beyond a \$5 million 'rainy day' reserve. Should institutionalization of these policies be extended in future budgets and end-of-year performance, upward rating action may be warranted.

Economy

From 1995 to 2001, property values dropped 23%, due primarily to the aftermath of a boom in construction and property values in the late 1980s driven by Japanese investment. After the departure of this capital, beginning in 1990, the property market weakened significantly. While the tax base has demonstrated this historic volatility, the rating and outlook reflect Standard & Poor's expectation that the current expansion is more sustainable than the one experienced during the late 1980s, due to a more stable source of investment, strong demand characteristics, and more limited housing supply. Since 2001, total AV has increased 35% to \$92.4 billion in 2005 and increased an additional 23% in 2006 to \$114 billion.

Chart 1

**City and County of Honolulu, HI
Assessed Value**



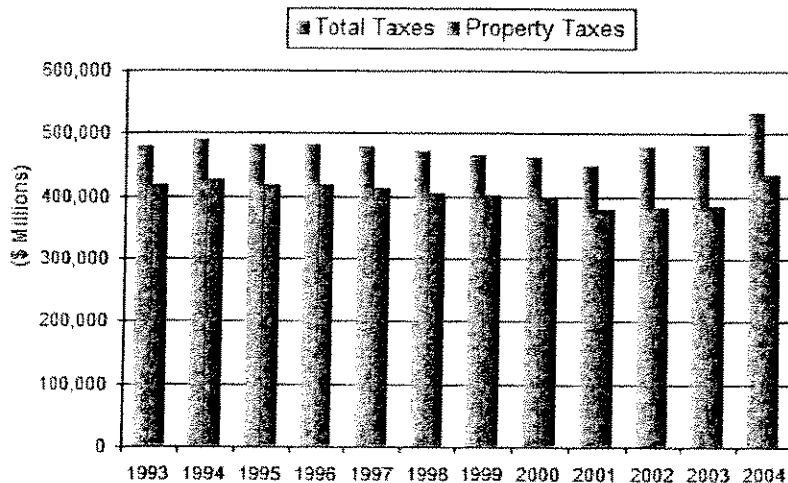
Finances

Property taxes are the city's primary discretionary revenue source, accounting for 70% of total general fund revenues. As a result, city revenues experienced significant pressure during the 1990s but have rebounded strongly. During the period of property tax declines, the city was able to cut expenditures, but also maintain lower-than-average fund balances. The average property tax rate was increased in 2004 after several years of reductions and was maintained at the 2004 level for the 2005 budget. The new city administration, elected in November 2004, has stated its intent to maintain property tax rates in order to support current service levels while paying close attention to the cost versus benefit of some more discretionary government expenditures. Property taxes in Honolulu and in Hawaii in general are currently among the lowest in the nation, as is the state's 4% sales tax. The city does not collect a sales tax but is distributed a portion of the state-collected transient occupancy tax (TOT), another major revenue source. Property tax delinquencies are currently at record lows.

The city maintains a 'rainy day' fund of \$5 million that the current mayoral administration plans to build-up further through one-time sales of under-utilized city land and other assets, as appropriate. The city general fund has delivered cumulative surpluses totaling \$20.8 million after transfers from fiscals 2002 through 2004, though it reported a \$10.5 million deficit in fiscal 2004 due to a budgeted use of a portion of the existing unreserved fund balance. In fiscal 2005 (unaudited), staff anticipated a surplus of \$14.8 million brought on, primarily, by mid-year cuts in certain budgeted costs and strong revenue growth. In practice, the city budgets the unreserved fund balance for use during the following fiscal year but does not expend the entirety of those appropriations. Tighter control over unreserved fund balances could be

a relative credit strength as current staff continues to institutionalize additional formalized financial controls. Such controls could include the partitioning of reserves beyond the \$5 million 'rainy day' fund, not to be appropriated for operating expenditures unless required due to economic or financial uncertainty.

Chart 2
City and County of Honolulu, HI
Tax Revenues



Debt

In the late 1990s, the city restructured some of its debt profile to extend maturities and reduce some annual debt service carrying costs. The current amortization schedule achieves 59% payout of principal over the next 10 years. Upon taking office, the new city administration eliminated approximately \$60 million in anticipated capital expenditures during fiscal 2005 deemed less essential than other core needs, such as road improvements. Additionally, fees and user charges have been increased substantially for the city's wastewater fund. This ensures that the wastewater enterprise will continue to be self-supporting both for operations and for additional debt, which is anticipated in order to upgrade the treatment facility to meet current environmental requirements.

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ATTACHMENT II

Tax Supported
New Issue

City and County of Honolulu, Hawaii

Ratings

New Issue

General Obligation Bonds,
Series 2005E and 2005F AA

Outstanding Debt

General Obligation Bonds AA
Rating Outlook Stable

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New Issue Details

About \$400,000,000 General Obligation Bonds, Series 2005E and 2005F, are scheduled to sell on or about Nov. 1 via negotiation by UBS Financial Services Inc. and Merrill Lynch & Co.

Security: The bonds are secured by the City and County of Honolulu's full faith and credit unlimited ad valorem tax pledge.

Purpose: Bond proceeds will be used to refund \$250 million in general obligation bonds, series 2001C, and \$150 million in commercial paper.

■ Outlook

Honolulu's credit strength rests in the sound fundamentals of its tourism-based economy, good financial operations and reserves, low debt burden, and strong fiscal management. The island's tourism base has adapted to a shift to more domestic-based visitors, as well as reduced activity, while the area's role as the commercial center and state capital and a sizable military presence add stability. Tourism on the island is highly developed and has strong underpinnings, providing continual demand. The city has restrained spending growth to keep in line with revenues, resulting in prudent general fund balances. The low debt burden reflects Hawaii's sizable role in financing capital needs. Expected annual issuance will increase debt levels, although they will remain affordable.

■ Rating Considerations

Honolulu is coterminous with the Island of Oahu, and the island's tourism draw is based on sustainable elements, such as natural beauty, diverse accommodations and activities, and proximity to sizable North American markets. Tourism activity exhibits volatility typical of the sector, reflected in a surge in 2004 following a long decline. Total visitors rose to a very strong 9.1% in 2004, and results through August 2005 suggest about an 8% gain. If the results for 2005 continue at this rate, the total year-end visitor count will exceed the 2000 peak. The recent rise follows a precipitous drop in 2001 and relative stability through 2003 at about 10% below the high. Visitor levels from the U.S. rose faster than international, largely Asian, visitor levels, as has been the case in most recent years. Domestic visitors now make up about 58% of total visitors. Other tourism indicators were strongly positive in 2004, as well, with hotel occupancy rising for the second consecutive year to nearly 80%, the highest level experienced in 10 years. The increase is notable given the rise in average hotel room rate to above the 1998 peak. Results so far in 2005 suggest strong gains in both occupancy and room rate.

Honolulu's nontourism economy is substantial and adds balance, as the state's commercial and business center, state capital, and home of the University of Hawaii. U.S. military also is a major economic element, taking advantage of the island's strategic location. Federal defense spending makes up about 8% of the gross state product, with most of the activity on Oahu. Honolulu has 72% of the population, about two-thirds of the visitors, and about one-half of the hotel rooms in the state. The real estate market has returned to strong activity, with taxable valuation rising considerably since recovery began in 2002. Building permits have risen steadily, reaching \$1.32 billion in 2004, suggesting continued tax base gains. Honolulu's unemployment rate fell to 3.2% in 2004, its lowest rate in several years.

October 27, 2005

www.fitchratings.com

Financial operations are sound, relying primarily on property taxes. Honolulu's revenue base includes only a small amount that is directly reliant on tourist activity. The general fund ran operating surpluses in four of the past six fiscal years, including estimates for positive results for fiscal 2005. Fiscal 2004 included an operating deficit, reducing the fund balance to \$62.3 million, which equaled an above-average 8.5% of spending. While this level was below fiscal 2003's 11.0%, it was near the 8.8% annual average over the past five years. In addition, the city maintains \$5.0 million in a rainy day fund. City officials expect the fund balance to rise considerably once audited results for fiscal 2005 are available. Fitch Ratings views the current reserve levels as prudent for a tourism-based economy during a strong economic period.

Honolulu's strong financial position primarily reflects expenditure growth kept to low levels through organizational restructuring and employee reductions. Operations in fiscal years 2002–2004 also benefited from a nonrecurring sizable capital spending reimbursement. The positive preliminary results for fiscal 2005 come from sound property tax revenue gains and some spending restraint, offsetting rising employee costs and the capital reimbursement loss. Honolulu's fiscal future should continue to be sound but will be challenged by a general trend of

sizable increases in pension costs, as well as ongoing salary raises.

■ Strengths

- Tourism-based economy has strong underpinnings, such as physical beauty, public and private infrastructure, and location.
- Role as regional economic center and state capital provides some diversity and stability.
- Financial operations benefit from sound management actions, resulting in preservation of satisfactory reserves.
- Prudent management actions in recent years, including tax rate and fee increases, organization consolidation, and spending controls.
- Low debt burden (average including state bonds).

■ Risks

- Economic volatility inherent in tourism-based economies.
- Ongoing financial pressures, including labor and pension cost increases.

For more information, see Fitch Research on "City and County of Honolulu," dated May 17, 2005, available on Fitch's web site at www.fitchratings.com.

