PORTLAND'S FISCAL SUSTAINABILITY AND FINANCIAL CONDITION:

Actions now can reduce risk of future problems

July 2011

LaVonne Griffin-Valade
City Auditor

Drummond Kahn
Director of Audit Services

Kristine Adams-Wannberg
Senior Management Auditor

Kari Guy
Senior Management Auditor

Office of the City Auditor
Portland, Oregon

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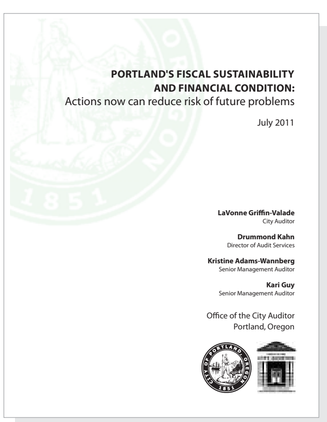

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Portland, Oregon

Production / Design
Robert Cowan
Public Information Coordinator

CITY OF PORTLAND

Office of City Auditor LaVonne Griffin-Valade

Audit Services Division
Drummond Kahn, Director
1221 S.W. 4th Avenue, Room 310, Portland, Oregon 97204
phone: (503) 823-4005
web: www.portlandoregon.gov/auditor/auditservices

July 28, 2011

TO: Mayor Sam Adams
Commissioner Nick Fish
Commissioner Amanda Fritz
Commissioner Randy Leonard
Commissioner Dan Saltzman
Jack Graham, Chief Administrative Officer

SUBJECT: Audit Report - Portland's Fiscal Sustainability and Financial Condition: Actions now can reduce risk of future problems (Report #399)

The City of Portland is nationally recognized as a leader in the early implementation of local government accountability and transparency initiatives. A primary example of such efforts is the biennial financial condition reports that our office has issued for two decades. These reports track various financial, economic, and demographic indicators and compile that information to show 10-year trends. This year, prompted by the national discussion regarding the long-term economic stability of government, which is being led by the Comptroller General of the United States, the federal Government Accountability Office, and other leaders and organizations, we added a more comprehensive and robust review of the City's fiscal sustainability to our report on the City's financial condition.

Drummond Kahn, Director of the Audit Services Division of my office, is one of 17 experts from around the country participating on a Governmental Accounting Standards Board (GASB) task force currently working to develop guidance on assessing and tracking the fiscal sustainability of government organizations. This provides the Auditor's Office with ready access to the best thinking on the economic issues facing all municipalities, states, and the federal government, and the strategies for addressing the long-term financial health of our civic structures.

The methodology used in the attached report is largely based on guidance from the International City/County Management Association on evaluating the financial condition of local government. To get at fiscal sustainability specifically, auditors reviewed background information from GASB. A fiscally sustainable city can meet its financial obligations and support public services on an ongoing basis. It can address the effects of fiscal interdependency between governments, withstand economic disruptions, and respond to changes in the underlying environment in which it operates. It must collect enough revenue to pay its short and long-term bills and to finance major infrastructure needs without shifting disproportionate costs to future generations. In addition, the concept also includes the governmental structure and willingness to make decisions that will keep the government fiscally sound.

We found there is both good news and bad news for City Council and the public. The financial condition of the City of Portland is currently stable, due in part to the City's diverse revenue base and the existence of strong policies that help in multi-year financial planning. However, the City's overall financial position has lost ground due to the growing debt, unfunded liabilities, and funding gaps in maintaining infrastructure. Additional infrastructure funding may require more debt if not funded out of current resources. Improving the City's financial position will involve difficult decisions, but Council must act soon to ensure an undue burden is not placed on future generations.

I plan to request a Council work session in the near future to review the details of this report in a public forum. Many of the trends we have identified will require thoughtful deliberation and perhaps fundamental shifts in how the City does business.

LaVonne Griffin-Valade
City Auditor

Audit Team: Drummond Kahn
Kristine Adams-Wannberg
Kari Guy

Table of Contents

SUMMARY

SUMMARY

Portland's financial health is currently stable, but increasing debt and liabilities weaken the City's ability to provide existing services on an ongoing basis. While the City's current financial health is satisfactory, actions now can reduce the risk of problems in the future. Now is the time to track and report measures of Citywide debt, reconsider options to fund pensions, and reduce unmet needs for maintenance.

To produce this status report on the City of Portland's financial health, we reviewed the City's fiscal sustainability. There is currently no universally accepted definition of fiscal sustainability. It is tied with the idea of intergenerational equity or fairness and the degree to which *future* taxpayers must pay for *current* policy decisions. To be "fiscally sustainable," the City must be able to pay its bills and provide current services on an ongoing basis. It must also be able to withstand economic downturns and to finance maintenance and new construction projects without shifting undue costs to future generations.

Fiscal sustainability is monitored by reviewing trends in several areas. The indicator areas we reviewed and the overall trends are included in the table below:

Indicator Trends

Indicators	Overall Trend
Revenues	Growing
Expenditures	Growing
Financial and Operating Position	Declining
Debt	Growing
Pension and Other Liabilities	Growing
Capital Assets	No trend
Demographic and Economic	Multiple trends
Fiscal Decision Making Capacity	No trend

Source: Audit Services Analysis of Portland CAFR and other data

During our audit, we found:

- The City's revenue base is diverse and financial policies help in multi-year planning.
- The City's overall financial position has lost ground due to growing debt, unfunded liabilities, and funding gaps in maintaining infrastructure. Additional infrastructure funding may require more debt if not funded out of current resources.
- Improving the City's financial position will involve difficult decisions, but Council should act soon to ensure an undue burden is not placed on future generations.

Columbia Slough Project construction

Source: Bureau of Environmental Services

To improve the City's long-term financial health, we recommend that the Office of Management and Finance:

1. Develop and monitor measures of Citywide debt and report this information annually to the Council.
2. Reconsider options to prefund and/or reduce the costs of FPDR pension and other post-employment benefit liabilities. This may include establishing goals to achieve particular funded ratios.

We recommend that the City Council:

3. Develop a funding strategy to shrink unmet budget needs for infrastructure maintenance, and follow City financial planning policies to take care of current assets before adding new ones.

Notes about the report: This report compares the City of Portland's finances over time and does not compare Portland to other jurisdictions. Data generally covers a 10-year period, from Fiscal Year 2000-01 (FY 2001) to Fiscal Year 2009-10 (FY 2010). Unless otherwise indicated, data presented in the text and in tables is from the City's audited Comprehensive Annual Financial Reports (CAFR) and has been adjusted for inflation. For more information on our report, see the "Why we do a Fiscal Sustainability Report" section of this document.

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

INDICATORS

REVENUE INDICATORS

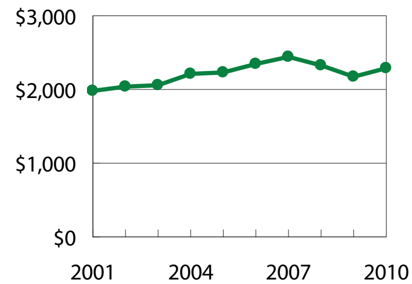
About the indicators

Revenues determine the capacity of a local government to provide services. Below, we show City revenues per resident, and the source of City revenues. We also show detail on City property tax and utility revenues. Financial information has been adjusted for inflation.

