CITY OF LONG BEACH

R-28

DEPARTMENT OF FINANCIAL MANAGEMENT

333 West Ocean Boulevard 6th Floor • Long Beach, CA 90802

June 22, 2010

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

Adopt the attached Resolution requesting that the Board of Harbor Commissioners:

Approve the transfer in full of $12,423,706, based on 10 percent of the Fiscal Year 2009 change in net assets, from the Harbor Revenue Fund (HR) to the Tidelands Operating Fund (TF) effective immediately;

Approve the subsequent annual transfer on October 1, 2010 based on 80 percent of the Harbor Revenue Fund's unaudited change in net assets as of September 30, 2010, for $9,938,965, with the remaining 20 percent of $2,484,741 to be transferred after March 31, 2011 upon issuance of the Harbor Department's Fiscal Year 2010 audited financial statements, with a corresponding true-up adjustment, as necessary, to reflect the final audited amount; and

Consider the elimination of the previous year's transfer from the base upon which the annual transfer is calculated, effective with the Harbor Department's Fiscal Year 2010 audited financial statements, for an additional $1.2 million. (Citywide)

DISCUSSION

City Charter Section 1209(c)(4) provides for the transfer of 10 percent of the Harbor Department's change in net assets as shown by the most recent available independently audited financial statements, to the Tidelands Operating Fund.

Traditionally, the City has based its request for the annual Harbor transfer on the change in net assets from two fiscal years prior (e.g., the FY 10 transfer to the Tidelands Operating Fund was based on the FY 08 audited financial statements of the Harbor Department). As such, the transfer based upon the Harbor Department's FY 09 audited financial statements would typically occur in FY 11. Consistent with the City Auditor's report dated June 15, 2010, staff is recommending the City Council request the Board of Harbor Commissioners make the transfer in full of $12,423,706 to the Tidelands Operating Fund, based upon the FY 09 change in net assets of $124,237,060, effective immediately as the FY 09 audit is complete. The Harbor

Department would retain a significant net income of $111,813,354 after the 10 percent contribution to the Tidelands Operating Fund.

In addition, pursuant to the recommendation made by the City Auditor's report dated June 15, 2010 (attached), an accelerated payment of the annual transfer is being requested for FY 11 due on October 1, 2010, based on 80 percent of the Harbor's unaudited change in net assets as of September 30, 2010, with the remaining 20 percent to be transferred to the Tidelands Operating Fund upon issuance of the Harbor Department's FY 10 audited financial statements expected to be issued by March 31, 2011. It is important to note that upon issuance of the FY 10 audited financial statements, the final total amount of the transfer must be based on 10 percent of the final audited change in net assets. Hence, the second 20 percent payment will likely require a simultaneous true-up adjustment based on the audited financial statements.

Finally, the City is also requesting that the Board of Harbor Commissioners consider the elimination of the previous year's transfer from the base upon which the annual transfer is calculated, effective with the Harbor Department's FY 2010 audited financial statements. If approved, this would result in a $1.2 million increase in the transfer to the Tidelands Operating Fund in FY 11.

Staff has determined that without the annual transfer, the Tidelands Operating Fund's existing structural deficit would worsen, likely necessitating the closure of beaches and elimination of safety services in the Tidelands areas in the near future.

Authority to transfer the funds must be expressed by Resolution (attached). The transfer(s) cannot occur until the Resolution is approved by a two-thirds majority of the entire City Council and a separate Resolution is approved by a majority of all members of the Board of Harbor Commissioners. Since the adoption of the FY 11 budget is dependent upon this transfer(s), the City Council and Board of Harbor Commissioners must adopt these Resolutions prior to the City Council's adoption of the FY 11 Proposed Budget, which includes the budget of the Harbor Department.

This matter was reviewed by Assistant City Attorney Heather A. Mahood on June 11, 2010 and Budget and Performance Management Bureau Manager David Wodynski on June 7, 2010.

