3. Appropriation and Budgetary Control and the Port's Capital Program

- **The Port does not have a clear vision of how to define and manage its capital program. The lack of a capital improvement program as well as deficiencies in the tracking and monitoring of capital project appropriations have resulted in inconsistent and flawed decision-making and a lack of accountability.**

- **First, the capital budget does not reflect the overall capital needs of the Port or effectively set capital priorities. An internal and perfunctory cost estimate developed by the Engineering and Maintenance Division in order to determine the order of magnitude of capital needs and dated July of 2003 computed the Port's substructure and superstructure capital needs to be approximately $545 million. According to the Port, this would bring the Port's infrastructure up to a condition that would support further development and capital improvements. This estimate does not include capital needs for a significant number of Port buildings and facilities that are not on piers. A subsequent cost estimate calculated three months later in October of 2003, and after the Budget Analyst's management audit commenced, estimated these costs to be $358 million, $187 million or 34.3 percent lower than the original $545 million estimate. According to the Director of Engineering and Maintenance, the revised estimate of $358 million was based on costs developed by an outside consultant for a specific scope of work on Pier 31. In contrast to this estimate, the FY 2003-2004 Capital Plan has identified $74.4 in unfunded capital needs and $80.6 million in funded capital needs, for a total of $155 million in capital needs, including the capital needs for buildings and facilities that are not on piers. Thus, the Port provided three different estimates of its capital needs and, clearly, does not have a complete or accurate estimate of its substantial capital needs at this time.**

- **Further, the Port has historically transferred significant appropriations between projects to meet its funding needs. From FY 1999-2000 through FY 2002-2003, a total of $12.6 million in appropriations were transferred between capital projects. $7.5 million or 59.5 percent were permanent transfers and were not returned to the original project appropriation.**

- **In FY 2002-2003, over $12 million in projects were either closed because they were completed or fully or partially de-funded. The de-funding of project appropriations, which was approved by the Port Commission, was never brought forward to the Board of Supervisors. While most of the $12 million was subsequently used to fund the FY 2003-2004 capital plan, at least $1.5 million was re-appropriated in FY 2002-2003 to pay for soil remediation at Pier 92 which was the result of a notice of violation received from the California Department of Toxic Substance Control. This project and appropriation were never submitted to the Board of Supervisors for approval.**

- **The de-funded projects included three projects that were reported as completed by the Engineering and Maintenance Division Director, the Fish Prep Building Relocation, Roundhouse Heating Ventilation and Air Conditioning (HVAC) project, and the Ferry Building Asbestos project, yet almost all of the capital funding originally appropriated for these projects remained unspent. The Fish Prep Building Relocation was completed with operating funds; the Roundhouse HVAC project was redesigned and engineered to significantly cut costs; and the Ferry Building Asbestos project was completed by a developer pursuant to a negotiated agreement. These projects demonstrate several issues with the management of capital projects, including inappropriate funding sources, flawed project scope and cost estimates, timing differences between appropriations and project work. Another example of a project that has not progressed as initially envisioned is the Illinois Street Bridge project, which originally had a cost estimate of $7.2 million in FY 2000-2001, but is now estimated to cost $22.6 million, a $15.4 million or 214 percent increase. Not all funding sources for the project have been secured, nor have all existing appropriations been authorized by the Board of Supervisors.**

- **Further, the Port's capital project appropriations as recorded in the financial accounting system, which is the mechanism by which budgetary control is maintained, are not simply correlated to project appropriations approved by the Board of Supervisors. Coupled with the significant project transfers, there has been a deterioration in budgetary control over capital expenditures. Additionally, the Port establishes appropriations for certain revenues, such as operating agreement restricted revenues and mitigation fees, without obtaining appropriation authority from the Board of Supervisors. The Controller concurs that it is imperative for departments to seek approval for all expenditures through the Annual Appropriations Ordinance, a supplemental appropriation, or have authority granted through the Municipal Code or the City Charter. The Budget Analyst also noted that 20, 33, and 46 year old bond funds remain unspent and several large, negative appropriation balances totaling $6.7 million in project funds have not been reconciled.**

- **Finally, three issues were identified where capital projects are either inappropriately being charged or are not being appropriately charged, including capital-funded labor working on operating activities, operating labor working on capital activities, and indirect capital costs not captured and allocated to capital projects.**

- **Clearly, the capital budget process is not controlling or reflective of capital activities at the Port and the risks of poor capital planning and management are significant. Ultimately, the situation has impaired the financial stability of the Port because the precise extent of the Port's capital needs are unknown and there is no mechanism in place to effectively and efficiently meet those needs. The Port needs to establish a formal capital improvement program which would provide a mechanism for sound decision making and accountability, facilitate the implementation of the Port's long-range Waterfront Land Use Plan, and serve as a financial management tool.**

One of the Port of San Francisco's primary objectives is to maintain and improve its capital assets in order to remain a viable enterprise. Accordingly, management of capital projects, which totaled approximately $12.1 million and constituted 21.0 percent of Port expenditures in FY 2002-2003, is one of the Port's most important functions. In total, the Port had approximately $26.8 million in continuing and annual capital project appropriations open as of June 30, 2003.

The Capital Budget Process

The foundation for sound capital management is the existence of a capital improvement program and a rigorous budget process. A formal capital improvement program has many benefits, including providing a mechanism for management decision making and establishment of a link to long-range planning. A capital improvement program is implemented through the budget process and together they establish priorities and provide a framework for public policy decisions, serve as financial management tools, act as a control on spending, and establish accountability. There are several components to a capital improvement program, but the most fundamental are that there should be a systematic identification of capital needs and established criteria to objectively evaluate those needs.

At the Port, capital project requests are reviewed by the Capital Projects Planning Committee, which is comprised of the five Division Directors. According to Port policy as stated in the annual Capital Plan, priority is given to projects in the following order:

1. Health and safety issues
2. Mandated projects
3. Increased revenues to the Port
4. Prevention of loss of revenue to the Port

5. Recovery of investment
6. Economic benefits to Port tenants
7. Economic benefits to the City

The Capital Projects Planning Committee determines which projects to propose for funding every year and the Capital Plan is developed by the Port's Finance unit. Once capital project appropriations have been approved by the Port Commission, the Mayor and the Board of Supervisors, the level at which appropriations have been approved establishes the legal level of appropriation and budgetary control. Any additional funding that may be required must obtain additional legislative authorization, pursuant to the San Francisco Administrative Code Sections 3.14 (Departments to Operate Within Amounts Budgeted) and 3.15 (Supplemental Appropriation Ordinances Budget, Modifications).