City revenues increased since 2001

Total City revenues are up 26 percent from $1.1 billion in 2001 to $1.3 billion in 2010. Portland's population has grown 10 percent during this time. Total revenue per resident increased 15 percent during the ten years, from $1,986 to $2,292.

Revenue per resident (adjusted)



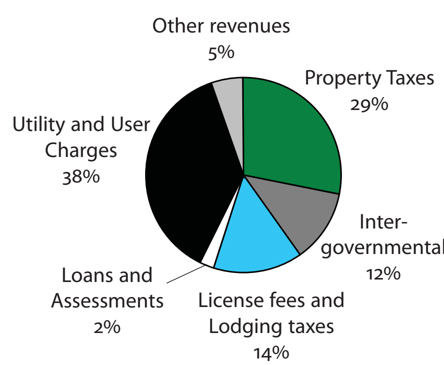
Source: Portland CAFRs and PSU Center for Population Research

Revenues are diversified between sources

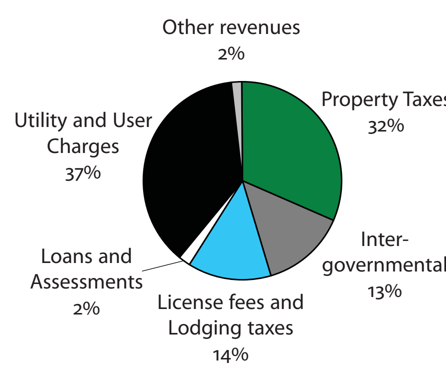
The make-up of City revenue sources stayed largely the same when comparing 2001 and 2010. Revenues are diversified between sources that are more stable, such as property taxes, and revenues that fluctuate with the economy, such as business licenses and lodging taxes. This diversified revenue base helps the City weather downturns in the economy.

Revenues by source (adjusted)

2001 ($1.1 billion)



2010 ($1.3 billion)



Source: Portland CAFRs

Where each dollar of City property tax goes

Total property taxes going to the City of Portland grew by 41 percent, from $300 million in 2001 to $424 million in 2010. City property taxes include the General Fund, the Fire and Police Disability and Retirement Fund (FPDR), urban renewal, local levies, and other debt. The General Fund pays for services such as public safety and parks. General Fund dollars are discretionary, meaning the City Council decides how they are spent. The services and obligations of City property tax dollars have shifted over the last 10 years, with an increasing share going to support urban renewal debt, and less going to the General Fund.

2001 City property tax dollar ($300 million, adjusted)

2010 City property tax dollar ($424 million, adjusted)

Source: Portland CAFRs

In 2010, less than half of each property tax dollar went to the City General Fund. Property taxes spent to pay for urban renewal debt increased from 16 cents to 24 cents per dollar. Property taxes for FPDR remained at 25 cents per dollar over the same period.

Growing losses due to property tax limits

All general government property taxes must fit within a limit of $10 per $1,000 of real market property value. This includes not only City of Portland taxes, but also Multnomah County, Metro, the Port of Portland, and other taxing districts. If the limit is exceeded, local option levies such as the Children's levy or the County library levy are reduced first, or 'compressed,' to zero if necessary. If further reductions are needed to reach the limit, all other taxes are reduced on a proportional basis.

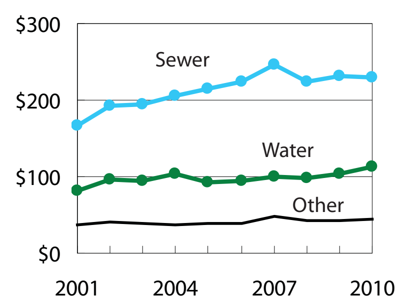
In 2010, reductions in real market value due to declining home prices, combined with increases in FPDR costs and more urban renewal taxes, increased compression. Actions of other local governments may also increase tax compression. In 2010, the City lost $13.4 million to compression, and total general government losses in Multnomah County totaled $32.7 million.

Utility and other fee-supported revenues increasing

Sewer fund revenues increased 37 percent, from $167 million in 2001 to $229 million in 2010. Water revenues showed a similar increase of 38 percent, from $81 million to $113 million over the same period.

Revenues to other City fee-supported activities, such as golf, the Portland International Raceway, and parking facilities increased 17 percent during the same time period, from $38 million to $44 million.

Water, Sewer, and Other Business Revenues 2001-10 (millions, adjusted)



Source: Portland CAFRs

EXPENDITURE INDICATORS

About the indicators

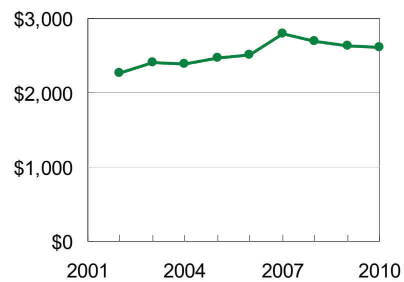
Expenditures measure a government's service output. Below, we show City spending per resident, which services get the biggest share of government spending, and how many employees work for the City. Financial information has been adjusted for inflation.

City spending per resident increased since 2002

City spending per Portland resident increased 16 percent, from $2,258 in FY 2002 to $2,621 in FY 2010. Total expenditures increased steadily from $1.21 billion to $1.53 billion, a 26 percent increase.

There was significant one-time spending for expansion of the Oregon Convention Center in FY 2001, so a nine-year view is more appropriate for comparison.

Spending per resident (adjusted)



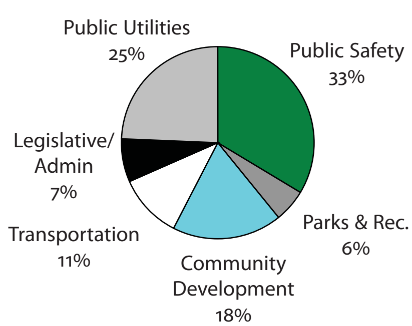
Source: Portland CAFRs and PSU Center for Population Research

Public safety services remain the single largest City expense

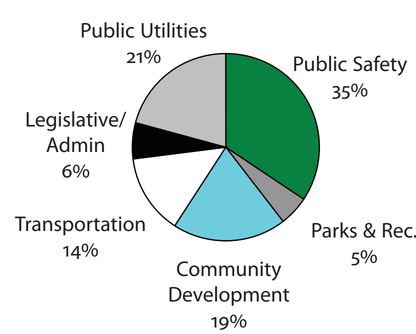
For the last nine years, the City spent more on public safety services than on other service areas. Some examples of public safety services are police, fire, emergency communications, and emergency management functions.

Expenditures by service area (adjusted)

2002 ($1.21 billion)



2010 ($1.53 billion)



Source: Portland CAFRs

In FY 2010, the City spent $525 million on public safety services (35 percent of total City spending), compared to $407 million (33 percent) in FY 2002. About a third of the increase was due to additional costs of the Fire and Police Disability and Retirement Fund (FPDR).

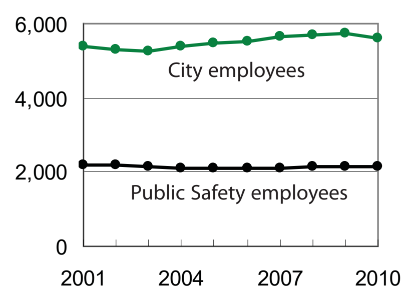
The second biggest category of spending was public utility services, such as for water and sewer services. This was over 20 percent of City spending in both FY 2002 and FY 2010. The City spent $316 million on public utility services in FY 2010, versus $297 million nine years ago.