TIMING CONSIDERATIONS

City Council approval is requested on June 22, 2010, prior to adoption of the FY 11 budget.

FISCAL IMPACT

The transfer of $12,423,706 is based on the Harbor Department's FY 09 audited financial statements, and will be used to support critical maintenance, safety and support services in the Tidelands Trust area. The accelerated transfer based upon the unaudited change in net assets as of September 30, 2010, is one-time in nature, and will be used for one-time needs only in the Tidelands Trust area. All future annual transfers from the Harbor Revenue Fund (HR) to the Tidelands Operating Fund (TF) will be based on the prior year's change in net assets, with 80 percent due on October 1 of each fiscal year, based on the unaudited change in net assets, with the remaining 20 percent based on the final reconciled change in net assets as indicated in the audited financial statements issued after March 31st of each year.

SUGGESTED ACTION:

Approve recommendation.

Respectfully submitted,

Lori Ann Farrell

LORI ANN FARRELL
DIRECTOR OF FINANCIAL MANAGEMENT/CFO

LAF:DW:
K:\BUDGET\FY 11\06-22-10 CCL - PORT TRANSFER FY11 V2.DOC

ATTACHMENTS: - JUNE 15, 2010 CITY AUDITOR'S REPORT
- RESOLUTION

APPROVED:

PATRICK H. WEST
CITY MANAGER

OFFICE OF THE CITY AUDITOR
Long Beach, California

R-28

LAURA L. DOUD, CPA
City Auditor

June 15, 2010

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

1. Receive and file the attached Harbor Department Transfer Analysis Report.
2. Request the Board of Harbor Commissioners to approve the annual transfer for the total amount of $12,423,706 based on the Fiscal Year 2009 Audited Financial Statements.
3. Request the Board of Harbor Commissioners to approve the annual transfer on October 1, 2010 based on 80% of the Harbor's unaudited change in net assets as of September 30, 2010, with the remaining 20% to be transferred upon issuance of the Harbor's Fiscal Year 2010 audited financial statements.
4. Consider the elimination of the previous year's transfer from the base upon which the current year's transfer is calculated.

DISCUSSION:

In response to a Special City Council Session regarding concerns over the future stability of the City's Tidelands Operating Fund (TOF), our Office conducted an analysis of the Harbor Department's annual transfer to the TOF.

We did not perform an audit of the Harbor Department's financial statements. The City's external auditor performs the financial audit annually. The purpose of our analysis was to provide clarity regarding the revenues and expenses used to determine change in net assets on which the annual transfer is based, and to identify alternative solutions to meet the lawful obligations of the Tidelands Operating Fund without an amendment to the City Charter.

Based upon the results of our analysis, we noted the following:

1) The Harbor currently deducts the previous year's transfer amount to arrive at the base for calculating the current year's transfer.
2) Because the transfer is based on the audited financial statements, there is a one-year lag between the end of a fiscal year and the time the related transfer is made.
3) Rather than receive the full transfer at the beginning of the fiscal year, the City has requested the payments be made quarterly, resulting in a loss of interest earnings to the TOF.

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4) Because of the disparity in size of operations between the Harbor and the TOF, an amount that is significant for purposes of auditing the Harbor is normally very different than an amount that is significant to the annual transfer to the TOF.
5) The City's enterprise funds, including the Harbor, have not been properly capitalizing interest costs related to construction in progress, thereby impacting the annual transfer.

Detailed information regarding the results discussed above is included in the attached report.

We express our appreciation to the Harbor Department for providing its time, information, and cooperation during this process.

TIMING CONSIDERATIONS:

City Council approval is requested on June 15, 2010 in order to receive the annual transfer in a timely manner and to maximize interest earnings for the Tidelands Operating Fund.

FISCAL IMPACT:

The requested transfer based on the Fiscal Year 2009 Audited Financial Statements will have a fiscal impact to the Tidelands Operating Fund of $12,423,706.