ATTACHMENT III



New Issue: Honolulu (City & County of) HI

MOODY'S ASSIGNS Aa2 RATING AND STABLE OUTLOOK TO HONOLULU'S GENERAL OBLIGATION BONDS

Approximately \$1.9 Billion of Debt Affected, Including Current Offering

County
HI

Moody's Rating

ISSUE	RATING
General Obligation Bonds, Series 2005E and Series 2005F	Aa2
Sale Amount	\$392,290,000
Expected Sale Date	11/01/05
Rating Description	General Obligation

Opinion

NEW YORK, Oct 27, 2005 -- Moody's Investors Service has assigned an Aa2 rating and stable outlook to the City and County of Honolulu's General Obligation Bonds, Series 2005E and Series 2005F to be issued in the approximate amount of \$392.29 million. The bonds will refund approximately \$250 million of the city's outstanding 2001 Series C General Obligation Bonds to a fixed interest rate from the current variable rate mode and will provide long term financing for approximately \$150 million of projects initially financed through the city's commercial paper program. In conjunction with the current credit review, Moody's has also affirmed the Aa2 rating and stable outlook on the city's approximately \$1.5 billion of outstanding general obligation bonds. The bonds are secured by an unlimited property tax pledge; debt service payments represent a first charge on the city's General Fund. The Aa2 rating primarily reflects the city's solid economic performance, rising real estate values on Oahu which have spurred steady growth in assessed valuation, the city's stable financial performance which reflects management's ability to control spending and raise property tax rates when needed, and a manageable debt profile.

ROBUST ECONOMY BENEFITS FROM STRONG PERFORMANCE OF TOURISM SECTOR

Honolulu's economy has performed well following the sharp declines in travel to Hawaii following the 9/11 terrorist attacks. Low unemployment and rising real estate values have had an important influence on the local economy, but a variety of other factors have contributed as well. Visitor traffic has improved significantly since the steep declines suffered immediately following the 9/11 terrorist attacks. Eastbound (primarily Asian) and other international traffic still lags historical performance, but Westbound traffic (primarily from the U.S. West and East coast markets) has more than offset these losses. Hawaii remains a unique and attractive tourist destination and officials have been successful in niche marketing the island. Examples include sports- and eco-tourism as well as a growing inter-island cruise business, all of which attract a higher percentage of first time visitors and stimulate longer average stays. Moody's notes that airline capacity serving the Hawaii tourism market relies on the health of the financially volatile airline industry. Moody's also notes improving diversity in the Honolulu economy which includes the military, health care, and banking sectors as important contributors. The city's successful efforts to finance light rail development through a recently-authorized general excise tax should help stimulate further housing and business development in west Oahu, especially in the Kapolei and Ko Olina areas. Despite the moderating influence of many tourism-related service jobs, wealth indicators in Honolulu are also favorable with per capita and median family income at 101.9% and 120.1% of the U.S., respectively.

STRONG OAHU REAL ESTATE MARKET SUPPORTS CONTINUING TREND OF ASSESSED VALUATION GROWTH

An important element of Honolulu's economic stability has been the robust Oahu real estate market, which has led to accelerating growth in assessed values since 2001. Following a period of rapid escalation in property values in the late 1980s and early 1990s Honolulu's tax base experienced significant erosion from 1996 through 2001, losing almost one-fifth of its value during that period. However, since 2001, assessed valuation has grown by an average of 10.7% annually, achieving a substantial \$114.1 billion in 2006. Residential, commercial and industrial real estate have all contributed to the growth, which should continue to translate into rising taxable values over the near term given the lag between real estate prices and assessed

valuation. Moody's also notes that the current real estate market shows no signs of the type of speculative bubble which occurred in the early 1990s. Honolulu's 2006 assessed value per capita totals an impressive \$126,401 and points to an unusually wealthy tax base.

SOUND FINANCIAL PERFORMANCE

The city's financial performance has been stable in recent years, due in large part to management's willingness to raise property tax rates as needed, combined with the city's successful multi-year effort to control expenditures. Recent growth in assessed valuation is particularly significant to the city's credit profile in that property tax revenues represent approximately two-thirds of operating revenues. Just as important, however, is the city's willingness to raise tax rates to fund increasing fixed costs such as pension, health and debt service expenditures. In addition, a variety of cost-cutting measures such as workforce reductions, department consolidations, hiring freezes and increasing self-support for enterprise activities, have resulted in relatively flat expenditure growth over time. As a result, management's commitment to maintaining budget balance and improving reserves has been increasingly evident and continues to be an important factor in Moody's credit evaluation of Honolulu.

Audited financial results for fiscal 2004 show a \$10.5 million operating deficit in the General Fund which resulted in total fund balance of \$62.3 million, or 8.7% of General Fund revenues; unreserved fund balance totaled \$41.5 million, or 5.8% of revenues, which is only slightly above the city's target of a minimum 5% unreserved General Fund balance. Much of the 2004 deficit is attributable to one-time capital projects. Leading up to fiscal 2004, however, the city experienced substantial operating surpluses in both fiscal years 2002 and 2003 following an understandably difficult 2001 which included 9/11-related declines in transient accommodations tax receipts as well as higher spending requirements, especially for public safety. Nevertheless, the city has posted significant operating surpluses in four of the six audited years since 1999 and an additional surplus is projected to add roughly \$16 million to the unreserved General Fund balance in fiscal 2005, bringing the total unreserved General Fund balance to more than \$57 million. The city also maintains a \$5 million rainy day fund outside the General Fund, providing additional flexibility.

Going forward, Moody's believes that the city's financial position should remain stable as it benefits from a combination of growing tax revenues and the ongoing savings associated with structural spending reforms implemented in recent years. Nevertheless, it remains likely that Honolulu will continue to face its share of budget challenges in the near term, in part due to the rising pension and health costs mentioned above. Despite these ongoing budget issues, Moody's believes that the city's demonstrated ability to manage its finances well under difficult circumstances bodes well for future financial stability, especially in light of anticipated revenue growth.

MANAGEABLE DEBT POSITION MODERATED BY REASONABLE BORROWING PROGRAM AND GROWING TAX BASE

Moody's expects that Honolulu's debt levels will continue to remain manageable given reasonable borrowing assumptions and the expectation of continued tax base growth in the near term. In addition, Honolulu benefits from the active role the state government plays in financing traditional municipal capital needs more typically funded at the local level throughout the rest of the country including transportation, health, justice, and education.

Management has begun to fund the construction activities of various enterprise systems from system rates rather than property taxes. As a result, future borrowings will emphasize revenue bond offerings rather than general obligation issuances. Debt burden measures compare favorably to other cities and counties in the U. S. with overall debt representing only 1.4% of fiscal 2006 taxable values. Including the current offering, the city has approximately \$1.9 billion of outstanding general obligation bonds and about \$463.9 million of remaining unissued authorization. Approximately 52.8% of the city's outstanding general obligation debt is retired in ten years.

Outlook

The stable rating outlook for Honolulu reflects Moody's expectation that the city's economy will continue to perform well and that assessed valuation will grow further in the near-term. The stable credit outlook also incorporates Moody's expectation that city management will continue to take the actions necessary to ensure fiscal stability in light of rising pension and health costs over the near- to medium-term.

KEY STATISTICS:

2000 population: 876,156

1999 per capita income: \$21,998 (101.9% of U.S.)

1999 median family income: \$60,118 (120.1% of U.S.)

2006 full valuation: \$114.1 billion

Direct and overall debt burden: 1.4%

Payout of principal, 10 years: 52.8%

FY 2004 total General Fund balance: \$62.3 million (8.7% of General Fund revenues)

FY 2004 unreserved General Fund balance: \$41.5 million (5.8% of General Fund revenues)

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ATTACHMENT IV

Tax Supported New Issue

State of California

Rating

General Obligation BondsAA
(Upgraded from 'AA-' on 2/16/00)

Analyst

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Issuer Contact

Hon. Philip Angelides
State Treasurer
1 916 653-2995

New Issue Details

\$500,000,000 Various Purpose General
Obligation Bonds for bids on Feb. 23 Bonds
will be due March 1, 2001–2030. Bidders may
specify term bonds with mandatory
redemption. Bonds are callable beginning
March 1, 2010 at 101%.

Security: General obligations of the State of
California payable out of the general fund,
subject only to the prior application of moneys
to the support of public education; full faith
and credit pledged.

■ Outlook

California's economic strength is continuing, causing revenues to surge. Final results for 1998–1999 show an enlarged general fund balance, which in essence is being carried forward as revenues this year are very positive. Interim collections indicate that revenue estimates for 1999–2000 and 2000–2001 may indeed be conservative. The recommended budget for 2000–2001 preserves a good reserve level. While structural problems, including strict property tax limits and the mandated budget share for education, will continue to have an impact on flexibility, the stronger than expected economic recovery and conservative budgeting leading to favorable financial operations underpin the rating upgrade.

Additionally, ratings assigned to lease obligations of the state have been upgraded to 'A+' from 'A'. The bonds are issued by the Board of Public Works, the Franchise Tax Board, East Bay State Building Authority, Los Angeles State Building Authority, Oakland State Building Authority, Riverside Company Public Financing Authority, San Francisco State Building Authority, San Bernardino Joint Powers Financing Authority (California Department of Transportation), and Sacramento City Financing Authority.

