



OFFICE OF THE CITY AUDITOR
COLORADO SPRINGS, COLORADO

13-01
Colorado Springs
Utilities Debt
Management
Audit

February 2013



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13-01 Colorado Springs Utilities Debt Management Audit

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Purpose

The purpose of this audit was to review the process Colorado Springs Utilities used to issue and administer debt. The audit focused on debt issuance and expenditure reimbursements from bond funds as well as comparison of policies and practices to the "best practices" recommended by the Government Finance Officers Association (GFOA).

Highlights

We concluded Colorado Springs Utilities general debt management practices followed GFOA best practices recommendations. These practices assisted in preventing conflicts of interest in financial transactions and encouraged adequate oversight of the process. The debt management policy could be strengthened by including written guidelines and restrictions as recommended by the professional organization, GFOA.

Management Response

Management was generally in agreement with our recommendation.

Recommendation

Enhance the Financial Risk Management Policy to include additional guidelines set forth by GFOA advisories and best practices, particularly in regard to permitted derivatives and the approval process.

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Office of the City Auditor

Colorado Springs Utilities Debt Management Audit

Date: February 6, 2013

To: President Hente, President Pro-Tem Martin, and Members of City Council

Re: 13-01 Colorado Springs Utilities Debt Management Audit

We conducted an audit of Colorado Springs Utilities debt management activities.

The purpose of this audit was to review the process Colorado Springs Utilities used to issue and administer debt. The primary focus of the audit was to review the processes used to issue debt and reimburse expenditures from bond funds, and compare written policies to the "best practices" recommended by the Government Finance Officers Association (GFOA).

We concluded general debt management practices were in place by Colorado Springs Utilities management per the best practices recommended by the GFOA. However, the overall written debt management policy could be strengthened by including written guidelines and restrictions as recommended by the professional organization. This observation and our recommendation are included in the attached report.

As always, feel free to contact me if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Denny Nester".

Denny Nester, MBA, CPA, CIA, CGFM, CFE, CGAP
City Auditor

Cc:

Jerry Forte, Chief Executive Officer

Bill Cherrier, Chief Planning and Financial Officer

Dede Jones, General Manager, Financial Services

Nancy Brisco, Manager, Treasury and Finance

David Maier, Manager, Enterprise Risk Management

Steven Berman, Manager, Financial Forecasting, Reporting, and Budgeting

Sonya Thieme, Manager, General Accounting



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REPORT DETAILS

PURPOSE AND SCOPE

The objectives of this audit were to review the process Colorado Springs Utilities used to issue and administer the bond funds. We also reviewed to ensure debt practices were in accordance with the Colorado Springs Utilities Financial Risk Management Policy.

We identified the Government Finance Officers Association as a resource for best practices information related to Finance and compared Colorado Springs Utilities' practices with the recommended guidelines. GFOA is a professional association of approximately 17,500 state and local government finance officers. We noted that GFOA was not an authoritative body and Colorado Springs Utilities was not required to conform to this guidance.

Based on our preliminary risk assessment, the primary focus of the audit was to document the process used to issue debt, and review bond reimbursement for compliance with policy and bond requirements. The audit period focused on 2012, as well as prior periods necessary to complete tests within audit scope.

BACKGROUND

In preparation for this audit, we reviewed published audits of the debt management function from municipalities in the United States. The GFOA guidelines relating to debt management address the risks identified in other audits of municipal debt management activities. The focus of the guidelines is to increase transparency, ensure proper oversight, help municipalities keep debt costs low, and to prevent conflicts of interest between parties.

Financing Process

Planning and Finance of Colorado Springs Utilities was responsible for working with the operating divisions to analyze the need for the various financing for capital projects. Treasury and Finance managed the short-term and long-term debt support for the Colorado Springs Utilities capital structure. Colorado Springs Utilities' Risk Management function was responsible for policy development and risk management activities related to any derivatives transactions.

In accordance with policy, Treasury issued debt obligations and managed interest rate exposures. The policies provided the framework for these activities; executive management provided oversight of the process, and approvals from City Council were required for debt transactions such as bond issues. Policy goals were to support the capital program, minimize debt cost, maintain a quality credit rating,



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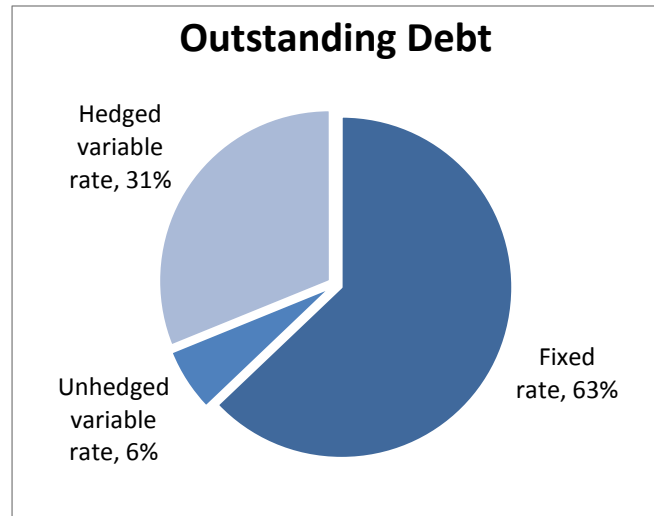
balance risk and benefits, and maintain financial flexibility with an optimal capital structure of a fixed and variable rate debt mix.