The requested transfer due on October 1, 2010 will have a fiscal impact based on 80% of the Harbor's unaudited change in net assets as of September 30, 2010. For example, if the change in net assets for Fiscal Year 2010 is similar to that reported in Fiscal Year 2009, then the fiscal impact would be approximately $9,938,965 on October 1, 2010 with the remaining 20% or $2,484,741 when the Harbor's FY 2010 audited financial statements are issued (which is normally in March).

In reviewing the annual transfers over the past six years, the estimated fiscal impact of eliminating the previous year's transfer from the base would be an increase in revenues to the TOF of approximately $1,000,000 each year.

SUGGESTED ACTION:

Approve recommendation.

Respectfully submitted,

Laura L. Doud

LAURA L. DOUD, CPA
CITY AUDITOR

Attachment

Office of the City Auditor

Harbor Department Transfer Analysis

June 7, 2010

Staff

City Auditor: Laura L. Doud
Deputy City Auditor: Danica D. Rogers
Audit Manager: Terra Van Andel
Senior Auditor: Jessica Machado

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Executive Summary

In response to City Council's recent discussions regarding the annual transfer from the Harbor Department of the City of Long Beach (Harbor) to the City's Tidelands Operating Fund (TOF), we have conducted an informational analysis of the annual transfers. Our analysis was performed in three stages: 1) reviewed the components of fiscal year (FY) 2008's increase in net assets; 2) performed a trend analysis from FY 2003 to FY 2008; and 3) highlighted certain areas we believe may have a significant impact on the amount of future transfers. Additionally, for certain topics, we reviewed the Harbor's FY 2009 audited financial statements, which were issued March 25, 2010.

We did not perform an audit of the Harbor Department's financial statements. The City's external auditor performs the financial audit annually. This analysis is an informational report that clarifies the calculation used to determine the annual transfer to the TOF. The details of this report were obtained through review of the external auditors' workpapers, discussion with Harbor management, and review of the Harbor's annual financial statements and related accounting records.

The results of our procedures are detailed in the body of this report. However, we have highlighted certain significant observations and provided recommendations for consideration below.

Observations

1) In recent years, the Harbor has transferred 10% of its increase in net assets to the TOF, as allowed by the City Charter. However, that 10% transfer is not mandatory. The Board of Harbor Commissioners may not approve the transfer, if they find the funds to be transferred will be needed for Harbor operations.

2) Over the next ten years, the Harbor intends to finance its capital projects by reducing its unrestricted cash ($664.8 million in FY 2009) and issuing roughly $1 billion in new debt. However, at the same time, the Harbor will pay down over $500 million of its existing debt through scheduled principal payments. In addition, the Harbor redeemed $134 million of revenue bonds in late FY 2008 and $29 million in commercial paper in early FY 2009 because of the financial markets' turmoil at that time. Therefore, the additional debt the Harbor will be incurring for its $3 billion construction program, over the debt level that existed in FY 2008, will be approximately $337 million. Conceptually, construction activities or other economic factors may impact the Harbor's ability to make the maximum allowable annual transfer in the future, because the Harbor may need those monies for its operations. However, Harbor management represents that their long-term cash flow models assume a 10% transfer rate in each of the next ten years and still meet the goal of maintaining a minimum of 2.0 times Debt Service Coverage Ratio, which is critical to the Harbor's credit rating.

3) The language in the City Charter states that the annual transfer may "not exceed ten percent (10%) of the net income of the Harbor Department." As a department of the City, the Harbor is a governmental entity and uses governmental accounting methodologies. As of 2002, resulting from an industry-

wide accounting change, the term "net income" is no longer used in government financial reporting, and the City began substituting "change in net assets" as the base for calculating the annual transfer. The Harbor currently deducts the previous year's transfer amount to arrive at the base for calculating the current year's transfer.