San Francisco Administrative Code Section 3.18, however, allows the Controller to transfer "unused" appropriation balances within the same governmental unit and fund. There is no definition of "unused" balances and the term is open to interpretation as to whether it refers to residual or surplus appropriation balances or whether it is inclusive of de-funded operations, activities, or capital projects. Pursuant to Administrative Code Section 3.18, any transfers that exceed 10 percent of the receiving appropriation must be reported by the Controller to the Mayor and the Board of Supervisors. The Controller's practice is to prepare a report once a year of the transfers that meet the 10 percent criteria. However, the Controller has historically relied upon departments to identify these transfers. There is no City or Controller policy regarding other types of transfers, such as when the source is loans or de-fundings, or any City policy specific to capital project appropriations.

Capturing, Tracking and Monitoring Capital Expenditures

If the capital budget is the foundation for sound capital management, then a financial system for capturing, tracking and monitoring capital expenditures provides the framework. In order to ensure budgetary compliance and facilitate efficient project management, an effective financial system and process must be in place.

The Port's financial management of capital projects typically begins with the Engineering and Maintenance Division requesting approval for expenditure on specific projects using the Capital Expenditure Approval Form (CEAF). The Accounting and Finance units of Administrative Services review the request to identify the appropriate capital project appropriation, verify sufficient funding is available, and assign a work order number that will be used both in the Port's Avantis facility maintenance management system and the Oracle financial system. Once the CEAF has been authorized and the work order established, the Engineering and Maintenance Division can begin work on a capital project. It is the responsibility of project managers in the Engineering and Maintenance Division to ensure that line supervisors are directing the work efficiently and effectively and charging staff time to appropriate work orders. See Section 4 and Section 5 of this report for further audit comment on work management in the Engineering and Maintenance Division.

In addition to project management in the Engineering and Maintenance Division, the Accounting unit of Administrative Services has a work group of three staff specifically responsible for the financial tracking and monitoring of capital project expenditures. This group prepares numerous tracking reports, conducts project reconciliations, and provides general oversight over capital project activities by approving CEAFs and assigning work orders.

Identifying Capital Needs and Priorities

The Port does not have a capital improvement program in place that links immediate, interim, and long-term capital needs and development plans. There has not been a comprehensive capital needs assessment performed, nor is there formal evaluation or measurement against established criteria during the review and selection process for those capital projects that get funded during the budget process. The capital budget for the past five years has been based on work that needs to be performed as proposed every year by the various Port divisions, primarily the Engineering and Maintenance Division. The Port's FY 2003-2004 Capital Plan appropriated approximately $14.8 million to capital projects and identified an additional $57.9 million in unfunded capital needs. Existing capital projects which did not receive funding in FY 2003-2004 had total estimated funding requirements of $82.3 million, of which $16.5 million was unfunded. Thus, unfunded capital needs, according to the FY 2003-2004 Capital Plan, are estimated to be approximately $74.4 million and funded capital needs are estimated to be $80.6 million, for a total of $155 million in capital needs. According to the Director of Engineering and Maintenance, cost estimates calculated for capital projects include a standard 10 percent contingency. However, project scheduling is not developed until the capital project is approved. Thus, workload and scheduling are not linked to the budget process which can impair the accuracy of the cost estimates included in the budget.

The Engineering and Maintenance Division is performing a "rapid assessment" of Port substructures and superstructures, and has been doing so since before our management audit started. The assessment, which began in FY 2001-2002, consists of Port inspectors and engineers performing a quick assessment of a structure and assigning a green, yellow, or red designation to signify the urgency of a second assessment. A red designation indicates an immediate need and results in a full-scale survey of the structure. According to the Director of the Engineering and Maintenance Division, the inspections on the substructures are 75 percent complete and inspections on the superstructures are 60 percent complete. The rapid assessment is scheduled to be completed in November 2004. However, the rapid assessments are only addressing the capital needs of the Port by identifying immediate needs.

In order to provide the Port a better understanding of the extent of its capital needs in terms of order of magnitude, an internal cost estimate developed by the Engineering and Maintenance Division using the rapid assessment, in conjunction with the Planning and Development Division and dated July of 2003, computed the Port's substructure needs to be approximately $345 million. Substructures include piers, aprons, and marginal wharves and the cost estimate was based on fixed repair costs per square foot for substructures deemed to be in good, fair, or poor condition and for marginal wharves in any condition. According to the Port, this estimate of substructure needs, along with an additional rough approximation of $200 million for superstructure needs for the buildings on top of the piers, would bring the Port's infrastructure up to a condition that would support further development and capital improvements. The Port views public/private partnerships as an important instrument to address the issue of capital needs by sharing the liability with a private party. In all, these needs totaled $545 million according to the Port's perfunctory analysis dated July of 2003. However, this analysis does not include capital needs for a significant number of Port buildings and facilities that are not on piers. A subsequent analysis in October of 2003, after the management audit started, resulted in a total cost estimate for substructure and superstructure needs of $358 million, a substantially different estimate than the one completed three months prior. According to the Director of Engineering and Maintenance, the second analysis was refined by using cost estimates developed by an outside consultant for a specific scope of work on Pier 31. Therefore, while the Port has identified the need for a greater understanding of its capital needs and has taken steps accordingly, the Port does not have an accurate and complete estimate of its true capital needs at this time.