The City spent $297 million in FY 2010 for community development services compared to $223 million in 2002 (a 33 percent increase). Some of these functions include housing, local improvement districts, and urban renewal. Almost half of the community development spending in FY 2010 was to pay for urban renewal bonds.

The number of City employees per resident was steady

Total City employment grew over 10 years, but the number of employees per 1,000 residents remained relatively constant. The total number of City employees grew from 5,386 in FY 2001 to 5,592 in FY 2010, a 4 percent increase. The number of employees per Portland resident remained at about 10 employees per 1,000 residents during the same time period.

City employees



Source: Portland SAP system and BHR position management system

In FY 2010, the Police and Fire Bureaus had the most staff among all City bureaus. There were about 1,200 staff in the Police Bureau and about 750 in the Fire Bureau. During that time, the City had approximately 4 public safety employees per 1,000 residents. This was relatively steady from 10 years ago.

About the indicators

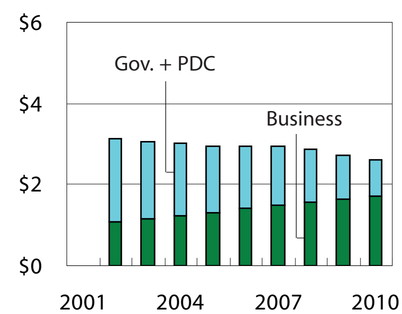
Financial position is a government's financial standing at a given point in time, while operating position is a government's ability to balance its budget, to maintain reserves for emergencies, and to have enough money to pay its bills on time. We present net asset and liquidity measures below which represent two measures of the City's financial and operating position.

Net asset data was not adjusted for inflation. This was because the information is based on point in time estimates and the measure includes actuarial estimates with assumptions that change over time. Liquidity data is based on financial data that has been adjusted for inflation.

The City's net assets decreased steadily since 2002

"Net assets" are a measure of a government's financial position. Net assets measure the difference between what the government owns (assets) minus what it owes (liabilities). In reality, the City's bills would not come due all at once, and the City is unlikely to sell its streets and water lines to pay for what it owes. What is important, however, is the change in net assets. It indicates how much the City's financial position has improved or worsened as a result of events and transactions made during the year.

City net assets (billions, unadjusted)



Source: Portland CAFRs

The City's total net assets (including PDC) declined 16 percent from FY 2002 to FY 2010, from $3.2 billion to $2.6 billion, unadjusted for inflation. We compare nine years because 2002 is when the Government Accounting Standards Board required this information in the City's government-wide financial statements.

Net assets for water, sewer, and other charge-based services (known as business activities), grew 55 percent, from $1.1 billion to $1.7 billion. This change masked the weakening position of the net assets of governmental activities supported by property taxes and revenues from other governments. Some examples of governmental activities include public safety and transportation services. The net assets for these services and PDC decreased from $2.0 billion to $0.9 billion (-56 percent).

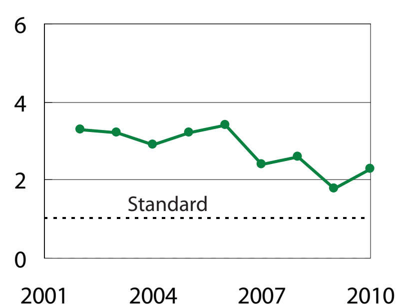
Net assets include only a portion ($1 billion of the $2.5 billion) of Fire and Police Disability and Retirement (FPDR) plan liabilities, as is currently required by financial reporting standards. If the full FPDR pension liability were included, the City's net assets for its government activities and PDC would be below zero in 2010, at -$615 million.

City liquidity trended downward, but remained positive over 10 years

Liquidity is the City's ability to pay its short-term bills. It is measured by a ratio of current assets to current liabilities. Current assets are cash, and assets that can be converted into cash or used within 12 months (i.e. for inventories and pre-paid expenses). Current liabilities are bills the City intends to pay within 12 months. A low ratio, below 1.0, is a warning trend and may indicate a cash flow problem and the need for short-term borrowing.

City of Portland liquidity (including PDC) has varied over time and trended downward in the last few years. Over the last nine years, it decreased from $3 of current assets for each current liability (3:1) to $2 of current assets (2:1) for each dollar owed in FY 2010. It has, however, stayed above a minimum ratio of 1:1.

City liquidity (1:1 standard)



Source: Portland CAFRs

DEBT INDICATORS

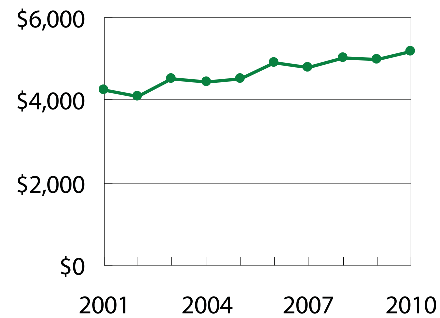
About the indicators

The City borrows money to pay for items ranging from new sewer pipes to computer systems. Below we show debt per City resident, the types of City debt, and information on debt for urban renewal areas. Financial information has been adjusted for inflation.

Debt per resident is increasing

The City's outstanding debt increased 34 percent from 2001 to 2010, from $2.3 billion to $3.0 billion. In 2010, the total outstanding debt per resident was $5,185. This is an increase of 22 percent from 2001 levels.

Debt per resident (adjusted)



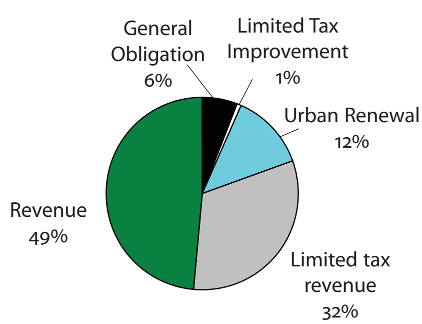
Source: Portland CAFRs and PSU Center for Population Research

The majority of debt is for revenue bonds

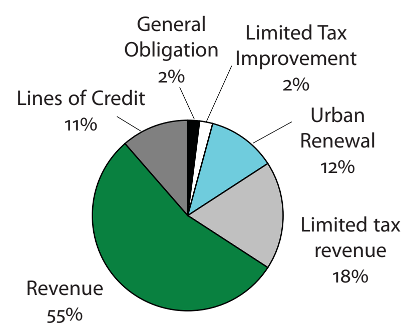
Fifty-five percent of the City's debt is from revenue bonds. These grew 50 percent from 2001 to 2010, from $1.1 billion to $1.6 billion. Almost all of the revenue debt is for sewage disposal bonds and water bonds. The remainder is related to the gas tax, golf, hydroelectric power, and parking facilities.

Debt by type (adjusted)

2001 ($2.3 billion)



2010 ($3.0 billion)



Source: Portland CAFRs

Limited tax revenue bonds backed by specific City revenues such as lodging taxes or parking revenues decreased 23 percent from 2001 to 2010, from $725 million to $555 million. These bonds are for specific projects, such as the streetcar or convention center.