Colorado Springs Utilities engaged a Financial Services firm in the capacity of Financial Advisor to assist with monitoring market conditions and planning issuance of new debt and refinancing of the debt portfolio. Underwriters were responsible for the actual placement and sale of the debt issue in the bond market. Once bonds were issued and proceeds were available, the funds were used to reimburse capital expenditures from each service.

Securities Firms and Advisors engaged by Colorado Springs Utilities were required to comply with Municipal Securities Rulemaking Board (MSRB) regulations related to their services. The MSRB regulates securities firms, banks, and municipal advisors that engage in municipal securities and advisory activities.

Current Debt Portfolio

As of September 2012, \$2.3 billion in aggregate bond principal was outstanding. Pursuant to related Policy, up to 30% of total outstanding debt could take the form of un-hedged variable rate debt. As of the most recent bond issuance in September 2012, Utilities had outstanding debt in fixed and variable rate instruments in percentages according to the chart above.



Colorado Springs Utilities current outstanding debt composition was 75% tax exempt bonds, 19% taxable Build America Bonds with a subsidy, and 6% taxable bonds as of November 30, 2012; issuing these types of debt introduces restrictions on transactions that may be reimbursed out of bond proceeds. Generally speaking, only capital expenditures may be reimbursed from bond funds.

Investment Derivative Transactions

Historically, Colorado Springs Utilities has engaged in interest rate swaps as an interest rate hedge. These financial instruments fixed the price Colorado Springs Utilities would pay for variable rate debt, providing more certainty related to debt service costs. Associated with this transaction was the requirement by either party to post collateral if the transaction exceeded a specified threshold based on change in market prices for interest rates.



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COMMENDABLE PRACTICES

After conducting a review of Colorado Springs Utilities Treasury and Finance, we would like to highlight several commendable practices:

- Treasury closely monitored rating agency relationships and initiated regular communications resulting in maintaining a stable outlook and strong credit rating of Aa2, AA, and AA for Moody's, Fitch, and S&P respectively.
- Increased diversification of variable rate debt liquidity provider portfolio, dividing the risk between more and higher rated counterparties.
- Treasury performed ongoing monitoring to identify opportunities to reduce cost and risk, and increase counterparty diversification.
 - Two swap novation transactions in which swap agreements were cancelled and replaced, resulted in more beneficial collateralization requirements and returned \$39.2 million in cash collateral.
 - Refinanced two existing debt series at record low interest rates to achieve \$12.3 million and \$27.7 million in present value savings.
 - Avoided \$1.1 million in debt costs through refinements in debt issuance timing from the fall of 2011 to the spring of 2012.
 - Replaced and /or extended three variable rate debt liquidity facilities expired in 2012 for an annual cost savings of \$373,000.

CONCLUSION

We concluded debt management practices were performed by Colorado Springs Utilities management in accordance with the best practices recommended by the GFOA. However, the overall written debt management policy could be strengthened by including written guidelines and restrictions as recommended by the professional organization. This observation and the related recommendation are detailed on the following pages.



OBSERVATIONS, RECOMMENDATIONS AND RESPONSES

OBSERVATION 1 – FINANCIAL RISK MANAGEMENT POLICY DID NOT SPECIFY SOME BEST PRACTICES IDENTIFIED BY THE GOVERNMENT FINANCE OFFICERS ASSOCIATION

The Government Finance Officers Association (GFOA) recommends all local governments adopt comprehensive written debt management policies, including policies related to derivative and interest rate swaps. These guidelines assist in preventing conflicts of interest in financial transactions involving the municipality, and encourage adequate oversight of the process. We noted that while Colorado Springs Utilities followed most of the identified best practices, some were not required by Colorado Springs Utilities policy, as follows:

- Financial Advisory Services - In 2011, requests for proposals were obtained from qualified Financial Services firms related to Financial Advisory services. However, Colorado Springs Utilities policy did not require that the Financial Advisor selection be reviewed on a regular basis to ensure the best value was obtained for the organization.
- Negotiated vs. Competitive Underwriting Services - Colorado Springs Utilities policy stated that the Chief Financial Officer was responsible for determining whether debt placement through underwriters would be based on competitive or negotiated basis. The policy did not require a Request for Proposal (RFP) process in the case of negotiated placement, but we noted that Colorado Springs Utilities consistently utilized the RFP process for negotiated placements of debt issues. We noted that documentation of the rationale for negotiated versus competitive placement was not required.
- Policy related to Interest Rate Derivative Instruments – Colorado Springs Utilities policy stated that speculative use of derivative instruments was not allowed and that when a new derivative product was used or the risk profile related to the product changed, it was to be presented to the internal oversight group (Risk Management Committee). Repeat transactions of the same product did not require presentation and approval by the Committee. Allowable transaction types were not specified in policy. In practice, Colorado Springs Utilities would have presented the interest rate hedging program and strategy to this oversight body for approval, but this was not required per policy.