Review of capital project appropriations and expenditures over the last five years indicates that the capital budget process has not effectively established priorities or served as a financial management tool for decision making, controlling expenditures or establishing clear accountability. The adjusted budget at the end of the fiscal year reflects dramatically different funding levels and, consequently, altered capital priorities than those adopted by the Board of Supervisors at the beginning of the year. The following table presents the variances between total capital project annual appropriations as adopted at the start of the fiscal year in the Annual Appropriation Ordinance and at the end of the fiscal year as recorded by the Controller's Office:

Table 3.1

Adopted and Adjusted Capital Project Appropriations FY 1998-1999 through FY 2002-2003

	FY 98-99 (1)	FY 99-00	FY 00-01	FY 01-02	FY 02-03
Adopted Budget	$3,776,154	$7,129,574	$7,570,252	$32,159,442	$5,872,000
Adjusted Budget	10,394,588	7,829,847	9,651,300	29,598,378	(883,862)
Variance	$6,618,434	$700,273	$2,081,048	$(2,561,064)	$(6,755,862)
As a Percent	175%	10%	27%	(8)%	(115)%

Source: Annual Appropriations Ordinances and the City Controller's Office.

(1) According to the Port, $6,434,954 in supplemental appropriations was approved in December 1998 once funding for 28 capital projects was secured.

Additionally, for the five year period shown above, projects were not always started in the first year of appropriation. Table 3.2 below shows the number of continuing project appropriations recorded in FAMIS with increased appropriations during the year, but for which no expenditures were recorded to the date of the end of the fiscal year in which the appropriation was increased. The Port's management decisions thereby result in a commitment of scarce capital resources that frequently remains idle while the many pressing unmet needs are not addressed.

Table 3.2

Capital Projects with Increased Appropriations but No Expenditures FY 1998-1999 through FY 2002-2003

	FY 98-99	FY 99-00	FY 00-01	FY 01-02	FY 02-03
Capital Projects with Increased Appropriations	35	39	30	48	13
Capital Projects with No Expenses Recorded	22	20	6	16	2
Percent	63%	51%	20%	33%	15%

Source: Compiled from data provided by the City Controller's Office.

Some of the appropriations were de-funded in the following year, such as for electrical service and roof at Pier 48, acquisition of a 50 ton crane, and an electrical transformer for Piers 24, 26, and 28 and then some of these appropriations were re-established in the third year. As discussed in the next section, the Port has historically advanced appropriations to other capital projects that had not yet been properly approved through the appropriations process. While some of these "loans" of capital appropriations were then returned to the initial appropriation, many were permanent transfers. According to the Port's Capital Projects unit, $12,557,156 was loaned in FYs 1999-2000, 2000-2001, 2001-2002, and 2002-2003. $5,087,673 or 40.5 percent of these appropriations were later returned to the initial projects (or a new project appropriation established for the original project purpose) and $7,469,483 or 59.5 percent were permanent transfers[1]. Clearly, the Port's budgeting strategy has not met it capital needs.

As can been seen in Table 3.1 and Table 3.2 above, capital project appropriations declined significantly in FY 2002-2003, which was the result of de-funding existing projects and closeout of completed projects. In all, the Port Commission approved de-funding and closeout of 76 projects and $12,014,217 in project appropriations on

[1] These amounts do not include permanent transfers of $1,492,262 for the remediation of contaminated soils at Pier 92 from eight projects de-funded or closed out in FY 2002-2003.

February 11, 2003. However, these de-fundings and closeouts were never presented to or approved by the Board of Supervisors. During the Port Commission hearing, the Engineering and Maintenance Division Director provided detail on which projects were completed and which ones were either partial or full de-fundings. Table 3.3 provides summary totals for the closeouts and de-fundings:

Table 3.3

Capital Projects Closeout and De-funding
February 11, 2003

	Number of Projects	Appropriations
Projects completed with unspent funds remaining	43	$3,345,605
Project partially de-funded	7	3,892,365
Projects fully de-funded	26	4,776,247
Totals	76	$12,014,217

Source: Compiled from the staff report to the Port Commission and February 11, 2003 meeting minutes.

Project Closeouts after Completion

The project closeouts indicate several issues with the Port's financial management of capital projects. First, completed projects are not being closed out in a timely manner. Of the 43 completed projects, 23 projects, or 53.5 percent, had no expenses for the first seven months in FY 2002-2003 and 13 of those projects, or 30.2 percent of completed projects, had no expenses in FY 2001-2002. Second, projects are overfunded. The following is a listing of completed projects where the funding returned to fund balance exceeded $100,000 and 10 percent of the original appropriation:

Table 3.4

Completed Capital Projects with Surplus Funding Exceeding $100,000 and 10 Percent of the Original Appropriation Reported February 11, 2003

Project	Original (1) Appropriation	Surplus Appropriation	As a Percentage
Pier 48/50 Maintenance Relocation (CPO647)	$8,027,000	$954,585	11.9%
Fish Prep Building Relocation (CPO746)	400,000	391,906	98.0%
Downtown Ferry Terminal (CPO670-01)	400,000	313,566	78.4%
China Basin Ferry Terminal (CPO684)	1,070,574	169,567	15.8%
Pier 28 Roof Replacement (CPO708)	331,000	155,572	47.0%
Ferry Building Shear Wall (CPO639)	401,876	137,744	34.3%
Roundhouse HVAC (CPO744)	121,000	117,963	97.5%
China Basin Park Shoreline Stabilization (CPO688-01)	592,200	107,769	18.2%
Ferry Building – Asbestos (CPO215)	106,146	106,146	100.0%

Source: Except as otherwise noted, compiled from the staff report to the Port Commission.

(1) As reported by the Accounting unit's Capital Projects work group, except CPO684 which was obtained from FAMIS appropriations reported by the Controller's Office.

Although three projects were reported completed by the Engineering and Maintenance Division Director, as can be seen in the table above, substantially all the funding originally appropriated for the purpose remained unspent. According to the Division Director:

(1) The Fish Prep Building Relocation was completed using operating fund appropriations.

(2) The Roundhouse HVAC was significantly under-budget (by 97.5 percent) because project design and engineering were simplified to reduce costs.

(3) The Ferry Building Asbestos project was established prior to the Port negotiating an agreement to renovate the building. The asbestos removal was completed by the developer of the Ferry Building pursuant to the negotiated agreement.

These three projects demonstrate several issues with the financial management of capital projects, including using inappropriate funding sources, flawed project scope and cost estimates, timing differences between appropriations and project work. As can been seen, the projects were not planned, managed or monitored through the capital appropriations with which they were approved.