Limited tax improvement bonds are used to finance the activities of local improvement districts, and are repaid by assessments on property owners. Limited tax improvement bonds more than doubled from 2001 to 2010, but remain a small percentage of total outstanding debt.

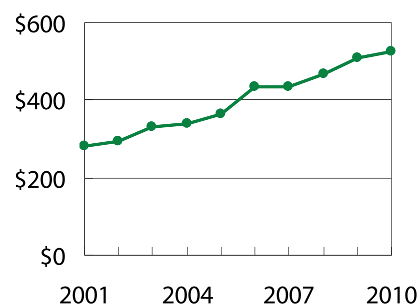
Total General Obligation debt decreased 53 percent from 2001 to 2010, and is now only 2 percent of the City's total debt. General Obligation bonds have the lowest interest rates, but must be approved by the voters.

The use of lines of credit increased significantly – from $9 million in 2001 to $342 million in 2010. Some lines of credit are used to provide temporary financing for urban renewal areas. Once the balance on a line of credit is large enough, the line of credit is converted to bonds. The 2010 total for lines of credit also includes $160 million for sewer system construction projects. The sewer system line of credit was replaced by a bond issue in August 2010.

Urban renewal debt is growing significantly

Urban renewal debt, including bonded debt and lines of credit, increased 88 percent from 2001 to 2010, from $280 million to $526 million. Urban renewal bonds pay for redevelopment projects in urban renewal areas, such as affordable housing and transit improvements. The bonds are repaid by the increase in property tax collections on property within the urban renewal areas.

Urban renewal debt (millions, adjusted)



Source: Portland CAFRs and Office of Management and Finance

2010 Urban renewal debt by URA
(millions, adjusted)

Urban Renewal Area	Debt Outstanding
Waterfront	$89
Convention Center	$69
South Park Blocks	$69
North Macadam	$63
River District	$58
Interstate Corridor	$56
Airport Way	$44
Lents District	$37
Central Eastside	$29
Gateway	$13
TOTAL	**$526**

Source: City of Portland CAFR and Office of Management and Finance

The increase in urban renewal debt can be attributed to increased debt for the South Park Blocks Urban Renewal Area (URA); new debt issued since 2001 for the River District, Lents District, and Interstate Corridor URAs; and lines of credit issued for Gateway, Central Eastside and Macadam URAs.

Debt is monitored and within limits, but a broader view may be needed

Using more City revenue to make debt payments reduces spending flexibility, and may be an indicator of fiscal strain. According to the Office of Management and Finance, however, planned debt may increase multi-period equity and increase spending flexibility through the ability to control long-term expenditure planning. The Office of Management and Finance monitors City debt and prepares a monthly debt report.

Sources we reviewed recommended debt service limits for General Obligation debt. The City's debt management policies are consistent with these best practices, with limits on debt service for debt backed by the General Fund. The City is currently well within these limits. Limits on other types of debt, such as revenue or urban renewal bonds, are based on multi-year financial plans. This approach is consistent with credit rating agencies, which also assess debt by the specific revenue source paying for the obligation.

A broader view of total debt would reflect the total costs to City residents – who will ultimately pay for the debt through property taxes, water and sewer bills, and other fees. Measures that clarify debt affordability to taxpayers could include debt per household, debt as a percent of assessed value, debt as a percent of personal income, or debt as a percent of City revenue. We found that the City paid 20 percent of its annual operating revenues on debt payments and related costs in 2010.

OMF should track and report the City debt service ratio to City Council

The City's debt policies do not identify a total debt limit. A more comprehensive review of Citywide debt could better inform City Council about the impacts of future borrowing. We recommend that the Office of Management and Finance develop and monitor measures of Citywide debt and report this information annually to the Council.

About the indicators

An "unfunded liability" is the current value of future payments, for which reserves have not been set aside. Information on pension and post employment benefit liabilities is provided below. Pension and other post-employment financial information was not adjusted for inflation. This was because the actuarial estimates are based on a point in time and calculation assumptions may vary from estimate to estimate.

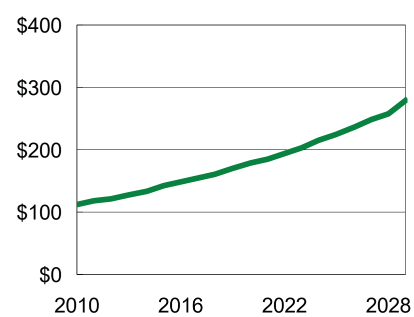
Fire and Police Disability and Retirement unfunded liabilities will increase taxpayer costs

Portland's Fire and Police Disability and Retirement Fund (FPDR) was created in 1948 for the benefit of sworn officers of the Bureaus of Police and Fire. The fund was set up as a 'pay-as-you-go' retirement system, with tax authority of up to $2.80 per $1,000 of property value.

Unlike a funded retirement plan, a pay-as-you-go plan does not set aside funds to pay for future benefits. Instead FPDR must collect sufficient revenues through property taxes each year to pay the annual costs. Because the plan does not reserve revenues for future retirements, the fund has an unfunded liability. As of June 30, 2010, the unfunded liability was estimated at $2.5 billion. This means that the City has promised future retirement benefits of $2.5 billion without having current funding to support them.

After the work of several committees over many years, in 2006 voters approved amendments to the City Charter governing the FPDR system. Beginning in 2007, new police officers and firefighters are enrolled in the Oregon Public Employees Retirement System (PERS), a pre-funded retirement plan. Taxpayers now pay for two generations of retirees – funding the pension costs of current retirees, and pre-funding the pensions for police and firefighters hired after 2007. Pension costs for retirees under the pay-as-you-go plan will continue to rise until all of those employees are retired, in 20 to 25 years.

FPDR projected annual costs
(millions, unadjusted)



Source: Mercer Inc.

Total annual costs are estimated to increase from $111 million in 2010 to $280 million in 2029, not adjusted for inflation. Because of uncertainty about future economic conditions, the estimates for later years have greater variability.

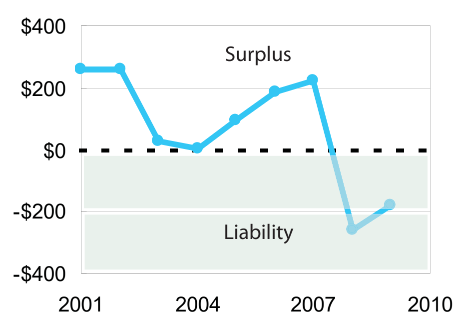
Growing FPDR tax payments present risks to taxpayers, the City, and other local governments. Taxpayers will see their property tax payments for FPDR increase about 35 percent over the next five years. Increases to the tax rate are likely to increase tax compression, decreasing revenue available to other local governments and particularly to special levies such as the Children's and Library levies. If the tax rate reaches the limit, any FPDR costs not funded by the FPDR levy must be funded from the City's General Fund. While this risk is small, current models show a 5 percent chance of the tax limit being reached in 2023.

For more information, see our June 2011 audit report, *Fire and Police Disability and Retirement: Improvements resulted from 2006 Charter reforms, but significant fiscal challenges remain*. This can be found at www.portlandoregon.gov/auditor/auditservices.

The City's PERS liability funded status is within an acceptable range

All civilian City employees, and nearly all sworn fire and police personnel hired after December 31, 2006, are participants in PERS. PERS is the retirement plan for the State of Oregon and many local governments and districts in Oregon.