■ Rating Considerations

The rating upgrade takes into account the fundamental strengths of California, buttressed by the sustained favorable economy and financial operations. Employment continues to gain steadily and, in 1998, was 8% higher than the pre-recession peak. Financial operations have benefited from the rebound leading to undesignated general fund balances. Revenues, spurred by the personal income tax, have been over estimates since 1996–97. A reserve position has been maintained, recommended at about 2% of revenue for 2000–2001. The state's debt position continues to be favorable, with net tax-supported debt of \$24.5 billion equal to \$776 per capita and 2.7% of personal income. A substantial amount of general obligation bonds, \$11.3 billion, remains authorized but unissued and \$4.69 billion bonds will be on the March ballot. The new bonds will fund existing commercial paper notes. The state's commercial paper program, limited to \$1.5 billion, is for bond anticipation purposes.

■ Strengths

- Extensive, industrialized, wealthy economy.
- Debt position now favorable.
- Financial operations positive; borrowable resources cover year-end cash deficits with good margin.
- Economic growth continuing.

■ Risks

- Short-term operating borrowing will still be required annually.
- Restrictions on flexibility from limits imposed by initiative and exposure to future such actions.

February 18, 2000

■ Debt Position

California's long-term debt position continues to be favorable, with about 75% representing general obligations and 17% of general obligation debt self-supporting from project revenues. Debt ratios are moderate; previously they were low but, as new debt has been payable from general resources, they have risen. This trend can be expected to continue, as \$10.8 billion bonds payable from general funds remain authorized but unissued after this sale and \$4.69 billion for general purposes will be on the March 2000 ballot. Amortization of general fund-supported debt is fairly rapid, and total tax-supported debt is somewhat above average. Net tax-supported debt has increased 350% from 1989, while personal income rose 64% from 1988 to 1998. Most of the increase was in the early 1990s. Since 1994, debt has risen 29%, matched by personal income gain of 29% from 1993 to 1998. Debt to personal income remains at the 1994 level.

Debt considerations in the stressful recession years centered on the short-term debt level. California, for several years, has required operating borrowing. The amount has declined from \$3 billion in 1997 to \$1.7 billion in 1998 and this year \$1.0 billion, or 3.3% of long-term debt and 4.1% of net tax-supported debt. The state utilizes commercial paper for bond anticipation purposes, with \$1.5 billion authorized. If the total authorization is included, short-term debt

equals 8.4% of long-term debt. The present issue will fund outstanding commercial paper in the amount of \$500 million. The state is also considering the use of variable rate debt. The state treasurer has prepared a debt affordability study, identifying resources and recommending a comprehensive investment plan.

■ Financial Operations

The general fund is the principal operating account, but its operations have been skewed in recent years by devolutions to local units and off-budget "loans" to school districts. Beginning in 1989-1990, a series of revenue shortfalls depleted fund balance and, as the recession was longer and more harsh than anticipated, continued overestimation of revenue created a large general fund deficit. The stated deficit reached about \$3.9 billion at the end of 1991-1992. It was technically reduced by the amount of loans to schools (\$1.1 billion), arising from the mandated portion of the budget for that purpose, made on the basis of estimated revenues that exceeded actual collections. The loans were placed off budget but remained a cash draw and part of the cash deficit. Financial statements include the loans in fund balance, as agreement has been reached to fund them over eight years, with the state paying \$935 million and the schools, \$825 million. Since all payments are made from state moneys, the entire amount is shown as a reservation of fund balance, which affects the undesignated deficit or fund balance. In 1995-1996 and 1996-1997, the share of revenues mandated for schools again has caused complications. Since revenues were well over estimates, the schools were entitled to receive more money, the reverse of the situation, which led to the loans in earlier years.

The state attempted to eliminate the deficit through spending control but, by the end of 1993-1994, it was obvious that a longer period was necessary. California issued \$4 billion revenue anticipation warrants (RAWs), with final maturity in April 1996, essentially a deficit financing. The RAWs were retired as scheduled and \$2 billion RANs were issued to provide cash for the remainder of the fiscal year. The RANs were paid through the use of internal borrowable funds.

California has achieved general fund operating surpluses for all but two of the past seven years. In 1997-98, revenues were about 4.1% over budget. Revenues rose more than 11% over 1996-97, fueled by a more than 18% surge in personal income taxes. Expenditures increased by 6.8%, in part reflecting a \$1.2 billion one-time payment to the pension fund. The operating surplus was approximately \$1.8 billion. The ending fund balance was \$2.792 billion,

Debt Statistics

(\$000)

General Obligation Bonds*	21,006,076
Revenue Anticipation Notes	1,000,000
Commercial Paper	681,065
Gross Direct Debt	22,687,141
Board of Public Works	5,714,229
Other Leases, etc.	1,199,727
Gross Debt	29,601,097
Less: Self-Supporting Water and Veterans Bonds	3,596,945
Revenue Anticipation Notes	1,000,000
Commercial Paper Being Funded	500,000
Net Tax-Supported Debt	24,504,152

Debt Ratios

Per Capita (\$)	776 (31,589,000, 1995 est. pop.)
% of Personal Income	2.7 (\$900,900,000,000 1998)

Amortization

(%)

	General Purpose	All General Obligation	Lease and General Obligation
Five Years	33	31	29
10 Years	59	57	54

*Including \$500,000,000 new bonds.

Financial Statistics

(\$ Mil., General Fund, Budgetary Basis)

	1997-98	1998-99*	1999-00**	2000-01**
Total Revenues	54,798	58,935	64,819	68,250
Total Sources	55,084	59,368	65,160	68,237
Income Tax	27,925	30,891	34,461	36,319
Sales	17,583	18,957	20,236	21,396
Expenditures	53,264	58,268	65,856	68,819
State Operations	14,042	14,776	15,667	16,563
Operating Result	1,820	1,100	(696)	(582)
Fund Balance	2,793	3,908	3,012	2,430
Unreserved	931	1,608	862	1,061
Adjusted Fund Balance†	3,064	3,708	N.A.	N.A.

*Estimated. **Budget. †Opening fund balance, as adjusted for accruals and Proposition 98 on succeeding July 1. N.A. - Not available.

of which \$478 million was reserved for encumbrances, leaving \$2.314 billion as the reserve for economic uncertainties. These figures do not reflect loan reservation, which is included in the table above.

When the governor's budget was presented in January 1999, it was premised on a slowdown and, accordingly, revenue estimates had been lowered. As the year progressed, the strong growth trend became evident, leading to substantial changes in the May budgetary revision. For 1998-1999, revenues were raised 2.9%. The personal income tax alone was increased 6.9% over the January estimate, while the bank and corporation taxes were lowered by about the same percentage. The revenue estimates for 1999-2000 were increased by 4.5%, with personal income tax collections up and bank and corporation taxes down, each about 9%. The changed estimates amounted to about \$1.6 billion higher revenue in 1998-99 and \$2.7 billion in 1999-2000, a total of \$4.3 billion over the two years.

Operations in 1998-1999 closed with a balance of \$3.9 billion, up from the previous estimates of \$1.1 billion, and 2.4 billion, reflecting about \$3 billion in additional revenues and transfers and \$200 million net higher expenditures. Revenues were up about 7.5% from 1997-1998, and expenditures are up 9%. The budget for 1999-2000 expects revenue growth of 11%, which, together with the opening balance, provides \$65.2 billion to support \$65.9 billion in expenditures. The closing balance would be \$3.0 billion, of which \$2.4 billion would represent the reserve held in the special fund for economic uncertainties. The remaining \$592 million would be reserved for liquidation of encumbrances. While there is an operating deficit of about \$696 million, expenditures include more than \$1 billion for one-time expenditures, including \$425 million for the state infrastructure bank. The bulk of increased spending is for

education. The high balance reflects the carryover of higher than projected 1998-1999 surplus.

The recommended budget for 2000-2001 anticipates moderate growth, with employment rising 2.9% in 2000 and 2.5% in 2001; personal income growth is set at 4.7% and 5.7%, respectively. Revenues are forecast to increase 4.7%, with the personal income tax up 5.4% and the sales tax, 5.7%. The opening balance is projected at \$3.0 billion. Revenues of \$68.2 billion are \$582 million below expenditures, reducing the closing balance to \$2.4 billion. The closing balance is comprised of \$592 million for encumbrances, \$500 million reserved for legal contingencies, \$100 million for legislative initiatives and \$1.2 billion in the reserve. The very strong revenue collections in recent months indicate that estimates for this year and next year may indeed be very conservative.

Revenue strength has continued in this fiscal year with a gain for seven months of 17.7% over the comparable prior year period and 4.3% above the estimate. Personal income tax was up 19.7% (some \$906 million over estimates). Sales tax was up 13.5%, while 10.0% was forecast.

The legislative analyst's most recent budget review projected that revenues will be some \$2.6 billion over estimates, \$684 million accruing to 1998-99 (actual was over \$700 million) and about \$1.9 billion to 1999-2000. Results to date support the forecast.

With improved financial operations and stronger cash flow, operating borrowing this year was only \$1.0 billion, down from \$1.7 billion last year and \$3.0 billion annually in the two prior years. Fiscal 1999 was the second consecutive year in which the general fund closed with a cash balance.

A test claim was brought by a consortium of counties to determine if the property tax shift (from counties

Revenues
(% Change)

	1996-97	1997-98	1998-99*	1998-99*	1999-00*	2000-02**
Income	12.1	7.6	7.6	10.6	11.6	5.4
Sales	5.2	6.9	6.9	7.8	6.7	5.7

*Estimated.

to school districts) is a reimbursable state-mandated cost. Exposure amounts to about \$10 billion and, for the future, \$3.7 billion annually. The state prevailed in hearings but Sonoma County filed suit to overturn the decision. The Superior Court of Sonoma County ruled in favor of the county. The state has appealed.