Capital Project De-fundings

Capital project de-fundings indicate shifting priorities, sometimes in mid-project, and ambiguous project scopes. For instance, the build out and modernization of Pier 45, Shed C, which the FY 2002-2003 capital plan reported to cost an estimated $5,950,000, was de-funded of $2,317,352 or 38.9 percent of the total project appropriation. From the staff report on the de-fundings as well as Port Commission meeting minutes, it is unclear what will not be completed as a result of the de-funding. According to the Port Commission meeting minutes for February 11, 2003, substantial work on the project was to continue. However, according to the Engineering and Maintenance Division Director, Shed C would be unable to accommodate fish processor tenants due to the de-funding. Yet, according to the FY 2002-2003 Capital Plan, the intent of the project was specifically to make space available for fish processing and storage. In the Commission meeting, Port management stated that if necessary, the Port could use appropriations that exist in more generalized appropriation categories. Further, the Executive Director stated that the Port may not need the $2.3 million to bring tenants into Shed C. This discussion indicates that the Port does not have clear project scopes, timelines or cost estimates for its capital projects.

Another example is the parapet flashing replacement at Piers 3, 29 and 31, originally appropriated in FY 1998-1999 and reported to be a continuing public safety issue three years later in the FY 2002-2003 capital budget. However, the project was eventually completely de-funded – five years after the initial appropriation. Another de-funding in which the capital budget proclaims that immediate repairs were needed was for the repair of Scoma's Seawall. The original appropriation of $300,000 in FY 1999-2000 was de-funded four years after the initial appropriation, with the appropriation being consolidated into a generalized seawall repair appropriation as part of the FY 2003-2004 budget process.

At the same time that the Port Commission approved the de-funding and closeout of 76 capital projects, the Commission also approved the consolidation of specific capital project appropriations into more generalized appropriation categories. $367,927 from four capital projects was de-funded with the intent to re-appropriate the funds in the next budget cycle for FY 2003-2004 as generalized capital project appropriations for seawall and marginal wharf repair, building structure repair, fire sprinkler repair, roof repair, environmental assessment remediation, and utilities projects. Increased flexibility is advantageous from a management perspective, but from an internal control perspective, less flexibility is preferred. The key for any organization is finding a balance that meets the goals and objectives of all parties given cost-benefit considerations. Within these categories, management should have structured policies and procedures for establishing estimates of funding needs and assigning the funding to actual capital projects. In this case, seeking generalized categories by re-allocating existing project appropriations appears to be imprudent, having been conceived without laying down the fundamental framework for using these funds.

During the FY 2004-2005 capital budget hearing, the Port Commission expressed frustration at not being able to fully understand the funding priorities of the Port, especially with respect to partially funded projects. Much of the Commission meeting discussion was focused on the Illinois Street Bridge. This project was established in FY1999-2000 for the purpose of funding the construction of an inter-modal bridge to provide direct rail and truck connections between Pier 80 and Piers 94-96. According to the Port, this bridge is needed to maintain rail service to Piers 48, 50 and 80 once the Mission Bay development project has commenced. Table 3.5 provides detail on the Illinois Street Bridge actual expenditures and appropriations.

Table 3.5

Illinois Street Bridge Appropriations and Expenditures FY 1999-2000 through FY 2002-2003

	FY 99-00	FY 00-01	FY 01-02	FY 02-03	Appropriation Balance
CPO687 – Capital Projects Fund					
Appropriations		$20,500	$6,200,000	$1,456,843	
Expenditures		$19,397	$149,743	$161,591	$7,346,612
CPO814 – 1984 Bond Proceeds					
Appropriations	$100,000				
Expenditures	$36,148	$61,376	$2,181		$295
CPO133 – State Funds					
Appropriations		$500,000			
Expenditures		$75,524	$212,077	$76,268	$136,131
Totals					
Appropriations	$100,000	$520,500	$6,200,000	$1,456,843	$8,277,343
Expenditures	$36,148	$156,297	$364,001	$237,859	$794,305

Source: The City Controller's Office

The initial project funding in FY 1999-2000 of $100,000 in CPO814 was advanced from another project in the 1984 bond fund. The FY 2000-2001 Annual Appropriations Ordinance approved $100,000 in CPO687, which was "returned" to the project which advanced the initial appropriations. However, the return of appropriations was not to the 1984 bond fund and the advancing project. Rather, the appropriations were assigned to a different project in the capital projects fund, albeit for the same purpose[2]. According to the Finance unit, the $20,500 was a permanent transfer to the Illinois Street Bridge from the Downtown Ferry Terminal Project (CPO670). The $1,456,843 in FY 2002-2003

[2] This project was subsequently de-funded by the Port Commission on February 11, 2003, and thus the bond funds were no longer appropriated or captured by the financial accounting system as bond funds.

appropriations was funded through mitigation fees paid pursuant to several new negotiated agreements with Port industrial tenants in the southern waterfront area. However, none of these appropriations were approved by the Board of Supervisors. In all, $1,477,343 or 17.8 percent of project appropriations through June 30, 2003 had not been approved by the Board of Supervisors. Only $6,800,000 in project funding had been approved by the Board of Supervisors and $100,000 of this was retroactive.

According to the FY 2000-2001 Capital Plan, the total project costs for the Illinois Street Bridge were estimated at $7.2 million. According to the proposed FY 2004-2005 capital budget, costs are now estimated to be $22,550,641 which is $15,350,641 or 214 percent higher than the total project costs estimated and reported four years earlier. Of these estimated costs, $3.6 million is proposed to be funded in the FY 2004-2005 capital plan and $14.8 in funding sources have been previously identified, although only $8.3 in appropriations had been established as of June 30, 2003. Of this $14.8 million, $6.3 million has been appropriated by the Board of Supervisors through the capital budget process, $2.5 million is expected to be funded by grants (of which only $500,000 has been appropriated by the Board of Supervisors), and $6.0 million is expected to be funded through mitigation fees and negotiated payments from the developer of the Mission Bay project. $4.2 million of project costs are currently unfunded. However, the Port expects to be awarded a $5 million Federal transportation grant that has been incorporated into the Transportation Equity Act recently passed by the House of Representatives.

