

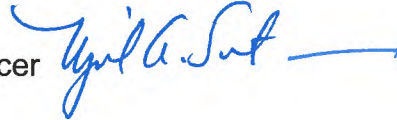
CITY OF LOS ANGELES
INTER-DEPARTMENTAL CORRESPONDENCE

0220-03994-0051

Date: July 27, 2016

To: City Council

From: Miguel A. Santana, City Administrative Officer



Subject: **CONTROLLER AUDIT OF PROPOSITION O PROJECTS DATED
JUNE 29, 2016 (C.F. 13-1526)**

This memorandum pertains to the Controller's June 29, 2016 audit of the Proposition O Clean Water General Obligation (GO) Bond (Prop O) program. In accordance with the original ballot measure that authorized the program, this Office requested an audit of the Prop O program to maintain transparency with the voters and to identify areas of improvement in the management of the program. While the audit acknowledged the successful delivery of Prop O projects, based on our review of the audit, this Office believes that the audit has over-simplified important factors including state law requirements for contracts and project-related issues that are at the core of the audit findings pertaining to Project Management and the existence of large cash balances in the Prop O program.

Specifically, with regard to Project Management Audit Finding 1, this memo provides a detailed list of documented project-related issues that were beyond the control of the City which led to project delays and/or cancellations, and ultimately unspent funds. As the examples demonstrate, in some cases unforeseen discoveries during excavation or other work delayed projects and expenditures from occurring. In other cases, scope changes that resulted in construction efficiencies and the receipt of lower than anticipated bids helped to generate project savings. In aggregate, the savings and unspent funds from these examples do not account for the entire cash balance, but they are important factors that we believe were not appropriately considered in the findings.

Perhaps even more important than the project-related issues that contributed to the cash balances, is the state law requiring the City to have enough cash on hand to pay for all obligations incurred via a contract at the time the contract is signed. This requirement is the reason why such large bond issuances were made at the start of the program, which when combined with the delays mentioned earlier have resulted in the large cash balances noted in the audit. Until the City, as advised by the City Attorney, can enter into construction contracts without the full contract appropriation on hand, this will continue to be an ongoing issue with regard to proper cash-flow management.

Additionally, this memo restates comments that this Office has already provided to the Controller's Office with regard to the methodology used for determining what was referred to as "unnecessary interest on idle funds" in the audit. The audit over simplified the analysis and merely stated an average value of the net interest cost incurred on existing funds.

This one-sided analysis does not recognize that interest payments would still be made if bonds were issued on a different date. As previously stated during the audit process, the terminology of “idle funds” is misleading because the methodology used in the audit was not a true cost-comparison based on interest rates and timing of bond issuances. The audit did not perform a cost-benefit analysis between two scenarios to demonstrate if issuing bonds at a different point in time would have resulted in “unnecessary interest”.

Finally, this Office finds significant problems with the recommendation to explore the use of short-term financing, such as commercial paper, to balance the cash flow needs of projects while improving the timing of bond issuances. As further explained, while this approach may be theoretically possible, the City has not used this interim financing mechanism for its GO Bond program, nor to our knowledge have other cities or counties used this method.

This Office appreciates the acknowledgements made in the audit with respect to the overall successful delivery of effective water quality projects and in particular the positive assessment that the oversight process has “largely worked as intended.” With regard to the Project Management Audit Finding 2, this Office will continue to maintain program transparency and implement procedures to ensure timely submission of all required reports.

Project Management – Audit Finding 1

Finding 1: The program has maintained a large cash balance of unexpended bond funds over time. As a result, since FY 2010, the City has incurred an average of \$1.36 million per year in net interest costs on idle funds.

The audit acknowledges that the City Attorney has advised, pursuant to state law, that the City is required to have enough cash on hand to pay for all obligations incurred via a contract at the time of contract award and execution. Due to this requirement, the City’s long standing practice, regardless of funding source, has been to have 100 percent of construction funds available at the time of bid and award of all construction contracts. Based on discussions with the City Attorney, the audit implies that this requirement may be eliminated if an appropriations clause is included at the time of contract execution. If this change occurs, the City will be better able to manage its cash flows for projects in the future. This Office welcomes this change.

The audit also provides comments on contingency funding. Based on market trends in the industry, construction bids have been coming in higher than the engineer’s estimate, so the contingency funding is important to be able to award many of these projects. It should be noted that the percentage of contingency funding is based primarily on the variability in project costs after award. Because of the unique and variable nature of green infrastructure projects, a slightly higher percentage of contingency is justified in comparison with more typical brick and mortar projects. However, the inclusion of an appropriations clause may also decrease the need to issue bonds for contingency funding at the time of contract execution.