4) The City Charter states that the annual transfer will be made at the beginning of a fiscal year and that the transfer amount "may not exceed ten percent (10%) of the net income of the Harbor Department as shown on the most recent available independently audited financial statements." Because the transfer is based on the audited financial statements, there is a one-year lag between the end of a fiscal year and the time the related transfer is made.

5) Rather than receive the full transfer at the beginning of the fiscal year, the City has requested the payments be made quarterly from October to July. By requesting the transfers occur over a nine-month period rather than in one lump sum payment at the beginning of the fiscal year, the TOF has lost as much as $0.3 million of interest earnings in a single year.

6) The FY 2010 transfer to the TOF (resulting from FY 2008's increase in net assets) was $16.1 million. Assuming a 10% transfer rate, the FY 2011 transfer (based on FY 2009's audited financial statements) will be $12.4 million, a reduction of $3.7 million (23%) from FY 2010's transfer. This reduction in the transfer is consistent with the Harbor's $36.1 million (22%) decline in operating income, which the Harbor primarily attributes to a worldwide decline of shipping trade.

7) Because of the disparity in size of operations between the Harbor and the TOF, an amount that is significant for purposes of auditing the Harbor is normally very different than an amount that is significant to the annual transfer to the TOF. This observation does not question the reliability or credibility of the Harbor's audited financial statements, but simply points out the materiality factor.

8) Accounting principles require that a portion of interest costs be capitalized when there is construction in progress. The Harbor's previous policy was to capitalize interest while the projects for which the funds were borrowed were still in progress. The Harbor did not capitalize interest from FY 2003 to FY 2008, as there were no projects in progress for which funds were specifically borrowed. As a result of the recommendation by the external auditor, in FY 2009, the Harbor revised its capital assets policy and capitalized $2.1 million of interest costs based on its interpretation of the relevant accounting principles. After the audit report was issued, it was discovered that an additional $3.1 million of interest should have been capitalized. As a result, the transfer to the TOF related to FY 2009 was approximately $0.3 million less than it would have been if the interest had been properly capitalized. It should be noted that the TOF will receive the exact $0.3 million in future years, as less depreciation expense will be recognized by the Harbor in future years.

9) Additionally, during the course of our procedures, it came to our attention that the City's other enterprise funds are not capitalizing interest costs related to

construction in progress. Again, accounting principles require that interest costs pertaining to eligible construction in progress be capitalized, and ultimately depreciated over the life of the asset.

10) The Harbor has taken advantage of the American Recovery and Reinvestment Act and restructured its debt in FY 2010. It issued $201 million of Series 2010A Harbor Revenue Bonds. At the same time, it redeemed an equivalent amount of Series 2000A, thus realizing a net present value savings of $20.4 million, net of all expenses and cost of issuance. It also issued $158 million in Series 2010B Harbor Revenue Refunding Bonds to replace an equivalent amount of bonds tendered, and realized an additional $4 million in net present value savings after all expenses and cost of issuance.

11) The Harbor has many significant construction projects planned over the next several years, funded through its own cash and new issuance of debt. The elimination of its excess unrestricted cash will likely result in a significant decrease in the Harbor's interest income (FY 2009's interest earnings were $18.6 million). Additionally, an increase in capital projects and new debt issuance will result in an increase in depreciation and interest expense. However, the Harbor's intent is for the revenue associated with capital projects to exceed the cost of those projects, resulting in an overall positive impact on net assets in the years to come.

12) The Harbor has been awarded several grants to improve its rail system that will require matching contributions. At September 30, 2009, the Harbor had restricted net assets totaling $89.7 million pertaining to these required matching contributions. Restricting those funds had no effect on the change in net assets. When the rail improvements are made, the Harbor will recognize grant revenue in the year they are constructed and will capitalize the cost of the improvements, including any of its matching contributions. The value of the capitalized assets will then be expensed over time through depreciation.