According to the Port Commission meeting minutes, the Commission expressed concern over the project noting that it does not make sense to build a bridge that no one can access, highlighting the fact that significant project components, such as approaches to the bridge, have not been addressed. Further, the escalation of project costs indicates that the project may have been poorly conceived in the planning stage. Because of the massive increase in the project's costs and because not all funding is secured, the Illinois Street Bridge project should be suspended until it is fully reviewed. The Port should bring legislation before the Board of Supervisors with detailed cost estimates and secured funding sources for the Board of Supervisors' review and determination of the future of the project.

The risks of poor capital planning and management are significant. The Port needs to establish a formal capital improvement program, especially in light of the undocumented and considerable capital needs. A capital improvement program would include funding priorities and project schedules over several years in order to coordinate the various capital project needs of the Port and to utilize Port resources in the most efficient and effective manner. Included in the development of a capital improvement program would be an analysis of whether the Port should do capital projects internally or contract for these services. The steps in developing a capital improvement program are as follows[3]:

[3] Adapted from *Capital Improvement Programming, A Guide for Smaller Governments*, by Patricia Tigue, Chicago, IL: Government Finance Officers Association, 1996.

- Establish the administrative structure to develop a capital improvement program,
- Establish the programmatic and financial policy framework,
- Develop capital project evaluation criteria,
- Prepare a capital needs assessment,
- Identify projects for the capital program,
- Conduct a financial capacity analysis and evaluate funding options,
- Evaluate and prioritize capital projects,
- Adopt the capital program and budget,
- Implement and monitor the capital budget, and
- Evaluate the capital improvement process.

A formal capital improvement program would provide a mechanism for sound decision making, facilitate the implementation of the Port's long-range Waterfront Land Use Plan, and serve as a financial management tool. It is a proactive approach to addressing the Port's asset management needs.

Weaknesses in the Port's Budgetary Control over Capital Project Appropriations

Just as important as establishing appropriate capital priorities, the budget process serves as a financial management tool, establishes controls on spending, and facilitates accountability. However, the Port's capital project appropriations as recorded in FAMIS, the City's financial accounting system used to establish budgetary control, do not reconcile to project appropriations as authorized by the Board of Supervisors and the Port Commission. Several Port capital budget and accounting practices are occurring which have severely deteriorated appropriation and budgetary control to unacceptably low levels such that the Board of Supervisors and Port Commission cannot be assured that authorized funds are spent on approved projects. These practices include:

- Project appropriation transfers,
- Project appropriation loans,
- Splitting of appropriations into separate projects, and
- Establishment of unauthorized appropriations that have not been approved by the Mayor and the Board of Supervisors.

The transfer of project appropriations can consist of (1) surplus or residual balances after a project has been completed, (2) excess appropriations as a result of projects being cancelled, suspended, or reduced in scope, and (3) consolidation of project appropriations to provide more administrative flexibility. The Port has conducted all of these types of transfers in the management of its capital project appropriations.

As previously noted, the Port also has used existing project appropriations to provide loans to other, unrelated projects prior to those projects obtaining either initial appropriations or supplemental appropriations from the Board of Supervisors and the Port Commission. According to the Finance unit, these types of transfers are no longer used by the Port.

Additionally, the Port splits capital project appropriations into several separate projects in FAMIS for tracking purposes. Appropriations may be divided based on project phases, types of project expenditures, or some other categorization. While splitting appropriations theoretically imparts further controls at lower level, the fact that there are no controls over the transfer of funds between projects, coupled with the increased complexity and the need to track the project's total budget "off-line", budgetary control is, in practice, compromised.

Finally, the Port has established appropriations for capital projects that have not been approved by the Port Commission or the Mayor and the Board of Supervisors by using dedicated revenue sources, such as operating agreement restricted revenues and mitigation fees.

The best way to demonstrate the effects of these practices and the lack of budgetary control is through tracing a few projects since inception. The following are only a few of the many capital projects established over the last five years.

<u>Fisherman's Wharf J-10 (CPO730)</u>

This project was established by the Port in FY 2000-2001 by transferring a total of $319,410 in appropriations from other projects. These projects were:

CPO697 - Replace Pile Driver/Pile Barge	$283,000
CPO619 - Emergency Facility Maintenance	$33,760
CPO647 - Pier 48/50 Maintenance Relocation	$2,650

In FY 2001-2002, the Port Commission and the Board of Supervisors approved $763,500 during the annual budget process for the removal of the wharf and replacement of the rip-rap embankment. With that appropriation, $283,000 was returned to CPO697. However, the advances from CPO619 and CPO647 were not returned. Then in FY 2002-2003, the Port transferred an additional $255,000 to the project from an existing appropriation for Pier Repair (CPO741), resulting in total project funding of $1,054,910, or $291,410 and 38.2 percent greater than project funds approved by the Board of Supervisors and the Port Commission in FY 2001-2002. All of the appropriation transfers which occurred in those three years were not reported to the Board of Supervisors by the Controller in the annual report of transfers exceeding 10 percent of the receiving appropriation. The Port did not identify these transfers to the Controller as transfers meeting the 10 percent criteria.

As of June 30, 2003, more than two years after the project was initially created, only $164,965 of project funds had been expended with a remaining balance of $889,945. According to the Assistant Deputy Director of the Engineering and Maintenance Division, this project has been delayed by litigation, which has resulted in increased costs for security purposes.

<u>Fisherman's Wharf (CPO728)</u>

This capital project is used to account for projects in the Fisherman's Wharf area pursuant to a management agreement with the Fisherman's Wharf Restaurant Association. The agreement stipulates that a portion of the Port's revenues generated by the Triangle Parking Lot at Fisherman's Wharf be spent on Fisherman's Wharf promotional projects or capital improvements. A project account was established to administer and control these funds and, according to the Port's Accounting unit, these appropriations are established as revenues are received. Over the last four fiscal years, $417,809 has been appropriated in this project. However, the Port did not provide documentation of appropriation authority and, thus, it appears appropriation authority has never been granted to the Port by the Board of Supervisors for expenditure of these funds. As of June 30, 2003, $214,315 of these funds had been expended since FY 1999-2000.