PERS liability (millions, unadjusted)



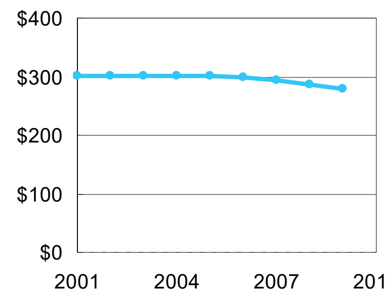
Source: Portland CAFRs and Mercer Inc.

The City's estimated PERS liability as of December 31, 2009 was $182 million. For most of the last decade, the City has not had a liability with PERS, due to paying the liability in full and covering the obligation with $300 million in pension obligation bonds. According to the Office of Management and Finance, however, changes in the investment market and interest rates created a liability for the City in 2008 and 2009.

Assumptions used in a liability estimate may differ from those used in prior projections. The estimate helps the City and creditors determine demands on the City's future cash flows. The liability is one of many measures that credit rating agencies consider when assessing City funds' credit-worthiness.

As of June 30, 2010, the City had about $280 million in principal outstanding on the pension bonds, and 19 years of debt service remaining. About half of the debt service is structured with a variable rate and half with a fixed rate. According to the Office of Management and Finance, the pension debt produces savings over the life of the obligation, compared to what the City would have been charged through PERS.

Pension debt principal
(millions, unadjusted)



Source: Portland CAFRs

One of the most recognized measures of the financial health of a pension plan is the "funded ratio." This ratio is the level of assets in the plan divided by the current value of its liabilities. If a plan were 100 percent funded, its assets plus investment returns would, in theory, be sufficient to pay all the benefits that plan members earned. A plan that is less well funded would run out of money (assets), while still owing benefits to its members.

Many experts find a funded ratio of 80 percent or more to be acceptable for a pension system. Based on information from the Office of Management and Finance and Mercer Inc., the City's funded ratio as of the end of 2009 is estimated to be 88 percent.

Lack of pre-funding other post employment benefits increases the City's liabilities

In addition to pension benefits, the City provides other post employment benefits (OPEB) for eligible retirees. These benefits are part of a total compensation package and are used to attract and retain qualified employees. The City does not pay for post-retiree health benefits, but does allow retirees to purchase health insurance at the City's group rate until age 65. This creates an implicit subsidy.

The City also contributes toward Medicare companion insurance through the state PERS Retirement Health Insurance Account (PERS-RHIA). These two provisions are required by state statute. In addition, the City pays medical costs, through the Fire and Police Disability and Retirement Fund, for retired police officers and firefighters for service-related disabilities and injuries.

The City's current unfunded liability for insurance continuation and the FPDR subsidy is $109 million, based on a 30 year projection. The liability for the PERS-RHIA is $11 million, based on a 10 year projection. As mentioned, many experts find an 80 percent funded ratio or more to be acceptable. The City's three OPEB benefits have a funded ratio of 0 percent.

The City offers OPEB benefits on a pay-as-you-go basis rather than pre-funding the benefits. The pay-as-you-go method is used by many employers who are unable to fund the benefits in advance. The problem is that it creates a growing liability that is not matched by a dedicated funding source. Council was made aware of this in June 2008, when it accepted a report from the Office of Management and Finance on the topic.

2010 OPEB liabilities and ratios
(Industry target is 80%)

	Liability (UAAL, millions)	**Funded Ratio**
Insurance continuation	$104	0%
PERS - RHIA	$11	0%
FPDR Subsidy	$5	0%

Source: City of Portland CAFR, and Mercer Inc.

OMF should develop funding options to address the pension and OPEB liabilities

The City employs over 5,500 staff, most of whom belong to one of the two retirement systems, and who may be eligible for post employment benefits when they retire. There is a public interest in ensuring employees have secure retirements and that retirement benefits are adequately funded. Prefunding the obligations increases the security of those benefits, allows managers to allocate costs on an annual basis, and preserves intergenerational equity by paying for benefits as they are earned.

We recommend that the Office of Management and Finance reconsider options to pre-fund and/or reduce the costs of FPDR pension and OPEB liabilities. This may include establishing goals to achieve particular funded ratios.

CAPITAL ASSETS INDICATORS

About the indicators

The City uses physical infrastructure to provide services to residents. Some examples are streets, sewer and water lines, parks, and public buildings. How these assets are treated can impact the quality of services residents receive. Good asset management requires investment in regular preventive maintenance. It increases the life of the asset and reduces costs. The risk in not maintaining the City's infrastructure is early failure of assets and increased costs over the life of the assets.

Source: Water Bureau

Bureaus report that most City assets are in good condition

The 2010 Citywide Assets Report states that the estimated replacement value of the City's physical infrastructure is $22.9 billion. Transportation, sewer, and water assets, combined, account for 92 percent of the replacement value of the City's physical infrastructure. Parks and recreation infrastructure and civic assets (such as City office buildings, police facilities, and technology assets), each make up about 4 percent of the total asset value.

The working condition of the City's infrastructure varies greatly. The Bureau of Environmental Services (sewer) reports the largest percent of assets currently in good or very good condition (74 percent), followed by the civic assets (64 percent). Parks has the lowest percentage at 42 percent, for those assets where there is information. This data is based on bureau estimates, and it has a range of confidence levels on how accurate and reliable the information is.

Condition of assets
(Includes assets where there is information)

	Good	Fair	Poor
Trans.	51%	27%	15%
Sewer	74%	12%	14%
Water	51%	34%	15%
Parks	42%	28%	11%
Civic	64%	36%	1%

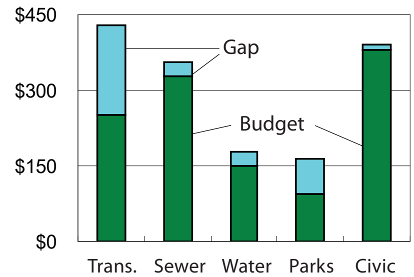
Source: 2010 Citywide Assets Report, Revised

Funding gaps persist in infrastructure budgets

According to the 2010 Citywide Assets Report, there is already a $312 million funding gap between the FY 2011 budget and what bureaus identified to:

1. develop needed capacity
2. maintain existing facilities
3. address regulatory requirements
4. meet service levels.

FY 2011 funding gap (millions)



Source: 2010 Citywide Assets Report

Transportation has the largest funding gap, with the bureau identifying $177 million in need beyond what is budgeted.

Resource constraints can make it challenging to adequately fund maintenance and replace capital assets. In 2008 the City Council revised its financial policies, and some of those changes addressed funding capital assets. A new provision in the City Comprehensive Financial Management Policy states that at least 25 percent of General Fund revenue that exceeds budgeted beginning balance will be allocated to infrastructure maintenance or replacement. There was no surplus allocated in FY 2010, but $2.4 million was allocated in FY 2011.

Source: PBOT

While the change to the financial policies is a good step, it does not produce a consistent, permanent funding stream. As presented in our 2009 *Transition Report: Key challenges for a new City Council*, we continue to support developing a funding strategy for infrastructure maintenance and a budget priority to take care of current assets, before adding more assets. According to the Office of Management and Finance, increased infrastructure funding would likely result in more debt, and if infrastructure funding is not resolved through increased expenditures, lower service levels will result.