13) The Gerald Desmond Bridge carries 15% of the nation's imports. A safe, uncongested bridge is critical to the Harbor's continued success. The Harbor intends to replace the Gerald Desmond Bridge. Construction on the new bridge, estimated to cost up to $1.1 billion, is anticipated to begin in 2010 and scheduled to conclude in 2016. The Harbor has already obtained significant commitments for certain grant funding and hopes to obtain additional grant funding for the construction cost. However, up to 10% of matching contributions may be required of the Harbor. As of FY 2008, the Harbor had set aside $52 million to be used on this project. Setting those funds aside had no effect on the change in net assets. The grant and various other agreements upon which the accounting transactions depend have not yet been finalized. However, past practice has been to depreciate the Harbor's net contributions to a project over a ten-year period (a contribution of $52 million would result in $5.2 million of expense per year). The bridge could then be transferred to the State of California with no further impact on net assets.

14) The Harbor has had 2 large environmental remediation projects in recent years: 1) remediation of property purchased in 1994 from Union Pacific Resources Company (subsequently acquired by Anadarko Petroleum Company); and 2) cleanup of the in-water sediments of the West Basin (IR Site 7) pertaining to former U.S. Navy property. The Harbor represents that remediation related to the Anadarko property has been for the most part completed, and that approximately $80 million has been recovered from the seller. The Harbor's net expenses related to this project were over $80 million between FY 2007 and FY 2009. Remediation of IR Site 7 is in process. The Harbor expensed approximately $20 million in FY 2008 and $0.5 million in FY 2009 pertaining to this project. The Harbor does not anticipate any significant additional remediation expense associated with its currently owned properties.

15) In FY 2007, the Harbor began incurring expenses associated with its Clean Air Action Plan (CAAP). It expensed $3 million in FY 2007, expensed $13.9 million (net) in FY 2008, and earned $13.3 of net revenue in FY 2009. Original estimates of CAAP expenditures, mostly related to the Clean Trucks Program were significant. However, the Harbor represents that future anticipated expenses related to this program have decreased dramatically, as the trucking industry has been replacing its own trucks, rather than using the Harbor subsidies to do so.

16) Operating revenues increased $109.8 million (44%) from FY 2003 to FY 2008. For the same period, operating expenses (excluding depreciation expense) increased $71.7 million (161%). Much of this disproportionate increase in operating expenses resulted from the following nonrecurring or unavoidable costs:

    a. Environmental remediation expenses in the amount of $19.6 million for IR Site 7 in FY 2008;

    b. Repairs and maintenance on the Gerald Desmond Bridge in the amount of $8.5 million. This is a one-time expense, not a recurring expense;

    c. Fire and safety costs, which are primarily charged to the Harbor by the City, have increased $5.7 million.

Recommendations for Consideration

This analysis has resulted in several issues that we believe merit further discussion and consideration.

1) Consider whether or not the transfer should be deducted from the base upon which the maximum transfer amount is calculated.

2) The City Council should consider requesting that the annual transfer be made at the beginning of the fiscal year as stated in the City Charter, rather than quarterly over a nine-month period. This would improve the TOF's cash flow and afford it additional interest earnings. It should be noted that this recommendation has

already been partially implemented, with the request from City Council to expedite the fourth and final payment for FY 2010.

3) Consider restructuring the requests for the annual transfer amount. For example, consider requesting a transfer amount due on October 1, 2010 based on 80% of the Harbor's unaudited change in net assets as of September 30, 2010, with the remaining 20% to be transferred to the TOF upon issuance of the Harbor's FY 2010 audited financial statements (usually issued in March of each year). This restructuring would eliminate the one-year lag between the operating results and the transfer payment to the TOF and would result in two transfers being made in FY 2011.
4) The City should enforce compliance with generally accepted accounting principles by requiring the other enterprise funds to capitalize interest on qualifying construction in progress. The Harbor changed its policy in FY 2009 to adopt a recommendation from the external auditors and represents it will ensure adherence to the policy in future years. Compliance with these accounting principles will result in a portion of interest expense being distributed over time, rather than expensed in one lump sum when incurred.
5) As mentioned above, due to the disparity in size of operations, an immaterial transaction to the Harbor that reduces its net assets may result in a material effect on the TOF. This potential disparity may be mitigated through voluntary actions agreed to by the Harbor, the City, and/or the City Auditor.