<u>Pier 48 Fire Insurance Proceeds (CPO605)</u>

Pier 48 Fire insurance proceeds reimbursed the Port for various insurance-funded interior and exterior repair work. According to the Accounting unit, the cost of these repairs totaled $5,405,005 and, while the Port Commission approved all contracts for the repair work, the Port did not seek approval from the Board of Supervisors for appropriation of these funds because appropriation authority is automatically granted for insurance proceeds, pursuant to administrative provisions in the Annual Appropriations Ordinance. However, there were approximately $284,000 in fire-related costs, including the $100,000 deductible, which were not reimbursed by the insurance proceeds. These expenses were directly funded by the Port with transfers from other capital project appropriations which were not authorized by the Board of Supervisors. Finally, the Port received $603,338 in settlement funds to cover any other Port or City costs and appropriations were increased in CPO605 by the $603,338 without Board of Supervisors approval.

Portable Fendering System (GPO530)

The FY 1999-2000 Annual Appropriations Ordinance funded a portable fendering system GPO630 for $197,000 in the Port's annual projects sub-fund. However, the Controller reports that the appropriation was actually split into two components in FAMIS with $39,151 posting to GPO530 in the annual projects sub-fund, which results in unused appropriations reverting to fund balance at year end, and the residual $157,849 posting to GPO530 in the continuing projects sub-fund. According to the Port's Finance unit, this split in appropriations was due to reclassification of projects to more appropriately reflect the Port's and the Controller's coding structures.

In the next fiscal year, the $157,849 was reclassified as CPO530, but $90,000 was transferred to establish a new project, the Pier 38 Sub-Structure Repair project (CPO732), which was not authorized by the Port Commission or the Board of Supervisors. According to the Finance unit, this was a transfer of surplus funds, indicating that the portable fendering system cost approximately $107,000, or 54.3 percent of the original cost estimate and appropriation.

Ferry Terminal Improvements (CPO670)

The FY 2001-2002 Annual Appropriations Ordinance approved $1.2 million in appropriations for Ferry Terminal Improvements. However, the Controller reports that for the fiscal year, only $51,754 in appropriations were posted to the project in FAMIS. According to the Port's Finance unit, significant appropriation transfer activity occurred during the year, as presented in Table 3.6:

Table 3.6

Ferry Terminal Improvements (CPO670)
FY 2001-2002 Appropriations and Transfers

Appropriation Per AAO		$1,200,000
Transfers In:		
CPO737 Crane Relocation project	$350,000	
CPO669 Hyde Street Harbor	251,880	
CPO741 Pier Repair project	161,535	
Total Transfers In		763,415
Transfers Out:		
CPO729 Conditions Survey	(50,000)	
CPO710 Piers 24/26/28 Electrical Transformer	(250,000)	
CPO694 Pier 48 Fender & Deck Repair	(324,000)	
CPO682 Pier 52 Boat Ramp project	(841,126)	
CPO737 Crane Relocation project	(285,000)	
CPO741 Pier Repair project	(161,535)	
Total Transfers Out		(1,911,661)
Ending Appropriation		$51,754

Source: Administrative Services Division Finance unit.

As discussed previously, some of these transfers were the return of appropriations which were advanced to the project in a prior year. One of these transfers, however, was returned to a different project in a different sub-fund. The $841,126 returned to the Pier 52 boat ramp project was initially appropriated in CPO915 in a separate sub-fund which is used to account for bond proceeds from the 1994 bond issuance. The return of the $841,126, while to a project identified for the same purpose, was to a new project number in the Port's main capital fund. To further complicate the accounting, this was the same project number which the Annual Appropriations Ordinance designated and appropriated an electric pole relocation project in the amount of $265,000. According to the Port's

Finance unit, the electric pole relocation was one component of the Pier 52 boat ramp project.

The only transfers to or from CPO670 reported by the Controller for FY 2001-2002 were the $251,880 from CPO669 Hyde Street Harbor and the net $65,000 from CPO737 Crane Relocation project. These transfers were permanent transfers to the project. The other permanent transfer of $50,000 to the CPO729 Conditions Survey project was not reported by the Controller, although it met the 10 percent criteria.

SWL/Ground Remediation Project (CPO232)

In FY 2002-2003, $1,492,262 in appropriations was established in FAMIS in order to fund the remediation of contaminated soil at Pier 92. According to the Port's Finance unit, the appropriation was established by de-funding or surplus transfers from eight different projects. While the de-fundings and project closeouts were approved by the Port Commission on February 11, 2003, the appropriation for soil remediation at Pier 92, which was the result of a Notice of Violation received from the California Department of Toxic Substance Control, was never submitted to or approved by the Board of Supervisors.

As these examples demonstrate, the Port is not effectively limiting its capital project expenditures to the amounts approved by the Port Commission and appropriated by the Board of Supervisors. Consistent and documented policies and procedures that support appropriation and budgetary control, project transfers, and project tracking do not exist. Accordingly, funds can be utilized for unauthorized purposes and projects. Further, the capital budget is not being used as a management tool and the current process reduces incentives to budget appropriately and to meet budgeted targets. Additionally, the complexity of the current structure makes tracking and monitoring of capital projects extremely difficult and unnecessarily time consuming.

The Port must maintain appropriation and budgetary control in the City's financial accounting system, FAMIS, at the level approved and appropriated during the annual budget process or through any other supplemental Board action. Further, the Port must establish, document, and communicate policies and procedures for the capital project budget process, including the use of generalized appropriation categories. Such policies and procedures should include the following:

- Appropriate and prohibited fund transfers,
- A maximum appropriation transfer amount using an administrative authorization process,
- Project closeouts and disposition of surplus funds including a statement that all surplus funds are subject to appropriation by the Board,
- Project de-fundings resulting from changes in project scope or budget priorities, and

- Administrative process for assignment of generalized appropriations, including appropriate and prohibited uses, and for tracking and monitoring such funds.

Establishing these policies and procedures and clarifying and simplifying the capital project coding structures will increase budgetary control over capital project expenditures and will increase accountability for establishing realistic capital project cost estimates and meeting budgetary goals.

Capital Project Reconciliation

Accounting staff are responsible for reconciliation of capital project activity between FAMIS, the Oracle financial system, and now the Avantis facility maintenance management system. All three systems have different and complex coding structures, making project reconciliation cumbersome at best. Given resource demands on the Port's Capital Project's work group, this is an activity that occurs only when necessary and, according to the group's supervisor, few projects have been reconciled to date.