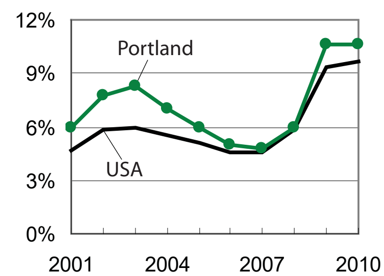
About the indicators

Economic and demographic information highlight community needs and resources. This section presents data on unemployment, jobs, income per resident, property values, and city employment. Financial information has been adjusted for inflation.

The Portland area is continuing a slow economic recovery

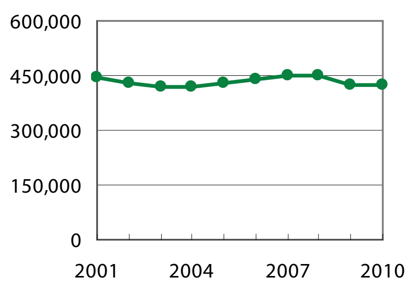
Portland's unemployment rate was about 11 percent in 2009 and 2010. This is the highest it has been in the last 10 years. In addition, Portland's unemployment rate has been higher than the national unemployment rate in most years since 2001.

Unemployment



Source: U.S. Bureau of Labor Statistics

Jobs in Multnomah County

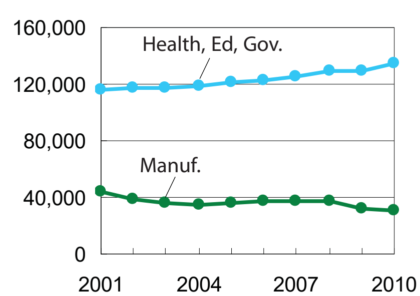


Source: State of Oregon, Department of Employment

The number of jobs in Multnomah County decreased recently, and some sectors were hit harder than others. There were about 422,000 jobs in Multnomah Country in 2010. This is a 5 percent decrease compared to 10 years ago. The number of jobs rose every year from 2004 through 2008, but decreased in 2009 and 2010.

Manufacturing jobs decreased the most, from about 44,000 jobs in 2001 to about 31,000 in 2010. Education and heath services jobs, as well as government jobs (federal, state, and local), have seen the biggest increases of the last 10 years. These sectors account for over 19,000 additional jobs from 2001 through 2010.

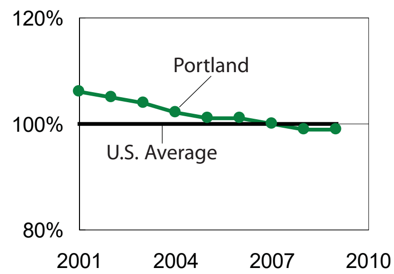
Jobs in Multnomah County:
Manufacturing, Health Service, Education, and Government



Source: State of Oregon, Department of Employment

The Portland area's income per resident was equal to or greater than the national average until 2007. Personal income per resident in the Portland area was $39,544 in 2009 – virtually the same as in 2001. The national average increased about 8 percent during the same time, from $37,140 to $39,977. Data for 2010 was not available at the time of publication.

Income per capita (adjusted)

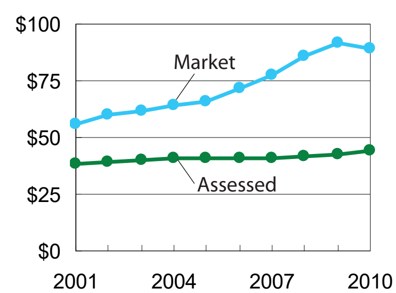


Source: U.S. Bureau of Economic Analysis

Property values are higher than they were 10 years ago

Comparing 2001 values to those in 2010, market values of Portland properties increased 60 percent, from $56 billion to $89 billion, while assessed values increased 14 percent, from $38 billion to $44 billion. The gap between assessed values and market values is due to the limitation set by Measure 50. This 1997 statewide ballot measure limited assessed value growth to 3 percent per year in most properties. The City of Portland's property tax revenues are based on assessed values rather than market values. According to the Office of Management and Finance, because property tax revenues are based on assessed values, the revenues are relatively stable in the current economic downturn.

Total property values
(billions, adjusted)



Source: Multnomah Tax Supervising and Conservation Commission Reports

Population increased over the past 10 years

Portland's population increased about 10 percent over the past 10 years, from 531,600 in FY 2001 to 582,133 in FY 2010. The growth over the past five years is about 5 percent. In 2009, Portland accounted for about 15 percent of Oregon's total population.

FISCAL DECISION-MAKING CAPACITY

About the indicators

Decision-making capacity is a government's ability to make decisions to keep it financially sound. Some factors that impact this capacity are an entity's form of government and decision-making processes.

Portland's form of government presents benefits and challenges in governing the City

The City of Portland has the last remaining commission form of government among large cities in the United States. In a commission form of government, the elected City Council's legislative functions include adopting the City budget and passing laws, policies, and regulations that govern the City. The Mayor and Commissioners also serve as administrators of City departments, individually overseeing bureaus and carrying out policies. The assignment of departments and bureaus is determined by the Mayor and may be changed at the Mayor's discretion.

Any form of government has strengths and weaknesses. One civic group identified some benefits of the Commission form as attracting strong leaders, providing opportunities to implement innovative policies and projects, and providing the public with greater access to City leaders. The 2007 Charter Review Commission, however, identified a number of drawbacks, some of which were difficulty coordinating service provision, varying levels of bureau responsiveness, and challenges for City Council members in developing citywide strategies and policies.

The City provides some services that may be more appropriate for other jurisdictions to supply

To provide services more efficiency, Multnomah County and its cities agreed in 1983 to swap some responsibilities. As a result, Portland and other cities transferred social services to the County and focused on "urban services," such as police, fire, parks, water, sewers, and streets. The County focused on human services and state-mandated responsibilities such as health, social services, elections, tax collection, prosecution and jails.

Over the years, the City provided some services that, in terms of the agreement with the County, may be outside of the City's core functions. Some examples are education funding, children's programs, and affordable housing. While providing these services can be worthwhile for the City, it raises questions about service coordination and whether funding them leaves fewer resources available for the City's core services. The City Council should consider revisiting the 30 year old agreement and, along with the County and other jurisdictions, consider which services each should be providing.

City processes are subject to public scrutiny and comprehensive policies help the City manage its finances

The public has various ways to inspect how the City spends its resources. State statutes, for example, outline how the City's budget is adopted and amended, as well as the requirements for public hearings. The City's financial statements are audited annually, and financial information is presented publicly in the Comprehensive Annual Financial Report (CAFR). There are also a number of opportunities for residents to volunteer on City advisory boards and commissions.

In addition to processes, City financial policies guide, and at times restrict, how the City spends its resources. Portland's financial policies meet many best practices established by the Government Finance Officers Association, and they address a number of different subject areas, such as financial planning and budgeting, revenue policies, and debt management. Some examples of their direction include requiring five-year financial plans for many bureaus and funds, as well as establishing the City's General Reserve Fund and limiting how it may be used.

The City's processes and policies do not guarantee that all decisions made by elected officials and bureau managers align with public opinion. They do, however, present opportunities for the public to review Portland's services and to provide input on City funding decisions. They also restrict how City leaders can use certain resources and compel the City to plan on more than just an annual basis.