Since detailed direction in regard to allowed derivatives were not specified in policy, reliance was placed on the expertise of the Treasury and Finance and the Chief Financial Officer to guide Colorado Springs Utilities financing activities.



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GFOA best practices are summarized in the following table, noting whether Colorado Springs Utilities had adopted the best practice into their policy, and whether they were following the policy in practice.

GFOA Best Practices	In Utilities Policy?	Does Utilities Perform?
Selecting a Financial Advisor (FA)		
Select on the basis of merit- use a Request for Proposal (RFP)	Yes	Yes
Not permit an FA to also act as underwriter	No*	Yes
Review Relationship Periodically	No	Yes
Define the role of a FA	Yes	Yes
RFP process requirement to provide 3 references	No	Yes
Maximize number of respondents	Yes	Yes
Document how selection was made	Yes	Yes
Fees paid on hourly or retainer basis, not contingent	No	No
Require a written contractual relationship	No	Yes
Selecting an Underwriter		
Use an Request for Proposal (RFP) process	Yes	Yes
Maximize the number of respondents	No	Yes
Document how selection was made	No	Yes
RFP process requirement to provide 3 references	No	Yes
Selecting Method of Sale Negotiated vs. Competitive		
Selection undertaken in partnership with FA	Yes	Yes
Method based on thorough analysis	Yes	Yes
Document the decision	No	Yes
Using Variable Rate Debt Instruments		
Reviewed and Approved by Internal oversight committee	Yes	Yes
Evaluate the need for an externally provided liquidity facility	Yes	Yes
Evaluate the total cost of issuing variable rate debt	Yes	Yes
Ensure the diversification of remarketing agents, liquidity facility providers and counterparties.	Yes	Yes
Using Derivative Financial Products		
Have a comprehensive derivatives policy	No	Yes
All derivative transactions be documented using standardized forms, ISDA agreements	Yes	Yes
Policy should require monitoring and take action to limit risk exposure.	Yes	Yes
Document the effect of derivatives on credit ratings	Yes	Yes

**prohibited by regulation*

As shown in the table, Colorado Springs Utilities followed all but one of the noted best practices relating to debt management identified by the GFOA; however ten of the identified best practices were not reflected in policy. A comprehensive derivative policy should address the acceptable products and transactions, and other factors related to the rationale for and risks related to such transactions. Before executing a derivatives strategy, the Risk Management Committee should evaluate all costs, benefits and risks inherent in the transactions.

AUDITOR'S RECOMMENDATION

We recommend Colorado Springs Utilities enhance their policy to include additional guidelines set forth by GFOA advisories and best practices, particularly in regards to permitted derivatives and the approval process.



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COLORADO SPRINGS UTILITIES RESPONSE

Colorado Springs Utilities agrees with this recommendation. While we feel our practices and guidelines for derivative transactions, financial advisory services and underwriting processes meet or exceed GFOA guidelines, many of the guiding documents are contained in secondary policies and procedures. Accordingly, CSU will update our policy level documents to include additional written guidance on specific topics, referencing GFOA standards in these documents where applicable. These policy enhancements will include financial advisory services, underwriting services, and interest rate derivative instruments. The expected completion date is July 31, 2013.

CITY COUNCIL'S OFFICE OF THE CITY AUDITOR

COLORADO SPRINGS, COLORADO

About our Office

The mission of the Office of the City Auditor is to provide City Council with an independent, objective and comprehensive auditing program for operations of the City. Our auditing program includes:

- Evaluating the adequacy of financial controls, records and operations
- Evaluating the effectiveness and efficiency of organizational operations
- Providing Council, management and employees objective analysis, appraisals, and recommendations for improving systems and activities

The Office of the City Auditor is responsible for auditing the systems used by the City of Colorado Springs and its enterprises, including Colorado Springs Utilities. We perform a variety of audits for these entities, including financial audits, performance audits, contract audits, construction audits, and information system audits. We also perform follow-up on a periodic basis to monitor and ensure management actions have been effectively implemented.

Authorization and Organizational Placement

Our audits are conducted under the authority of Chapter 1, Article 2, Part 7 of the Colorado Springs City Code, and more specifically parts 703, 705 and 706 of the Code. The Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council.

Audit Standards

The audit was conducted in a manner that meets or exceeds the International Standards for the Professional Practice of Internal Auditing, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors, with the exception of the requirements under standards 1312 and 1321 to obtain an external quality assurance review once every five years. We do not believe this non-compliance impacted the quality of our audit.

The audit included interviews with appropriate personnel and such tests of records and other supporting documentation as deemed necessary in the circumstances. We reviewed the internal control structure and compliance tests. Sufficient competent evidential matter was gathered to support our conclusions.