■ **The Economy**

California's economy is broad and diverse; its population, in 1995 estimated at 31,589,000, is nearly 70% greater than that of Texas, now the second largest. Services are the largest employer, accounting in 1998 for 31%, with trade at 23%. Manufacturing now provides only 14%, down from 16% in 1990; high technology employment declined 30% over the period, from 5.4% to 3.9% of the total. During the recession, about a 5% job loss was experienced, but most had been regained by 1995, and employment in 1998 was about 8% over the pre-recession peak. Recovery from the recession was both faster and stronger than anticipated. In Oct. 1999, compared with the same month a year earlier, employment was up 2.5% with gains of 7.9% in construction; 4.4% in services; 1.3% in trade; government, 2.2%; and FIRE, 1.0%; manufacturing declined 0.6%. The unemployment rate was 4.6%, well below earlier levels, and reportedly the lowest in 30 years.

Personal income was depressed, with the state gain well below the national rate in 1991-1996, but, with recovery, the state outperformed the U.S. in 1998 and 1997. In second quarter 1999, the state gain was 6.7%, compared with 5.4% for the U.S. On a per capita basis, the state figure has declined to a level only slightly ahead of that for the U.S. The state's rank has dropped to 12 while, traditionally, it was within the top 10. For the past three years, the state per capita growth rate has about matched the national experience. Expansionary expectations have centered on the entertainment industry and trade with the Pacific Rim. Economic problems in Asia have affected manufacturing in California a major exporter to the region. In 1998, exports to the region, about 40% of the state's total exports, were down 20%. The slack was made up by exports to NAFTA, which rose 12.5%. Europe was up 6.8% and Canada up 10.9% keeping the overall decline to 4.2%. Recovery is evident. From third-quarter 1998 to third-quarter 1999, total exports rose 10.2%, spurred by an increase of 48.5% to East Asia; third-quarter 1998 was down 9.4%, with a 30.3% drop in East Asian trade. Primary state exports include computers and other industrial machinery and electronic components and equipment. The largest Asian effect has been felt in manufacturing.

Economic Trends

Employment
(000)

	CA	% Change	U.S.	% Change
1980	9,849	—	90,406	—
1985	10,979	11.5	97,387	7.7
1988	12,103	10.0	105,210	8.0
1989	12,569	3.4	107,884	2.5
1991	12,359	(1.7)	108,249	0.3
1992	12,153	(1.7)	108,601	0.3
1993	12,045	(0.9)	110,713	1.9
1994	12,160	1.0	114,163	3.1
1995	12,422	2.2	117,191	2.7
1996	12,743	2.6	119,608	2.1
1997	13,130	3.0	122,690	2.6
1998	13,584	3.5	125,826	2.6
October 1999	14,119	3.9	129,311	2.8

Unemployment Rates
(%)

	CA	U.S.	CA as % of U.S.
	6.8	7.1	85
	7.2	7.2	100
	5.3	5.5	96
	5.1	5.3	96
	7.5	6.7	112
	9.1	7.4	123
	9.2	6.8	135
	8.6	6.1	141
	7.8	5.6	139
	7.2	5.4	133
	6.3	4.9	129
	5.9	4.5	131
	4.6	4.1	112

Personal Income
(Change from Prior Year)

	% Change	U.S.	CA as % of U.S. Growth
1990	8.2	6.7	122
1991	2.3	3.7	62
1992	4.9	6.0	82
1993	2.0	4.4	44
1994	2.9	5.0	58
1995	5.0	5.5	91
1996	5.0	5.8	86
1997	6.0	5.7	105
1998	6.4	5.7	112

Per Capita Income
(Change from Prior Year)

	% Change	U.S.	CA as % of U.S.
	5.7	6.5	88
	0.6	2.6	23
	3.3	4.8	69
	1.0	3.3	30
	2.3	3.9	59
	4.4	4.6	96
	4.8	4.8	100
	4.7	4.7	100
	4.8	4.7	102

Components of Personal Income Earnings

	CA		% Change	U.S.		% Change
	1996	1998	1996-98	1996	1998	1996-98
Manufacturing	15	16	18	18	17	11
Durables*	11	11	20	11	11	13
FIRE	8	9	25	8	9	21
Services	32	32	16	28	29	17
Trade	15	15	15	15	15	14
Construction	5	5	27	6	6	19
Government	15	14	9	15	14	8

*Durables is a subhead of manufacturing.

State Population: 31,589,000 (1995 est.)

Population Change 1990-95 est.: CA 5.4%, U.S. 5.4%

Personal Income Per Capita 1998: \$27,579 = 104% of U.S.; rank 12

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State of California

ATTACHMENT V



Moody's Investors Service

Global Credit Research

New Issue

7 SEP 2000

Save as PDF

New Issue: California (State of)

MOODY'S RAISES STATE OF CALIFORNIA GO RATING FROM Aa3 TO Aa2. (\$22 BILLION IN DEBT AFFECTED)

Ratings on Bonds Supported by State Leases Raised from A1 to Aa3 (\$6 Billion In Debt Affected)

State
CA

Moody's Rating

ISSUE	RATING
General Obligation Bonds	Aa2
Sale Amount \$850,000,000	
Expected Sale Date 09/13/00	
Rating Description General Obligation Bonds	

Opinion

NEW YORK, Sep 7, 2000 -- Moody's has raised the rating on the general obligation bonds of the State of California to Aa2 from Aa3, affecting \$22 billion in debt, including \$850 million in bonds to be issued on September 13, 2000. In addition, the ratings on bonds supported by state leases, issued through the California State Board of Public Works and several other state authorities, have been raised to Aa3 from A1, affecting an additional \$6 billion in debt.

The upgrade reflects the strength and diversity of a state economy that continues to exceed consensus growth expectations and comfortably outpaces the nation in terms of personal income and employment growth. The increased diversity of the economy has positioned the state well for future expansion, and the deep customer base of the high technology sector decreases the likelihood of a statewide economic downturn absent a national recession. Consensus economic forecasts call for the state's economy to remain strong and to continue to outpace the nation. Consistent with its historical practice, the state's official economic forecast for the near term remains at or below these forecast estimates.

The economic growth over the last several years has dramatically improved the state's financial condition, driving cash and budget reserves to record levels. While the targeted budget reserve remains moderate at 2.2% of general fund revenues, other internal funds are available to provide a buffer against volatile revenue performance during periods of economic downturn. The state currently estimates that it will end the current fiscal year with internal borrowable resources totaling more than \$12 billion, eliminating the need for a cash-flow borrowing for the first time in over two decades.

The upgrade also reflects the state's increased fiscal conservatism, particularly over the last two years. The state has realized a dramatic increase in revenue collections, due in large part to growth in capital gains tax collections. Overall revenues in fiscal 2000 came in approximately 13% over original budget estimates. Such strong results were driven by personal income tax revenues, which were 19% in excess of budget and 27% over prior year actuals. But despite a nearly \$9 billion revenue windfall in the prior fiscal year, the state resisted efforts during the fiscal 2001 budget debate to spend the bulk of such unanticipated resources on recurring expenses. General fund expenditures for the current fiscal year are \$11 billion higher than fiscal 2000 levels. However, this figure includes \$2 billion in one-time tax relief and approximately \$5 billion in one-time capital expenses that largely could be scaled back if revenue collections do not meet budget estimates. In addition, the state has again based its current year budget on conservative revenue estimates.

While the credit strengths described above provide the basis for our rating upgrade and stable outlook, the state credit remains tempered by its relatively inflexible budget structure, due in large part to education

expenditures mandated by Proposition 98; its potentially volatile revenue structure during periods of economic weakening; the lack of a formal mid-year spending adjustment mechanism; and the negative impact a stock market correction could have on capital gains tax collections. In addition, the state's significant infrastructure needs put pressure on its moderate debt position, although developing debt management policies offer the potential for managing debt levels successfully.

The general obligation bonds to be sold on September 13th are being used to fund various state and local capital facilities projects, and to retire commercial paper notes issued to finance investments in public schools and higher educational facilities, and various clean air and transportation improvement projects.

Following is a listing of the various bonds affected by this rating action. Approximately \$28.1 billion of such bonds is outstanding.

STATE OF CALIFORNIA GENERAL OBLIGATION BONDS

- Various issues upgraded from Aa3 to Aa2. Approximately \$21 billion was outstanding as of July 1, 2000. This Aa2 is also assigned to the \$850 million in bonds to be issued on September 13, 2000.

STATE PUBLIC WORKS BOARD LEASE REVENUE BONDS

- Various non-University of California Public Works Board issues upgraded from A1 to Aa3. Approximately \$4.7 billion was outstanding as of July 1, 2000.

OTHER STATE BUILDING LEASE PURCHASE ISSUES

- Various issues upgraded from A1 to Aa3. Approximately \$989 million was outstanding as of July 1, 2000.

EAST BAY BUILDING AUTHORITY CERTIFICATES OF PARTICIPATION

- Upgraded from A1 to Aa3. Approximately \$80 million was outstanding as of July 1, 2000.

SAN BERNADINO JOINT POWERS FINANCING AUTHORITY

- Upgraded from A1 to Aa3. Approximately \$61 million was outstanding as of July 1, 2000.

SAN FRANCISCO STATE BUILDING AUTHORITY LEASE REVENUE BONDS

- Upgraded from A1 to Aa3. Approximately \$50 million was outstanding as of July 1, 2000.