Bonds are issued based on cash flows provided at the time of issuance. Pursuant to the Internal Revenue Service (IRS) guidelines, at the time of issuance, the City

certified it had a reasonable expectation to expend substantially all of the bond proceeds within three years. However, as the audit attests to, Prop O projects are "...unique, innovative, and ambitious efforts to improve water quality in the City." Consequently, unforeseen project delays caused expenditures to be delayed. Below are just a few examples of those challenges, beyond the control of the City, that led to delays in completion of projects (and related expenditures) and/or project savings that contributed to large cash balances:

- Machado Lake Phase I (Wilmington Drain) – During pre-design, LA County requested the City to return the Drain to its 1977 topographic condition. This request was not anticipated during the Concept phase, and additional time was needed to meet LA County's request. In addition, the Environmental Impact Report required more time to complete, than originally forecasted. In April 2011, this project received 5 bids for construction. In July 2011, a Least Bell's Vireo (LBV), a federally endangered bird, was detected within the project area. This required additional LBV protection measures be incorporated into the construction contract, in compliance with the US Army Corp of Engineers permit. Therefore, the Board of Public Works rejected all bids, to allow for re-advertising of the project with LBV protection measures.
- Machado Lake Ecosystem Rehabilitation – In August 2011, the design and permit phase was extended by 7 months to end in May 2012, based on BOE's experience with Wilmington Drain, which is adjacent to this project. In June 2012, a LBV was observed within the project area. In order to obtain reliable LBV protection permit requirements, 4 months was added to the bid and award phase, ending in April 2013. In May 2013, all construction bids were rejected due to 2 bidders' failure to pass Business Inclusion Program requirements, and the sole remaining bid being over the project budget. This extended the bid and award phase to February 2014. The construction contract was finally awarded in February 2014.
- Temescal Canyon Stormwater BMP – Due to community concerns about pollution hazards, a longer Mitigated Negative Declaration (MND) process was prepared. This necessitated the withdrawal of the California Coastal Commission permit and a resubmittal after certification of MND. Community concerns also restricted construction work hours. There were also delays due to testing issues for a new diversion system and additional time was needed fill a tank with stormwater to allow for start-up testing.
- Santa Monica Bay Low Flow Diversion Upgrades Package 3 – Delays occurred due to unmarked underground utilities and vaults in close proximity to the pipe alignment. Construction noise during the night caused residents to complain, resulting in suspension of night work and extended expenditures. A pothole survey for underground conflicts revealed that an Edison vault and duct bank was in conflict with 900 feet of the Coastal interceptor Relief Sewer being constructed. The most efficient solution to this problem was to remove this portion from this project and bid out the work as a separate project, which created further delays.
- Inner Cabrillo Beach Bacterial Water Quality Improvement – Permitting delays occurred related to potential disturbance of eel grass habitat. US Army Corp of Engineers imposed restrictions during construction.
- Penmar Water Quality Improvement Phase I – The project relied on a Categorical Exemption for California Environmental Quality act clearance. However, high

volumes of soil excavation and community concerns caused the City to change to a longer MND process. The project construction was also extended because the groundwater level at the project site was shallow, highly variable due to rainfall, and difficult to manage.

- Rory Shaw/Strathern Wetlands Park – Soil exploration testing uncovered presence of organic material within the landfill which triggered extensive studies and testing, resulting in major design scope changes.
- Westchester-LAX Stormwater BMP – At 90 percent completion of design, the Los Angeles World Airports requested additional scope for the project. The change in scope and budget put the project on hold for over five years until an agreement with LAWA was finalized. This lengthy delay was partly attributed to the amount of time to obtain Federal Aviation Administration approval.
- Cabrito Paseo Walkway/Bike Path – The project was originally co-sponsored by LA Neighborhood Land Trust (LANLT), but LANLT was not able to secure the anticipated funds, so after a long delay, they withdrew their request for Prop O funding.
- Albion Dairy Land Acquisition and Remediation – During excavation, the contractor discovered 19 pylons and one underground tank whose existence were unknown and subsequently had to be removed, extending the excavation work. After demolition, severely contaminated soil was discovered underneath the foundations. This led to additional soil remediation and the initiation of groundwater monitoring, as well as the completion of a Human Health Risk Assessment.
- La Cienega Fairfax Stormwater BMP – This project was canceled due to opposition from the community based on a misperception that a stormwater pollution treatment plant would be constructed. After cancellation of this project, additional time was needed to conceptualize and gain support for the Westside Park Rainwater Irrigation Project.
- Taylor Yard River Park – Parcel G2 Land Acquisition – This project is for acquisition of Parcel G2, owned by Union Pacific Railroad (UPRR). Negotiations between the City and UPRR have been on-going since 2007. The project schedule has been repeatedly extended.