Improving the City's financial position involves difficult decisions

Portland's financial position is currently stable, and the City benefits from strong financial policies that help in multi-year planning. However, in this audit we identified three trends that may weaken the City's long-term fiscal sustainability: increasing debt; unfunded pension and other post-employment benefit liabilities; and a growing funding gap in infrastructure maintenance. Addressing these issues requires difficult decisions on long-term issues, the benefits of which will not appear in the near term. But strengthening the City's long-term financial position should be taken on sooner rather than later, in order to not pass undue costs to future generations.

To improve the City's long-term financial health, we recommend that the Office of Management and Finance:

1. Develop and monitor measures of Citywide debt and report this information annually to the Council.
2. Reconsider options to pre-fund and/or reduce the costs of FPDR pension and other post-employment benefit liabilities. This may include establishing goals to achieve particular funded ratios.

We recommend that the City Council:

3. Develop a funding strategy to shrink unmet budget needs for infrastructure maintenance, and follow City financial planning policies to take care of current assets before adding new ones.

WHY WE DO A FISCAL SUSTAINABILITY REPORT

Why we do a fiscal sustainability report

This report provides residents and public officials with information on the City of Portland's financial health. While useful information is presented in various City documents, such as the Comprehensive Annual Financial Report (CAFR) and the Adopted Budget, this report is intended to provide financial and demographic information in a popular report format so it can be read and understood by a wide audience. In presenting the measures, we identify both favorable and unfavorable trends, and we make recommendations where needed.

The data generally covers a 10-year period, from Fiscal Year 2000-01 (FY 2001) through 2009-10 (FY 2010). City fiscal years run from July 1 to June 30. We also present liability information for the City. In some cases, such as for pension and post-employment benefit liabilities, these are actuarial calculations that represent the present value of costs projected into the future.

What is fiscal sustainability?

There is currently no universally accepted definition of fiscal sustainability. According to the Governmental Accounting Standards Board (GASB), the term is tied with the idea of inter-generational equity or fairness, which considers the degree to which future generations of taxpayers will have to address the fiscal consequences of current policies. GASB's tentative definition is:

> *Fiscal sustainability is a government's ability and willingness to generate inflows of resources necessary to honor current service commitments and to meet financial obligations as they come due, without transferring financial obligations to future periods that do not result in commensurate benefits.*

A fiscally sustainable city can meet its financial obligations and support public services on an ongoing basis. It can address the effects of fiscal interdependency between governments, withstand economic disruptions, and respond to changes in the underlying environment in which a government operates. A financially stable city collects enough revenue to pay its short and long-term bills and to finance major infrastructure needs without shifting disproportionate costs to future generations. In addition, the concept also includes the governmental structure and willingness to make decisions that will keep the government fiscally sound.

We monitor fiscal sustainability by reviewing trends in several areas, such as

- Revenues and expenditures
- Net assets and liquidity
- Liabilities, such as outstanding debt, and pension, and other post-employment benefit liabilities
- Demographics and economy

Monitoring these areas over time enables public officials and residents to access a city's fiscal sustainability and to identify problem areas that may need attention.

Report scope and methodology

The methodology used in this report is based on *Evaluating Financial Condition: a Handbook for Local Government* by the International City/County Management Association. We also reviewed background information on fiscal sustainability from the Governmental Accounting Standards Board.

This report focuses on citywide spending. It includes Governmental Activities, Business Activities, and Fiduciary Activities (Fire and Police Disability and Retirement Fund), as defined in the annual CAFR. The indicators presented were selected by the Audit Services Division, are not the result of requirements by standard-setting bodies.

With the exception of our calculations of net assets and City liquidity, we did not include the separate expenditures of the Portland Development Commission in the financial information, because a proxy of much of that activity is already included in the City of Portland's spending in the form of debt. Urban renewal financing is reflected in several City funds that are used to record the property tax revenues as well as each separate urban renewal areas' debt payments. We exclude City internal service fund's spending, because it represents a double count of costs.

Financial data came from the City's independently audited Comprehensive Annual Financial Reports, and the City's financial system. We used the City's Adopted Budget document, Citywide Assets Report, and other bureau reports for background information. Employee numbers and position information came from the City's SAP system, as well as the Bureau of Human Resources position management system for older data. Socio-economic data came from the Center for Population Research at Portland State University, the U.S. Bureau of Economic Analysis and the U.S. Department of Labor, the Oregon State Employment Division, and the Multnomah County Tax Supervising and Conservation Commission. We conducted several interviews with managers and staff at the Office of Management and Finance about their views of the City's finances.

For more information on the City of Portland's budget and annual financial statements, please visit the Office of Management and Finance website:

www.portlandonline.com/omf

In order to account for inflation and unless noted otherwise, we expressed most financial data in constant dollars. We adjusted dollar amounts for each prior year to equal the purchasing power in FY 2009-2010. We used the Portland-Salem Consumer Price Index for All Urban Consumers, as reported by the Bureau of Labor Statistics, U.S. Department of Labor. Unless otherwise stated, financial data are based on the City's fiscal year. In many cases numbers are rounded for ease of use and reporting.

We reviewed information for reasonableness and consistency. We questioned or researched data that was not reasonable or needed additional explanation. We did not, however, audit the accuracy of source documents or the reliability of the data in computer-based systems. As nearly all financial information presented is from the City's CAFRs, we relied on the work performed by the City's external financial auditors.

Our review of data was not intended to give absolute assurance that all information was free from error. Rather, our intent was to provide reasonable assurance that the reported information presented a fair picture of the City's financial health. In addition, while the report offers financial highlights, it does not thoroughly determine the reasons for negative or positive performance. More analysis may be needed to provide such explanations.

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

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

RESPONSES TO THE REPORT

OFFICE OF MAYOR SAM ADAMS
CITY OF PORTLAND

July 19, 2011

Lavonne Griffin-Valade
City Auditor
1201 SW Fourth Avenue, Room 140
Portland, Oregon 97204

Dear Auditor Griffin-Valade,

Thank you for completing your audit of the City of Portland's fiscal sustainability and financial conditions.

You have noted that the data contained in the audit is not new and that it is sourced from other audits or city financial documents. Nonetheless, I find it is useful to have it compiled into a single document along with the updated narrative.

While these financial issues apply to most all municipalities across the United States, Portland is fortunate to have consistently taken early and aggressive steps to deal with many of the funding challenges. The City's successful track record in this regard is evidenced by the high credit ratings awarded by external and independent credit rating agencies. Still, as noted in your audit, we have much work to do.

I would like to add my own recommendation to your audit: Portland needs to grow our economy and make it more resilient. With a stronger and more resilient economy, Portland will be better equipped to deal with the civic challenges indentified in your audit.

I will continue to work with OMF and the City Council to ensure that the City's financial policies consider long-term financial sustainability as a key objective, and that budget planning and financial decision-making takes this into consideration. I will use your audit findings to help finalize the emerging 25-year Portland Plan, as well as to put together my next proposed budget.

Once again, thank you for your work to help ensure that the City retains its fiscal health and sustainability.