Outlook

The rating outlook for the state is stable. Changes in the approach to budget management has positioned the state to better weather cycles more successfully, despite its volatile revenue structure and inflexible spending base. These include cautious revenue forecasts which avoid committing the most volatile part of the revenue base to fixed expenses, improved reserve levels, and deploying revenue windfalls to one-time investments that improve the state's readiness for future revenue stress. In the near to medium term, the economy is projected to continue to grow, and will continue to outpace the nation. Given the scale of capital needs, the debt burden is likely to grow, further highlighting the importance of new plans to institute a formal multi-year capital planning process.

Analysts

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ATTACHMENT VI



RESOLUTION

AMENDING THE DEBT AND FINANCIAL POLICIES OF THE CITY.

WHEREAS, debt and financial policies for the City and County of Honolulu were initially established by the adoption of Resolution 96-26 as a result of the 1995 Budget Summit, which was convened by the Council of the City and County of Honolulu with the participation of business, government, and financial experts from both the public and private sectors, to investigate ways to reengineer City government to make it more efficient, responsive, and accountable; and

WHEREAS, the debt and financial policies for the City were last amended by Resolution 02-140, CD1, adopted September 25, 2002, which superceded all prior resolutions establishing and amending the debt and financial policies; and

WHEREAS, the Council wishes to further amend the debt and financial policies for the City in the form attached to this Resolution as Exhibit "A"; and

WHEREAS, this Resolution is intended to supercede in its entirety said Resolution 02-140, CD1; and

WHEREAS, this Resolution does not affect the separate debt and financial policies for the wastewater system, established by Resolution 98-197; now, therefore,

BE IT RESOLVED by the Council of the City and County of Honolulu that the "Debt and Financial Policies," attached hereto as Exhibit "A" and made a part hereof, are hereby established as the guidelines under which the City shall manage its operating and capital programs and budgets and its debt program, provided that the wastewater system shall continue to be governed by the policies established by Resolution 98-197; and

BE IT FURTHER RESOLVED that this Resolution shall supercede in its entirety Resolution 02-140, CD1; and

RESOLUTION

BE IT FINALLY RESOLVED that copies of this Resolution shall be transmitted to the Mayor, the Managing Director and the Director of Budget and Fiscal Services.

INTRODUCED BY:

Ann Kobayashi (BR)

DATE OF INTRODUCTION:

March 3, 2003
Honolulu, Hawaii


Councilmembers

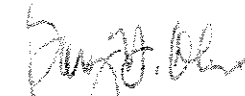
(OCS/051603/ct)

CITY COUNCIL
CITY AND COUNTY OF HONOLULU
HONOLULU, HAWAII

I hereby certify that the foregoing RESOLUTION was adopted by the COUNCIL OF THE CITY AND COUNTY OF HONOLULU on the date and by the vote indicated to the right.

ATTEST:


GENEVIEVE G. WONG
CITY CLERK


GARY H. OKINO
CHAIR AND PRESIDING OFFICER

Dated 06/04/03

ADOPTED MEETING HELD			
06/04/03			
	AYE	NO	A/E
CACHOLA	X		
DELA CRUZ	X		
DJOU			E
GABBARD	X		
GARCIA	X		
KOBAYASHI	X		
MARSHALL	X		
OKINO	X		
TAM	X		
	8	0	1

Reference:

Report No. 225

Resolution No.

03-59, CD1

EXHIBIT A

DEBT AND FINANCIAL POLICIES

(Note: For informational purposes only policy material added is underlined and material no longer included is bracketed.)

1. OPERATING BUDGET

A. OVERALL

1. The operating budget details a financing and spending program to meet the goals and objectives of the City which have been established by the City administration, the City Council, and the public. It contains information and data regarding expected revenues, expected expenditures and expected service and performance outcomes. To the extent feasible, the budget also should include outcome measures which reflect each programs' success in meeting established goals and objective.
2. Operating expenses are the costs for personnel, materials and equipment required for a government entity to function. Operating expenses are expenditures for day to day operations and exclude expenditures for capital purposes, as defined herein. Operating expenses include the cost of paying salaries and benefits to civil service employees except that salaries for employees funded with cash from the sewer fund may be included in the capital budget.
3. The City administration shall have written policies with respect to the preparation and implementation of the City's operating budget that incorporate the guidelines and definitions contained herein.
4. As a comprehensive business plan, the budget includes the following elements as recommended by the Government Finance Officers Association: public policies, financial plan, operations plan, and communications device.
5. The City's annual budget presentation should display the City's service delivery/performance plan in a public-friendly format.
6. Under the Mayor's direction, Department Directors have primary responsibility to formulate budget proposals and implement the budgets appropriated by the City Council and allotted by the Mayor.

B. FISCAL INTEGRITY

1. The City will maintain the fiscal integrity of its operating and capital budgets by maximizing its level of public services while minimizing its level of debt.
2. Cash balances in excess of the amount required to maintain a long-term contingency reserve shall be used to fund one-time or non-recurring costs.

C. LONG-TERM CONTINGENCY RESERVE - "RAINY DAY FUND"

The City shall pursue the creation of an appropriated Long-Term Contingency Reserve in order to accommodate dire financial emergencies. The funding of this reserve shall be based upon a formula established in ordinance and contingent upon increasing real property assessments. This reserve shall be used only for dire financial emergencies with the approval of the Mayor and the City Council.

D. REVENUES

1. The City shall make every effort to maintain a very high tax collection rate (over 98.5 percent) to the extent consistent with the marginal costs of collection.
2. The City shall place increased emphasis on user fees to finance municipal services.
3. The City shall seek to diversify its revenue mix to be less dependent on property tax revenues and temporary revenues.
4. The City annually shall review all revenue schedules, including taxes, rates, licenses, user fees, and other charges to determine the appropriate level of each revenue source required for the operating and capital costs of the programs they finance. Multi-year rate schedules shall be established whenever feasible.
5. The City shall maintain a sewer fee rate structure which is adequate to insure that the programs the sewer funds finance remain firmly and separately self-supporting, including the costs of operations, maintenance, and debt service; provided that this shall not preclude the use of community facilities districts, benefit districts, unilateral agreements, development agreements, user fees and impact fees to pay for sewer capital improvements.

6. The City shall make every effort to maximize investment income by achieving and maintaining a high level of prudent and legally appropriate cash investments.
7. The City diligently shall seek Federal, State and other revenues to fund its current and new programs. However, the City shall ensure that its long-term financial planning considers the eventual loss of these temporary financing sources.
8. No monies from the sale of any City property shall be budgeted as revenue in the executive operating budget unless the City has an executed contract with a realtor concerning the listing of the property and public notice of the listing of the property has been given.
- [9. No monies from the solid waste special fund, or any account therein, or from the sewer fund shall be budgeted or expended to reimburse the general fund for expenses incurred in prior fiscal years.]

E. SELF-INSURANCE PROGRAM

The City shall continue to set aside funding in the City's risk management account. As the City's mix and level of liabilities increase, the City should implement a cost-effective program to mitigate the expense of commercial insurance.

F. MINIMIZATION OF ADMINISTRATIVE COSTS

Administrative costs should reflect an appropriate balance between resources allocated for direct services to the public and resources allocated to ensure sound management, internal controls, and legal compliance.

G. MULTI-YEAR ESTIMATES

1. With every annual budget, the Mayor shall propose a six-year operating and capital expenditure and revenue plan for the City which shall include estimated operating costs for future capital project proposals that are included in the Capital Program. The plan for the operating and capital components shall detail the six-year projections according to the categories of expenditures and revenues shown in Attachments A and B, made a part hereof, and shall show how future expenditures are to be met by existing or new revenue sources.

2. This budget data shall be presented to elected officials in a form that will facilitate annual budget decisions, based on a multi-year strategic planning perspective.

H. CITIZEN INVOLVEMENT

1. Citizen involvement shall be encouraged in the annual budget decision-making process through public hearings and community meetings. Such involvement shall include assistance in establishing program and budget priorities for the City.
2. Involvement shall also be facilitated through City boards, task forces and commissions, which shall serve in advisory capacities to the City Council and the Mayor.

I. USER FEES

Whenever the City charges user fees, those fees shall be phased toward covering 100 percent of the cost of service delivery, including debt service costs, unless such amount prevents an individual from obtaining an essential service. Fees may be less than 100 percent if certain factors (e.g., market forces, competitive position, etc.) need to be considered.

J. NON-PROFIT ORGANIZATIONS

All grants of public funds to private organizations shall be based on standards established in ordinance.

II. CAPITAL BUDGET

A. OVERALL

1. Capital costs funded in the capital budget shall be limited to costs that do not recur annually. These include equipment having a unit cost of \$5,000 or more and estimated service life of 5 years or more, except for equipment funded with cash from the sewer fund. Items such as light poles and playground equipment whose individual cost is less than \$5,000 may be funded in the capital budget if aggregated and made an integral part of a project costing \$25,000 or more and the estimated service life of every major component of the project is 5 years or more, such as a project to replace all of the light poles in a neighborhood or a project to replace a park's facilities including playground equipment. To be included, improvement and replacement costs of public infrastructure must substantially expand the capacity or extend the

life of the public infrastructure. Eligible capital costs would include the repaving of parking lots but not painting and slurry sealing of parking lots. It would include the installation of a new roofing surface but not spot patching of a roof. Contracts to hire engineering and design professionals under a personal services contract with a definite termination date may also be included. Costs associated with paying the salaries of civil service employees shall not be included except for salaries funded with cash from the sewer fund. Major renovations costing more than \$5,000 to existing facilities may qualify as a capital project. Routine maintenance of existing facilities, however, shall not qualify; instead, such costs shall be included in the operating budget. All other necessary costs that do not qualify for funding in the capital budget shall be included in the operating budget and deemed operational costs.