Projects with Significant Savings –

- Echo Park Lake Rehabilitation – This project had a total of \$47 million in savings compared to the original estimate. The original estimate accounted for the risk associated with completing construction of the new lake bottom and the effect of rain delays over multiple years. However, the anticipated rain did not materialize, and significant savings were achieved.
- The Imperial Highway Sunken Median Stormwater BMP had savings of \$1.4 million because the project scope was improved by constructing one long infiltration trench in place of a larger number of smaller, but separate trenches.
- The LA Zoo Parking Lot had savings of \$7.7 million because pervious pavement was placed strategically to maximize surface runoff capture.
- The Rosecrans Recreation Center Stormwater Enhancements had savings of \$1.9 million due to a scope modification and low bids received during a competitive construction market.

- The Santa Monica Bay Low Flow Diversion Upgrades Packages 1, 2, and 4 had a combined savings of \$5.9 million attributed mainly to the low bids received during a competitive construction market.
- The Westside Park Rainwater Irrigation had savings \$2.3 million due to the use of a subsurface irrigation system that required minimum excavation and hauling of soil.

The unspent funds and savings based on these examples in addition to other incidents have also contributed to the large balance of cash within the Prop O program. As indicated, many of these project-related issues were beyond the City's control. Nevertheless, the audit makes a determination that since 2010, the City has incurred an average of \$1.36 million per year in net interest costs on "idle funds." This Office finds that the methodology used for calculating the \$1.36 million in net interest costs on "idle funds" is misleading because it does not use comparable interest rates to determine if the outstanding bonds would cost more than bonds issued on a different date. GO bonds are paid over a 20-year period and debt service is calculated based on a fixed interest rate, thus to determine if there was an impact to the net interest cost by deferring the bond issuances to a different date would require an analysis comparing the interest rates of the bonds issued to interest rates at a different point in time.

The audit also suggests exploring the use of short-term financing, such as commercial paper, to provide cash for the early phases of approved projects and subsequently retire those instruments with the proceeds from bond sales. The audit notes that the State issues commercial paper for GO bonds. However, the State-issued GO bonds are different than City-issued GO bonds. State GO bonds are repaid from its General Fund whereas the City's GO bonds are repaid from ad valorem taxes levied on taxable property in the City. If the audit is inferring that the City's General Fund should be used to subsidize the Prop O program, this Office completely disagrees and recommends against this new policy direction as this will impact funding for other vital capital projects.

If this is not the case, and the audit is instead proposing that a commercial paper program be created specifically for Prop O, this Office finds this recommendation impractical. We are not familiar with any city or county using commercial paper, or any variable rate instrument, in a GO bond financing. Due to the use of variable rates with commercial paper programs, there would be added difficulty in setting the tax rate that would be used to levy the tax onto the property tax bill. Without a fixed rate that is typically used in GO bond financing, the City would have to rely on some arbitrary interest rate assumptions or levying at the maximum rate or the bank obligation rate, the latter two being artificially high. Consequently, projects could be more expensive to finance. Therefore, while it is theoretically possible to levy on an assumed interest rate, it is not something we have done, nor to our knowledge have other cities or counties, due to practical and fiscal considerations.

Though a commercial paper program could mitigate the large cash balances, it exposes the City to interest rate risk and may lead to higher interest costs depending on market conditions. Additionally, a commercial paper program involves additional costs such as dealer fees and letters of credit fees that would otherwise not be present if the City issued long-term fixed rate GO bonds.

Project Management – Audit Finding 2

Finding 2: The CAO did not timely submit the annual SB 165 report to the Mayor and City Council as required by State Statute, lessening the relevance of this oversight control.

The audit has incorporated our comments regarding the City's efforts to maintain program transparency through reports and public meetings. This Office intends to comply with the recommendation to implement procedures to ensure timely submittal of SB165 reports. While we have previously waited for the Comprehensive Annual Financial Report (CAFR) to be finalized, which typically occurs in January to February of the following fiscal year, we will request the necessary information for the report as soon as the fiscal year is complete allowing for a more timely submission. The late completion of the CAFR contributed to the delay in our reporting.

We appreciate the Controller's efforts in conducting an independent review of the program, and we will work diligently on implementation of the recommendations. Moving forward, we look forward to a joint effort between our Office, the Controller, the City Attorney, and the City Engineer in evaluating the processes for estimating bond funding needs.

Cc: Honorable Mayor Eric Garcetti
Honorable City Attorney Mike Feuer
Honorable Ron Galperin, City Controller
Members of the Proposition O Citizen Oversight Advisory Committee
Members of the Proposition O Administrative Oversight Committee
Siri Khalsa, Interim Director of Auditing

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