Sam Adams
Mayor
City of Portland

Sam Adams, Mayor
Kenneth L. Rust, Chief Administrative Officer
1120 SW Fifth Ave., Suite 1250
Portland, Oregon 97204-1912
(503) 823-5288
FAX (503) 823-5384
TTY (503) 823-6868

CITY OF PORTLAND

OFFICE OF MANAGEMENT AND FINANCE

MEMORANDUM

TO: LaVonne Griffin-Valade, City Auditor

FROM: Kenneth L. Rust, Chief Administrative Officer (outgoing) jdg for KLR
Jack Graham, Chief Administrative Officer (incoming) jdg

DATE: July 13, 2011

SUBJECT: Response to Fiscal Sustainability/Financial Condition 2001-2010 Report

Thank you for the opportunity to review and comment on your audit of the City's Fiscal Sustainability and Financial Condition (the "Audit"). When OMF was presented with the initial working draft we completed a thorough review of it and compiled a list of 80 comments that was submitted to Audit Services for review and consideration. OMF appreciated the opportunity to meet with Audit Services staff to review in detail our questions, comments, and concerns and note that the final report addresses some of these concerns and issues. OMF is particularly relieved to see that the Audit includes broad disclaimer language that we had recommended to help avoid potential disclosure liability issues. Even with these changes, however, OMF still has serious issues with the Audit's underlying methodology and its conclusions. OMF does not agree with the Audit's key finding that the City of Portland's (the City) current financial health ranks only as satisfactory. Neither do we agree with the Audit's recommendation regarding pre-funding of pension and employment benefit liabilities.

When work on this Audit first commenced, OMF expressed concerns about its scope, particularly its intent to include an assessment of the City's fiscal sustainability. This concern was raised knowing that efforts by the Governmental Accounting Standards Board (GASB) to extend accounting standards to accountability areas like fiscal sustainability were still under development, and that the promulgation of such accountability standards by GASB were strongly opposed by organizations like the Government Finance Officers Association and others. To help assuage these concerns OMF was told in writing that:

> *"…this audit will assess and compare Portland's debt and spending patterns against other jurisdictions, best practices, and against state and federal ratios. Specifically, we will assess Portland's ratio of debt to revenue, the average maturity of Portland debt, and ratios of liability/debt to assets, presenting a publicly-framed report on the results of Portland continuing its current financial decisions."*

In our review of the working draft report it became immediately apparent that significant parts of the work effort as described above (particularly the comparative and best practice analyses) had not been undertaken, or if they had, were not presented in the report itself. OMF raised this issue at its meeting with Audit Services staff and their response was that they reserve the right to change scope during the course of an audit and that the comparative analysis and other work was not undertaken. OMF continues to believe that this omission in the final report fundamentally undermines the value of the Audit and its findings.

An Equal Opportunity Employer
To help ensure equal access to programs, services and activities, the Office of Management & Finance will reasonably modify policies/procedures and provide auxiliary aids/services to persons with disabilities upon request.

OMF is also concerned that the Audit as written could confuse readers by making it appear that a determination of financial health and fiscal sustainability was the result of well-thought out and agreed upon methods and standards. The Audit makes reference to GASB, audit standards, and work done by the International City/County Management Association (ICMA) to give the imprimatur of validity to the underlying methodology, the conclusions reached, and the recommendations presented. However, as previously mentioned, there are no agreed upon standards for this type of fiscal sustainability work. Furthermore, even the financial trend methodology promulgated by the ICMA in their publication "Evaluating Financial Condition: a Handbook for Local Government" and referenced in the Audit as the basis for analysis was not strictly followed. Instead it appears that a self-selected and narrower set of indicators was used that may or may not provide a complete, fair, and comprehensive analysis of the City's financial trends and fiscal health. Throughout the Audit report the lack of context and clarifying information weakens the ability of a reader to understand the tradeoffs between incurring debt and choosing other funding options such as pay-as-you-go, or the dedicated revenue stream for the City's Fire and Police Disability and Retirement system that serves to offset its liabilities. The Audit also fails to describe what basis was used to assign a satisfactory grade to the City's financial health, what the grading scale is comprised of (i.e., satisfactory/unsatisfactory, poor/satisfactory/good, etc.) and where the City currently stands on this grading scale. Consequently, what the Audit represents is simply the opinion of Audit Services about the City's financial condition and fiscal sustainability.

The City has a long-standing and well-deserved reputation for financial excellence. With substantial operating reserves, strong financial policies, a commitment to long-range financial planning and decision making, and General Fund reserves that were not tapped even during the nadir of the "Great Recession," the City's current financial condition is very sound and the envy of other cities of similar size and complexity. The City's credit ratings are uniformly excellent, have not been subject to ratings downgrades, and include the gilt-edged Aaa rating that has been in place for more than 27 years. Over this time period the City has weathered a number of exogenous shocks including citizen initiatives affecting and limiting property tax collections, economic recessions, and others. The City's financial policies and practices have proven their resiliency over a long time period and will likely continue to do so on into the future. Over the past ten years the City has successfully and aggressively dealt with its pension liabilities through innovative financing practices and much needed changes to the City Charter. The 2006 Charter changes approved by City voters was the culmination of three attempts over an eight-year period to reform the funding model for the City's Fire and Police Disability and Retirement system in a manner that is prudent and manageable while at the same time minimizing financial impacts on City property owners. Even infrastructure funding, which continues to be a challenge for the City and most other cities across the United States, has seen substantial progress and success over the past 10 years with the on-time and under budget completion of large-scale projects such as the mid-County Sewer Project and Big Pipe Project. These indicators of actual, proven financial performance and resiliency easily justify a financial condition ranking of strong or higher, at least in the opinion of OMF and other outside entities that routinely review the City's financial condition such as credit rating agencies, bond insurers, and investors.

OMF does concur with the Audit's recommendation that the City should develop a strategy to address its infrastructure funding needs in order to maintain and/or improve service levels that these assets support. OMF has worked with other City bureaus over the past 10 years to improve its asset management processes. OMF will continue to work with City bureaus and the Council to address infrastructure funding needs, knowing that if adequate resources are not made available the infrastructure funding issue will resolve itself in the form of lower service levels and likely higher long-term capital maintenance costs.

OMF also sees merit in expanding the methods already used to measure the City's outstanding debt, debt burden, and debt capacity and will undertake efforts to bring this expanded reporting information to Council during the course of the annual budget process.

OMF disagrees with the Audit's recommendation to continue investigating options to pre-fund pension and other post-employment benefits. OMF has already extensively studied and analyzed funding options for these types of benefits. In the absence of a change in state law that would enable the City to invest in equity securities, pre-funding options would only increase the cost of these programs without the benefit of higher investment earnings that could offset costs over the long run.

Audit Services Division
Office of the City Auditor
1221 SW 4th Avenue, Room 310
Portland, Oregon 97204
503-823-4005
www.portlandoregon.gov/auditor/auditservices

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

Portland's Fiscal Sustainability and Financial Condition: Actions now can reduce risk of future problems

Report #399, July 2011

Audit Team: Kristine Adams-Wannberg
Kari Guy

Other recent audit reports:

Portland Center for the Performing Arts: Outsourced management good for the City, but agreements and oversight need improvement (#393, June 2011)

Fire and Police Disability and Retirement: Improvements resulted from 2006 Charter reforms, but significant fiscal challenges remain (#408, June 2011)

Police Property Evidence Division: Internal controls and physical security strong; tracking system needs improvement (#403, April 2011)

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