2. The City administration shall have written policies with respect to the preparation and implementation of the City's capital budget that incorporate the guidelines and definitions contained herein.
3. The preparation and adoption of the capital budget shall be coordinated with the operating budget so that the City may ensure that sufficient resources are available to operate and maintain its facilities.

B. FISCAL POLICIES

1. Capital project proposals should include as complete, reliable, and attainable cost estimates as possible. Project cost estimates for the capital budget should be based on a thorough analysis of each project and be as reliable as the level of detail known about the project. Project cost estimates for the six-year Capital Program may vary in reliability depending on when they are to be undertaken during the first through the sixth year of the Program.
2. Capital project proposals should include a comprehensive resource plan. This plan should include the amount and type of resources required, and the funding and financing strategies to be employed. The specific fund and timing should be outlined. The plan should indicate resources needed to complete any given phase of a project in addition to the total project.
3. All proposals for the expenditure of capital funds shall be formulated and presented to the City Council within the framework of the capital budget.

4. Project proposals will include the project's impact on the operating budget, including, but not limited to, additional personnel requirements and long-term maintenance costs necessary to support the project.
5. At the time of a contract award, each project shall include a reasonable provision for contingencies. The amount set aside for contingencies shall correspond with industry standards and should not exceed ten percent of the estimated project costs.
6. The City administration shall minimize administrative costs of the Capital Program.
7. The annual capital budget shall include those projects which can reasonably be accomplished in the time frame indicated. The capital budget shall include a projected time schedule for each project.

C. CAPITAL PROGRAM POLICIES

1. Citizen participation in the Capital Program formulation is a priority for the City. Among the activities which shall be conducted to address this need are the following:
 - a. Community meetings shall be held in a timely manner to receive community input to the Capital Program before it is submitted to the City Council.
 - b. Council deliberations on the Capital Program shall be open to the public and advertised sufficiently in advance of the meetings to allow for the attendance of interested citizens.
 - c. Prior to the adoption of the Capital Program, the Council shall hold noticed public hearings to provide opportunities for citizens to express their opinions on the proposed Capital Program.
2. All projects included in the Capital Program shall be consistent with the City's General Plan and Development Plans. The goals and policies for services, facilities, and transportation should serve as guidelines for the development of the Capital Program.
3. Capital projects shall be financed when possible through user fees, impact fees, community facilities districts, benefit districts, unilateral agreements and development agreements.

4. Projects that involve intergovernmental cooperation in planning and funding shall be established by an agreement that sets forth the basic responsibilities of the parties involved.
5. The City annually shall review and establish criteria to evaluate capital project proposals. Factors to be considered for priority-ranking include the following:
 - a. Projects required to meet public health and safety needs;
 - b. Projects mandated by federal or state law;
 - c. Projects which have a positive impact on the operating budget (i.e., reduces expenditures, increases revenues);
 - d. Projects which are programmed in the operating budget multi-year estimates;
 - e. Projects which can be completed or significantly advanced during the six-year Capital Program; and
 - f. Projects which realistically can be initiated during the year they are scheduled.

III. DEBT POLICIES

- A. Debt shall not be used to finance ongoing operational costs as defined herein.
- B. Whenever possible, the City shall pursue alternative sources of funding in order to minimize the level of debt.
- C. When feasible, the City shall use special assessment, revenue, or reimbursable bonds in lieu of general obligation debt.
- D. Long-term general obligation debt may be incurred when necessary, based on the City's ability to pay. This debt shall be limited to those capital projects that cannot be financed from existing revenues and when there is an existing or near-term need for the project. The project also should be integrated with the City's long-term financial plan and Capital Program.
- E. The maturity date for any debt shall not exceed the reasonable expected useful life of the project so financed.

- F. The City shall encourage and maintain good relations with financial and bond rating agencies and will follow a policy of full and open disclosure on every financial report and bond prospectus. A rating agency presentation/update shall be conducted at least once annually.
- G. The City shall establish affordability guidelines in order to preserve credit quality. Guidelines, which may be suspended for emergency purposes or because of unusual circumstances, are as follows:
 - 1. Debt service for general obligation bonds including self-supported bonds as a percentage of the City's total operating budget, including enterprise and special revenue funds, should not exceed 20 percent.
 - 2. Debt service on direct debt, excluding self-supported bonds, as a percentage of General Fund revenues should not exceed 20 percent.
- H. The total outstanding principal of the City's variable rate debt should not exceed 120% of the City's total short-term investments.
- I. Variable rate debt should be used only as a source of interim or construction financing, financing of equipment with a useful life of five years, and short-term financing of debt service. In the event variable rate debt is used to finance debt service, the variable rate debt shall be refunded as a part of the next long-term bond issuance.
- J. Whenever possible, the City shall seek State funding for financing of qualified wastewater projects.
- K. The City continually shall review outstanding City debt and initiate refinancing when feasible.
- L. Unless the refunding of bonds is for the purpose of restructuring existing debt service on outstanding bonds or to refund outstanding bonds which bear interest at a rate or rates which shall vary from time to time, the City shall refund callable fixed rate bonds only if the present value savings which shall inure to the City as a result of the refunding shall not be less than 2%.

ATTACHMENT A: CATEGORIES OF EXPENDITURES

OPERATING EXPENDITURES

Executive:

- General Government
- Public Safety
- Highways and Streets
- Sanitation
- Health and Human Resources
- Culture-Recreation
- Utilities or Other Enterprises
- Debt Service
- Miscellaneous

Legislative:

- General Government - Legislative

CAPITAL EXPENDITURES

- General Government
- Public Safety
- Highways and Streets
- Sanitation
- Human Services
- Culture-Recreation
- Utilities or Other Enterprises

ATTACHMENT B: CATEGORIES OF RESOURCES

OPERATING RESOURCES

- Real Property Tax
- Fuel Tax
- Motor Vehicle Weight Tax
- Public Utility Franchise Tax
- Federal Grants
- State Grants
- Transient Accommodations Tax
- Public Service Company Tax
- Licenses and Permits
- Charges for Services
- Sewer Charges
- Bus Transportation Revenues
- Solid Waste Revenues
- Other Revenues
- Carry-Over

CAPITAL RESOURCES

- General Obligation Bonds
- Bikeway Fund
- Parks and Playgrounds Fund
- Sewer Revenue Bond Improvement Fund
- Federal Grants Fund
- Community Development Funds
- State Funds
- Sewer Assessment
- Developer
- Board of Water Supply
- Utilities

ATTACHMENT VII

Selecting and Managing the Method of Sale of State and Local Government Bonds (1994)

Background. It is in the interest of state and local government issuers to sell public debt using the method of sale that is expected to achieve the best sales results, taking into account both short-range and long-range implications for taxpayers and ratepayers. However, there is a divergence of views as to the relative merits of the competitive and negotiated methods of sale due to the lack of comprehensive, empirical evidence that would favor one method over the other. Furthermore, in negotiated sales, there is concern about the fairness of the selection process and the possibility of higher borrowing costs because of the potential for underwriter selection on the basis of political favoritism rather than merit and cost. There also is the recognition that conflicts of interest may arise because of agreements by and between outside financial professionals involved in the transaction.

Recommendation. If state and local governments are able to choose their method of bond sale, the Government Finance Officers Association (GFOA) recommends that policies be adopted to ensure that the most appropriate method of sale is selected in light of financial, market, and transaction-specific and issuer-related conditions; the method of sale is evaluated for each bond issue, including an assessment of the different risks associated with each method; and thorough records are kept about the process to demonstrate that it was equitable and defensible.

The GFOA also recommends that the competitive method of sale be chosen when conditions favoring this method of sale are present. Such conditions include the following:

1. The market is familiar with the issuer, and the issuer is a stable and regular borrower in the public market.
2. There is an active secondary market with a broad investor base for the issuer's bonds.
3. The issue has an unenhanced credit rating of A or above or can obtain a credit enhancement prior to the competitive sale.
4. The debt structure is backed by the issuer's full faith and credit or a strong, known or historically performing revenue stream.
5. The issue is neither too large to be easily absorbed by the market nor too small to attract investors without a concerted sales effort.
6. The issue is not viewed by the market as carrying complex or innovative features or requiring explanation as to the bonds' soundness.
7. Interest rates are stable, market demand is strong, and the market is able to absorb a reasonable amount of buying or selling at reasonable price changes.

While issuers often use negotiated sales to address public-policy issues such as the desire for disadvantage business enterprise (DBE) and regional firm participation in the

syndicate and the allocation of bonds to such firms, they may be able to meet these goals by specifying their requirements in the notice of sale.

If conditions do not allow for a competitively bid bond sale, GFOA recommends the following practices:

1. Promote fairness in a negotiated sale by using a competitive underwriter-selection process that ensures that multiple proposals are considered.
2. Remain actively involved in each step of the negotiation and sale processes to uphold the public trust.
3. Ensure that either an employee of the issuer or an outside professional other than the issue underwriter, who is familiar with and abreast of the condition of the municipal market, is available to assist in structuring the issue, pricing, and monitoring sales activities.
4. Avoid using a firm to serve as both the financial advisor and underwriter of an issue because conflicts of interest may arise.
5. Require that financial professionals disclose the name(s) of any person or firm compensated to promote the selection of the underwriter; any existing or planned arrangements between outside professionals to share tasks, responsibilities and fees; the name(s) of any person or firm with whom the sharing is proposed; and the method used to calculate the fees to be earned.
6. Review the "Agreement Among Underwriters" and ensure that it governs all transactions during the underwriting period.