<u>Large Negative Appropriation Balances</u>

A review of project appropriation and expenditure activity for the last five years identified several unreconciled amounts in non-specific projects, such as "M/P Port of San Francisco" and "Unallocated Project," which have large negative appropriation balances. In all, they totaled approximately $(6,669,342) as of June 30, 2003. According to the Accounting unit, these balances have resulted from a number of different issues, including the Controller's conversion to on-line FAMIS in FY 1995-1996 and unreconciled project details from the Loma Prieta earthquake, which was completed in 2000. Unreconciled activity, in general, reduces the Port's ability to use and rely upon its own financial data and information. The large negative balances result in reduced appropriation authority overall for any given fund. The capital projects which are impacted and how they are impacted is unknown.

<u>20, 33, and 46 Year-Old Bond Funds</u>

A few, very old bond funds remain unspent. As of June 30, 2003, the remaining bond fund appropriation balances are as follows:

- 1958 Harbor Bond Funds - $54,726
- 1971 General Obligation Bond Funds - $80,075
- 1984 Revenue Bonds - $101,140
- 1991 Revenue Bonds - $56,356

As previously noted, some bond appropriations have been transferred to the Port's Capital Projects fund and, accordingly, those remaining appropriation balances are no longer captured, tracked and monitored as bond funds. Thus, the amounts presented here are understated. Clearly, however, bond funds that are 20, 33, and 46 years old should have been fully expended on the capital projects for which they were originally earmarked.

Inactive Projects Established Prior to FY 1997-1998 That Should Be Closed

Despite the closeout and de-funding of a substantial number of projects in FY 2002-2003, a cursory review of project appropriation balances as of June 30, 2003 identified additional projects that should be closed according to the Director of the Engineering and Maintenance Division. They are as follows:

Table 3.7

Inactive Project Appropriations

Project	Year of Appropriation	Year of Last Expense Activity	Balance as of 6/30/03
Maintenance Relocation (CPO642)	Prior to FY 1997-1998	FY 2000-2001	$13,560
Jefferson Street Seawall (CPO803)	Prior to FY 1997-1998	Prior to FY 1997-1998	14,733
Fisherman's Wharf Breakwater (CPO806)	Prior to FY 1997-1998	Prior to FY 1997-1998	51,112
Rehab Pier 47A- Fisherman's Wharf (CPO112)	Prior to FY 1997-1998	Prior to FY 1997-1998	527,889
Ferry Terminal Improvements Pier ½ (CPO002)	Prior to FY 1997-1998	Prior to FY 1997-1998	86,286
Total			$693,580

Source: City Controller's Office.

Although these projects should be closed, they do not necessarily represent available funding for new capital projects. Two of the projects are from external funding sources, including the $527,889 which was a Federal grant that was not utilized. According to the Director of the Engineering and Maintenance Division, CPO112 was cancelled because the Fisherman's Wharf Waterfront Advisory Group representing the local community decided that the project would not benefit the area. Prior to the project being cancelled, $56,139 in project funds were expended for design and drafting charges that were not ultimately not recovered from the grant. Additionally, several of the projects detailed in Table 3.7 represent old bond funding discussed in the previous section. However, these projects show that projects are not systematically reviewed and closed out. A thorough reconciliation would likely identify other projects that should be closed as well as funding for new capital appropriations.

Capturing Capital Expenditures

One of the primary purposes of having a financial tracking and monitoring process in place is to ensure that capital projects are appropriate charged and all project costs are captured. During the audit, three issues were identified where capital projects are either inappropriately being charged or are not being appropriately charged.

Capital Labor Adjustments

The Port has designated several positions as "capital-funded", earmarking the positions as limited-term for the life of the project to which they were assigned in the authorized personnel requisitions. According to the Administrative Services Division, this practice began in FY 1999-2000 and, at the time, bypassed the annual budget process and the Annual Salary Ordinance (ASO). The policies guiding the use of capital-funded labor are unclear. According to the Port's Administrative Services Division, the personnel requisitions authorize these positions to be paid for from capital funds and, therefore, there is no authority to pay for them using the operating budget.

According to the Port's Fiscal Officer, these positions historically recorded all of their time to the capital projects to which they were assigned. However, the capital-funded employees were not necessarily working on the dedicated projects, having been assigned to either other capital projects or routine engineering and maintenance work paid for from the operating budget. There was some confusion with respect to the proper treatment of time worked by these employees, especially when Avantis was implemented and a new coding structure was developed. At that time, Engineering and Maintenance staff was informed by the Fiscal Officer that for proper cost accounting employees must record time to the actual work task performed, regardless of funding source. Because there is no authority to use other funds to pay for these labor costs, the Port's Accounting unit adjusts these charges, posting them to the authorizing capital project and reversing the charges against the capital project or operating budget for which the actual work was performed. From FY 2000-2001, when these adjustments started, through December 5, 2003, adjustments have totaled $1,362,565. However, $104,000 was reversed in FY 2002-2003 when the Port determined that the percentage of completion for one project was less than what was being reported for financial reporting purposes based on cost data.

If City policy is in fact that capital-funded labor cannot be paid for with operating funds, then the Port is not in budgetary compliance, regardless of where ultimately these costs are posted. The fact remains that these costs have been incurred against either another capital project or the operating budget. The second, and more egregious, issue is that the Port is not posting these expenditures to where the costs were incurred, thereby understating some costs and overstating the costs of the capital projects for which these positions were actually assigned. The Fiscal Officer appropriately identified this as an issue and requested that actual time worked be charged and captured by the financial accounting systems. While it will never be known how much of these costs were not captured because of improper recording of time, operating and other capital project costs have been understated by, and the assigned capital projects have been overstated by, at least $1,258,562 based on the adjustments made by the Accounting unit to date. For more discussion on capital-funded positions, see Section 1.

Capitalized Labor Paid for with Operating Funds

A significant amount of labor charged to the operating fund is capitalized every year because the work performed represents either an improvement to or creation of a fixed asset. According to Port policy, "An improvement is a replacement of a component part of a fixed asset by an improved or superior part, an addition of new parts, or an alteration or structural change to a fixed asset which results in a functional improvement over its original state which materially adds to the value of the assets or appreciably extends its life." As shown in the table below, for the last three fiscal years, $5,921,570 in Port labor costs have been capitalized, which is approximately 9.8 percent of the Port's operating-funded labor expenditures.