References

- *Competitive v. Negotiated Sale Debt*, Issue Brief No. 1, California Debt Advisory Commission, September 1992.
- *An Elected Official's Guide to Debt Issuance*, J.B. Kurish and Patricia Tigue, GFOA , 1993.
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- *Competitive v. Negotiated: How to Choose the Method of Sale for Tax-Exempt Bonds*, GFOA, 1994.

ATTACHMENT VIII

Rule G-23: Activities of Financial Advisors

(a) *Purpose.* The purpose and intent of this rule is to establish ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities.

(b) *Financial Advisory Relationship.* For purposes of this rule, a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services. Notwithstanding the foregoing, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.

(c) *Basis of Compensation.* Each financial advisory relationship shall be evidenced by a writing entered into prior to, upon or promptly after the inception of the financial advisory relationship (or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences). Such writing shall set forth the basis of compensation for the financial advisory services to be rendered, including provisions relating to the deposit of funds with or the utilization of fiduciary or agency services offered by such broker, dealer, or municipal securities dealer or by a person controlling, controlled by, or under common control with such broker, dealer, or municipal securities dealer in connection with the rendering of such financial advisory services.

(d) *Underwriting Activities.* No broker, dealer, or municipal securities dealer that has a financial advisory relationship with respect to a new issue of municipal securities shall acquire as principal either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from the issuer all or any portion of such issue, or act as agent for the issuer in arranging the placement of such issue, unless

(i) if such issue is to be sold by the issuer on a negotiated basis,

(A) the financial advisory relationship with respect to such issue has been terminated in writing and at or after such termination the issuer has expressly consented in writing to such acquisition or participation, as principal or agent, in the purchase of the securities on a negotiated basis;

(B) the broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer at or before such termination that there may be a conflict of interest in changing from the capacity of financial advisor to purchaser of or placement agent for the securities with respect to which the financial advisory relationship exists and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipt of such disclosure; and

(C) the broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer at or before such termination the source and anticipated amount of all remuneration to the broker, dealer, or municipal securities dealer with respect to such issue in addition to the compensation referred to in section (c) of this rule, and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipt of such disclosure; or

(ii) if such issue is to be sold by the issuer at competitive bid, the issuer has expressly consented in writing prior to the bid to such acquisition or participation.

The limitations and requirements set forth in this section (d) shall also apply to any broker, dealer, or municipal securities dealer controlling, controlled by, or under common control with the broker, dealer, or municipal securities dealer having a financial advisory relationship. The use of the term "indirectly" in this section (d) shall not preclude a broker, dealer, or municipal securities dealer who has a financial advisory relationship with respect to a new issue of municipal securities from purchasing such securities from an underwriter, either for its own trading account or for the account of customers, except to the extent that such purchase is made to contravene the purpose and intent of this rule.

(e) *Remarketing Activities.* No broker, dealer, or municipal securities dealer that has a financial advisory relationship with an issuer with respect to a new issue of municipal securities shall act as agent for the issuer in remarketing such issue, unless the broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer:

(i) that there may be a conflict of interest in acting as both financial advisor and remarketing agent for the securities with respect to which the financial advisory relationship exists; and

(ii) the source and basis of the remuneration the broker, dealer or municipal securities dealer could earn as remarketing agent on such issue.

This written disclosure to the issuer may be included either in a separate writing provided to the issuer prior to the execution of the remarketing agreement or in the remarketing agreement. The issuer must expressly acknowledge in writing to the

broker, dealer, or municipal securities dealer receipt of such disclosure and consent to the financial advisor acting in both capacities and to the source and basis of the remuneration.

(f) *Disclosure to Issuer of Corporate Affiliation.* If the financial advisor for the issue is not a broker, dealer or municipal securities dealer, and the broker, dealer or municipal securities dealer that acquires the issue or arranges for such acquisition pursuant to section (d) of this rule is controlling, controlled by, or under common control with such financial advisor, the broker, dealer or municipal securities dealer must disclose this affiliation in writing to the issuer prior to the acquisition and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipts of such disclosure.

(g) Each broker, dealer, and municipal securities dealer subject to the provisions of sections (d), (e) or (f) of this rule shall maintain a copy of the written disclosures, acknowledgments and consents required by these sections in a separate file and in accordance with the provisions of rule G-9.

(h) *Disclosure to Customers.* If a broker, dealer, or municipal securities dealer acquires new issue municipal securities or participates in a syndicate or other account that acquires new issue municipal securities in accordance with section (d) of this rule, such broker, dealer, or municipal securities dealer shall disclose the existence of the financial advisory relationship in writing to each customer who purchases such securities from such broker, dealer, or municipal securities dealer, at or before the completion of the transaction with the customer.

(i) *Applicability of State or Local Law.* Nothing contained in this rule shall be deemed to supersede any more restrictive provision of state or local law applicable to the activities of financial advisors.

MSRB INTERPRETATIONS

NOTICE ON APPLICATION OF BOARD RULES TO FINANCIAL ADVISORY SERVICES RENDERED TO CORPORATE OBLIGORS ON INDUSTRIAL DEVELOPMENT BONDS

May 23, 1983

In a recent letter to the Office of the Comptroller of the Currency, the staff of the Securities and Exchange Commission has taken the position that private placements of industrial development bonds ("IDBs") constitute transactions in municipal securities as defined in the Securities Exchange Act of 1934, as amended. The Municipal Securities Rulemaking Board has received a number of inquiries concerning this letter. The Board is publishing this notice for the purposes of: (1) reviewing the application of its rules to private placements of municipal securities and (2) expressing its views concerning whether certain Board rules apply to financial advisory services rendered by municipal securities dealers and brokers to corporate obligors on IDBs.

A. Private Placements of IDBs

The Board's rules apply, of course, to all transactions in municipal securities, including securities which are IDBs. The SEC letter dealt in particular with the activities of commercial banks. That letter pointed out that if a commercial bank has a registered municipal securities dealer department, under Board rule G-1, which defines the term "separately identifiable department or division of a bank," any private placement activities of the bank in securities which are IDBs must be conducted as a part of the registered dealer department. The Board urges all bank dealers which have registered as a separately identifiable department or division to review their organizations and assure that all departments or units which engage in the private placement of IDBs are designated on the bank's Form MSD registration and other applicable bank records as part of its separately identifiable department or division. The Board also notes that such activities must be under the supervision of a person designated by the bank's board of directors as responsible for these activities. In addition, under Board rule G-3, concerning professional qualifications, persons who are engaged in privately placing municipal securities must be qualified as municipal securities representatives and be supervised with respect to that activity by a qualified municipal securities principal.

B. Financial Advisory Services Rendered to Corporate Obligors on IDBs

Board rules G-1 and G-3 provide that rendering "financial advisory or consultant services for issuers" is an activity to which those rules are

applicable (emphasis added). Similarly, Board rule G-23, on the activities of financial advisors, applies to brokers, dealers, and municipal securities dealers who agree to render "financial advisory or consultant services to or on behalf of an issuer" (emphasis added). Clearly these rules are applicable to financial advisory services rendered to state or local governments and their agencies, as well as to municipal corporations. In the Board's view, however, rules G-1, G-3, and G-23 do not apply to financial advisory services which are provided to corporate obligors in connection with proposed IDB financings.

The Board wishes to emphasize that the scope of its definition of financial advisory services is limited to "advice with respect to the structure, timing, terms, and other similar matters" concerning a proposed issue.¹ If persons providing such advice to the corporate obligor on an IDB issue also participate in negotiations with prospective purchasers or are otherwise engaged in effecting placement of the issue, then, as indicated above, rules G-1 and G-3 would apply to their activities.

[Excerpts of the Commission letter follow.]

This is in response to your letter of December 1, 1981, requesting our views concerning certain activities by commercial banks in connection with industrial development bonds ("IDBs").² Specifically, you asked (1) whether the private placement activities of banks in IDBs involve transactions in municipal securities, (2) whether involvement in such activities alone would require such banks to register with the Commission under Section 15B of the Securities Exchange Act of 1934 (the "Exchange Act") as municipal securities dealers, (3) whether a bank that had registered a separately identifiable department or division with the Commission as a municipal securities dealer would be required to conduct such activities through such separately identifiable department or division, and (4) if such bank activities are required to be conducted in the separately identifiable department or division, whether the advisory services provided by those banks to the corporate obligor on an IDB should be regarded as advisory services provided to an issuer of municipal securities in connection with the issuance of municipal securities. Pursuant to your letter and subsequent telephone conversations, we understand the following facts to be typical of the activities in question.

A commercial bank offers private placement and financial advisory services to corporate entities on a regular and continuous basis. From time to time the bank recommends to the corporate entity that IDBs be used to raise capital. The bank advises the corporate entity regarding the terms

ATTACHMENT IX

Selecting Bond Counsel (1998)

Background. An essential member of the bond financing team of governmental issuers is bond counsel. Bond counsel renders an opinion on the validity of the bond offering, the security for the offering, and whether and to what extent interest on the bonds is exempt from income and other taxation. The opinion of bond counsel provides assurance both to issuers and to investors who purchase the bonds that all legal requirements are met. An issuer should assure itself that its bond counsel has the necessary expertise to provide an opinion that can be relied on and will be able to assist the issuer in completing the transaction in a timely manner.

Recommendation. The Government Finance Officers Association (GFOA) recommends that issuers select bond counsel on the basis of merit using a competitive process. A competitive process using a request for proposals (RFP) or request for qualifications (RFQ) process permits issuers to compare qualifications of firms and select a firm or firms that best meets their needs. The RFP or RFQ should clearly describe the scope of services desired, the length of the engagement, evaluation criteria, and the selection process. The GFOA has developed a recommended practice on selecting financial advisors and underwriters that provides advice on setting up an objective RFP process, advice which is also generally applicable to the selection of bond counsel.

An RFP or RFQ should require firms proposing to serve as bond counsel to submit information that permits the issuer to evaluate the following factors, at a minimum:

1. The experience of the firm with financings of the issuer or comparable issuers, and financings of similar size, types and structures, including financings in the same state.
2. The experience of the firm with federal, state, and other laws including tax matters.
3. The experience of the firm with and its approach to applicable federal securities laws and regulations.
4. The knowledge and experience of the attorneys that would be assigned to the transaction, particularly the individual with day-to-day responsibility for the issuer's account.
5. The ability of the firm and assigned personnel to evaluate legal issues, prepare documents, and complete other tasks of a bond transaction in a timely manner.
6. Relationships or activities that might present a conflict of interest for the issuer, including financial relationships with other firms providing services that the issuer will procure for a bond issue.

In making the final selection of bond counsel issuers should consider the

following factors:

7. Issuers should consider the use of oral interviews of candidates, in which the attorney who would have day-to-day responsibility for the issuer's account should be asked to assume the lead role in presenting the qualifications of the firm.
8. The selection should not be driven solely by proposed fees. The experience of the firm with the type of transactions contemplated by the issuer is the most important factor in the selection of bond counsel.
9. For issuers that have ongoing needs of a similar nature, continuity is an important factor.
10. While bond counsel fees typically have been contingent on the sale of bonds, fees based on this arrangement may create an incentive to provide opinions that would allow the inappropriate issuance of bonds. Fees based on an hourly, retainer or fixed fee arrangement may more appropriately reflect the complexity and scope of the services provided.
11. Before making a final selection, the issuer should check the references furnished by the prospective bond counsel.

Once a bond counsel has been selected, issuers should enter into an engagement letter or other agreement with the firm as required by state or local law or procurement codes. Issuers should consider using the form of the model engagement letter for governmental bonds suggested by the National Association of Bond Lawyers.

If co-bond counsel are being engaged, the issuer should

- delineate in the RFP or engagement letter the roles and responsibilities of each firm;
- assign discrete tasks to each firm in order to minimize cost duplication; and
- exercise appropriate oversight to ensure coordination of tasks undertaken by the firms.

If co-bond counsel are engaged or if bond counsel firms are rotated, the issuer should

- evaluate whether higher costs for legal services will result because of the need for two or more firms to familiarize themselves with the issuer; and
- consider the possible need to resolve differing viewpoints of each bond counsel.

Throughout the term of the engagement, the performance of bond counsel should be evaluated in relation to the stated scope of services and any areas where service needs to be improved should be communicated to the lead attorney. Ongoing contracts should be reviewed regularly and resubjected to competitive selection periodically.

References

- "Preparing RFPs to Select Financial Advisors and Underwriters" GEOA

Recommended Practice, 1997.

- *A Guide to Selecting Financial Advisors and Underwriters: Writing RFPs and Evaluating Proposals*, Patricia A. Tigue, GFOA, 1997.
- "Model Engagement Letters," National Association of Bond Lawyers, 1998.
- "The Selection and Evaluation of Bond Counsel," National Association of Bond Lawyers, 1998.

ATTACHMENT X

§103D-304 Procurement of professional services. (a) Professional services shall be procured in accordance with sections 103D-302, 103D-303, 103D-305, 103D-306, or 103D-307, or this section; provided that design professional services furnished by licensees under chapter 464 shall be procured pursuant to this section or section 103D-307. Contracts for professional services shall be awarded on the basis of demonstrated competence and qualification for the type of services required, and at fair and reasonable prices.

(b) At a minimum, before the beginning of each fiscal year, the head of each purchasing agency shall publish a notice inviting persons engaged in providing professional services which the agency anticipates needing in the next fiscal year, to submit current statements of qualifications and expressions of interest to the agency. Additional notices shall be given if:

- (1) The response to the initial notice is inadequate;
- (2) The response to the initial notice does not result in adequate representation of available sources;
- (3) New needs for professional services arise; or
- (4) Rules adopted by the policy board so specify.

The chief procurement officer may specify a uniform format for statements of qualifications. Persons may amend these statements by filing a new statement prior to the date designated for submission.

(c) The head of the purchasing agency shall designate a review committee consisting of a minimum of three persons with sufficient education, training, and licenses or credentials for each type of professional service which may be required. In designating the members of the review committee, the head of the purchasing agency shall ensure the impartiality and independence of committee members. The names of the members of the review committee established under this section shall be placed in the contract file.

The committee shall review and evaluate all submissions and other pertinent information, including references and reports, and prepare a list of qualified persons to provide these services. Persons included on the list of qualified persons may amend their statements of qualifications as necessary or appropriate. Persons shall immediately inform the head of the purchasing agency of any change in information furnished which would disqualify the person

from being considered for a contract award.

(d) Whenever during the course of the fiscal year the agency needs a particular professional service, the head of the purchasing agency shall designate a selection committee to evaluate the statements of qualification and performance data of those persons on the list prepared pursuant to subsection (c) along with any other pertinent information, including references and reports. The selection committee shall be comprised of a minimum of three persons with sufficient education, training, and licenses or credentials in the area of the services required. In designating the members of the selection committee, the head of the purchasing agency shall ensure the impartiality and independence of committee members. The names of the members of a selection committee established under this section shall be placed in the contract file.

(e) The selection criteria employed in descending order of importance shall be:

(1) Experience and professional qualifications relevant to the project type;

(2) Past performance on projects of similar scope for public agencies or private industry, including corrective actions and other responses to notices of deficiencies;

(3) Capacity to accomplish the work in the required time; and

(4) Any additional criteria determined in writing by the selection committee to be relevant to the purchasing agency's needs or necessary and appropriate to ensure full, open, and fair competition for professional services contracts.

(f) The selection committee shall evaluate the submissions of persons on the list prepared pursuant to subsection (c) and any other pertinent information which may be available to the agency, against the selection criteria. The committee may conduct confidential discussions with any person who is included on the list prepared pursuant to subsection (c) regarding the services which are required and the services they are able to provide. In conducting discussions, there shall be no disclosure of any information derived from the competing professional service offerors.

(g) The selection committee shall rank a minimum of three persons

based on the selection criteria and send the ranking to the head of the purchasing agency. The contract file shall contain a copy of the summary of qualifications for the ranking of each of the persons provided to the head of the purchasing agency for contract negotiations. If more than one person holds the same qualifications under this section, the selection committee shall rank the persons in a manner that ensures equal distribution of contracts among the persons holding the same qualifications. The recommendations of the selection committee shall not be overturned without due cause.

(h) The head of the purchasing agency or designee shall negotiate a contract with the first ranked person, including a rate of compensation which is fair and reasonable, established in writing, and based upon the estimated value, scope, complexity, and nature of the services to be rendered. If a satisfactory contract cannot be negotiated with the first ranked person, negotiations with that person shall be formally terminated and negotiations with the second ranked person on the list shall commence. The contract file shall include documentation from the head of the purchasing agency, or designee, to support selection of other than the first ranked or next ranked person. Failing accord with the second ranked person, negotiations with the next ranked person on the list shall commence. If a contract at a fair and reasonable price cannot be negotiated, the selection committee may be asked to submit a minimum of three additional persons for the head of the purchasing agency to resume negotiations in the same manner provided in this subsection. Negotiations shall be conducted confidentially.

(i) Contracts awarded under this section for \$5,000 or more shall be posted electronically within seven days of the contract award by the chief procurement officer or designee and shall remain posted for at least one year. Information to be posted shall include, but not be limited to:

- (1) The names of the persons submitted under subsection (g);
- (2) The name of the person or organization receiving the award;
- (3) The dollar amount of the contract;
- (4) The name of the head of the purchasing agency or designee making the selection; and
- (5) Any relationship of the principals to the official making the award.

(j) Contracts for professional services of less than the limits in

section 103D-305, may be negotiated by the head of the purchasing agency, or designee, with at least any two persons on the list of qualified persons established pursuant to subsection (c). Negotiations shall be conducted in the manner set forth in subsection (h), with ranking based on the selection criteria of subsection (e) as determined by the head of the agency.

(k) In cases of awards made under this section, nonselected professional service providers may submit a written request for debriefing to the chief procurement officer or designee within three working days after the posting of the award of the contract. Thereafter, the head of the purchasing agency shall provide the requester a prompt debriefing in accordance with rules adopted by the policy board. Any protest by the requester pursuant to section 103D-701 following debriefing shall be filed in writing with the chief procurement officer or designee within five working days after the date that the debriefing is completed. [L Sp 1993, c 8, pt of §2; am L 1995, c 178, §10; am L 1997, c 21, §1 and c 352, §7; am L 2000, c 141, §1; am L 2003, c 52, §5; am L 2004, c 216, §1]

Note

L 1997, c 352, §23 purports to amend this section.

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