Table 3.8

Capitalized Labor
FY 2000-2001 through FY 2002-2003

	Total Operating Funded Labor	Capitalized Labor	As a Percent
FY 2002-2003	$21,398,921	$2,492,773	11.6%
FY 2001-2002	20,186,020	1,745,530	8.6%
FY 2000-2001	18,825,106	1,683,267	8.9%
Totals	$60,410,047	$5,921,570	9.8%

Source: Administrative Services Division Accounting unit.

According to the Port's Fiscal Officer, the capital budget for a particular project may not capture all of the costs of that capital project and some costs may be paid for with operating or other project funds. At year end, the Accounting unit identifies these costs so that they may be accurately reflected in the financial statements.

The co-mingling of operating and capital budgets distorts the tracking and reporting of capital activities, resulting in difficulties in the planning, management, and control of capital projects. Project scopes can increase or decrease without being detected and there is little accountability.

The Port's capital and operating budgets should mirror the economic substance of Port activity. The operating budget should be used for routine maintenance and repair and the capital budget should be used for all capital expenditures such that these activities are creating tangible capital assets.

Indirect Costs

The Port does not track and allocate indirect costs to capital projects. Indirect costs include administrative costs of the Engineering and Maintenance Division as well as administration and support costs provided by other divisions, such as the Administrative Services Division which includes the Information Systems, Accounting, and Finance units. The Accounting unit alone has three staff people dedicated to the tracking and monitoring of capital projects. In total, these costs are likely to be substantial and, by not allocating these costs to capital projects, the Port understates the actual costs of the capital projects, the capital program in general, and also does not maximize reimbursement from any outside funding sources. The Port should put in place a process by which these costs are accumulated and distributed annually to capital projects. According to the Fiscal Officer, the Port has developed a model to allocate indirect costs as part of the facility cost accounting system discussed in more detail in Section 13 of this report.

Conclusions

The Port does not have a systematic approach for addressing its capital needs. A review of the capital project financial activity and balances over the last five years, along with the methods for tracking and monitoring capital projects, demonstrates that the Port does not have a clear vision of how to define and manage its capital program. The lack of a capital improvement program as well as deficiencies in the tracking and monitoring of capital project appropriations and actual expenditures have resulted in inconsistent and flawed decision making and a lack of accountability. Capital priorities are short-lived; cost estimates and project scheduling are not reasonably precise; appropriation and budgetary control over projects are not maintained; and the true cost of any given capital project is not captured by the accounting systems and processes in place. Ultimately, the situation has impaired the financial stability of the Port because the precise extent of the Port's capital needs are unknown and there is no mechanism in place to effectively and efficiently meet those needs.

Recommendations

The Board of Supervisors should:

3.1 Amend the Administrative Code to affirm the legal level of budgetary control for capital project appropriations at the project level and establish a threshold for which increases or decreases to capital appropriations require supplemental review and approval by the Board of Supervisors.

3.2 Amend the Administrative Code to establish a City policy that any capital project appropriation that is fully de-funded or partially de-funded by a specified threshold such as 10 percent, subsequent to the project having been authorized by the Board of Supervisors, be reported to the Board of Supervisors.

The Executive Director of the Port should:

3.3 Assign the Finance Manager in the Administrative Services Division the responsibility for the development of a capital improvement program.

3.4 Require the Division Directors to meet monthly as a group with the Finance Manager to facilitate the development of the capital improvement program and to resolve any problems that arise.

3.5 Dedicate sufficient staffing resources to complete the development of a realistic capital improvement program by December 31, 2004 such that it can be used to develop the FY 2005-2006 capital budget.

3.6 Suspend the Illinois Street Bridge project and bring legislation before the Board of Supervisors with detailed cost estimates and secured funding sources for the Board of Supervisors review and determination of the future of the project.

The Administrative Services Division should:

3.7 In conjunction with the development of a capital improvement program, clearly delineate operating activities from capital activities in the budget and in the accounting for such activities, which includes the work order process.

3.8 Maintain budgetary control in the financial accounting system, FAMIS, at the level approved and appropriated during the annual budget process and any other supplemental Board action for all new capital project appropriations and any existing projects exceeding $200,000 in outstanding appropriations and unfunded costs combined.

3.9 Cease making capital labor adjustments, which effectively charge expenditures to capital projects that were not incurred.

3.10 Develop the mechanism and accounting procedures to capture capital project indirect costs and allocate such costs to the various capital projects.

3.11 Reconcile all capital projects accounting records, commencing with projects with negative balances, and closeout obsolete and inactive projects.

3.12 Determine the allowable disposition of remaining bond funds and expedite their use.

3.13 Establish, document, and communicate policies and procedures for the capital project budget process, including:

(a) Budget modifications,

(b) Project transfers, including a maximum limit for transfer amounts using an administrative process,

(c) Project closeouts and disposition of surplus funds including a statement that all surplus funds are subject to appropriation approval by the Board of Supervisors, and

(d) Project de-fundings.

3.14 Establish, document, and communicate policies and procedures for the use of generalized appropriation categories, including:

(a) Administrative process for assigning funds to projects,

(b) Criteria for the use of funds, as well as prohibited uses, for each generalized appropriation category, and

(c) Process for tracking and monitoring of such funds.

The Engineering and Maintenance Division should:

3.15 Work with the Administrative Services Division to establish controls and ensure that the time worked by its staff is appropriately and accurately captured in the facility maintenance management and financial accounting systems.

Costs and Benefits

The costs of establishing a capital improvement program, including a comprehensive capital needs assessment, will require the allocation of Port staff and management resources. The benefits, however, are substantial in that scarce resources will be efficiently and effectively deployed in meeting the Port's most pressing and costly capital needs. Reconciliation of all projects and closeout of completed or inactive projects may require additional staff resources, but should be more than offset by the reduction in capital project appropriations. Establishment and maintenance of budgetary control at the level authorized by the Board of Supervisors, clearly delineating operating and capital activities, and establishment of guiding policies and procedures, will require minimal staff resources, but will ensure that appropriations are used for authorized purposes and that accountability is maintained. Further, the Port's future capital projects would be established and funded only with the full policy and appropriation approval of the Board of Supervisors.