We would like to thank personnel in the Harbor Department's Finance Division for the insight, cooperation and resources afforded us during our procedures.

Background

Charter Language

Article XII of the City Charter created the Harbor Department to promote and develop the Port of Long Beach. The Harbor Department's operations are included in the City's reporting entity as an enterprise fund; its activities are conducted in the Tidelands Trust area of the City and are subject to coastal area state laws of the State of California and to the terms of the trust agreement between the City and State of California.

Section 1209 (c) 4 of the City Charter addresses the annual transfer from the Harbor Department to the TOF as follows:

> [Monies credited to the Harbor Revenue Fund may be appropriated and used only for the following purposes:] For the transfer to the Tidelands Operating Fund at the beginning of a fiscal year from revenues in the Harbor Revenue Fund of such sums as shall have been determined by the City Council, by a vote of two-thirds of all its members, expressed by resolution, to be required to meet the lawful obligations of the Tidelands Operating Fund; provided, however, that such sums designated shall not exceed ten percent (10%) of the net income of the Harbor Department as shown on the most recent available independently audited financial statements; and further provided that such transfer of funds shall be subject to the prior approval of a majority of all members of the Board of Harbor Commissioners, expressed by resolution, finding and determining that the funds proposed to be transferred will not be needed for Harbor Department operations, including, without limitation, operating expenses and capital projects, and that such transfer will not result in insufficient funds to pay the principal and interest as they fall due, or otherwise impair the ability to meet covenants, of general obligation or revenue bonds issued for harbor purposes. All such transfers shall be made by journal entry on the books of the City in the manner determined by the City Manager.

As a department of the City, the Harbor is governmental entity and uses governmental accounting methodologies. As of 2002, resulting from an industry-wide accounting change, the term "net income" is no longer used in government accounting, and the City began substituting "increase in net assets" as the base for calculating the annual transfer. As a matter of practice, in response to the City's request, each year the Harbor Department transfers 10% of its increase in net assets from the previous fiscal year to the TOF. That transfer has traditionally been made on a quarterly basis. As such, for the fiscal year ending September 30, 2007, 10% of that increase in net assets was transferred to the TOF in quarterly installments beginning October 1, 2008.

Audited Financial Statement Materiality

The Charter stipulates that the maximum transfer amount be calculated as 10% of the Harbor's net income as "shown on the most recent available independently audited financial statements." The objective of a financial statement audit is to express an opinion as to whether the financial statements present fairly, in all material respects, the financial position of the entity as of the end of its fiscal year, as well as the changes in its financial position (change in net assets) and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles. The firm that audits the City as a whole currently performs these audits, and we are not questioning the credibility of the Harbor's audited financial statements.

The determination of what is material to the financial statement users is a matter of professional judgment. Common quantitative thresholds to help define materiality include:

- Percentage of increase in net assets (i.e., 3 - 5%);
- Percentage of total assets (i.e., 0.5 - 2%); and/or
- Percentage of total revenue (i.e., 0.5 - 2%);

Materiality also has a qualitative aspect, referring to the notion that a misstatement or omission of information can be significant to the users of the financial statements due to the nature, rather than the size, such as the omission of a critical disclosure from the financial statement footnotes.

As an example, using 1% of the Harbor's total assets to calculate materiality, the Harbor's materiality level would be $34 million. Additionally, financial auditors typically establish an amount that they consider to be immaterial. That amount may be calculated as 5% of materiality. In this example, the calculation would result in $1.7 million immateriality threshold. Each quantitative error identified in an amount less than $1.7 million would be deemed immaterial and not be considered for adjustment.

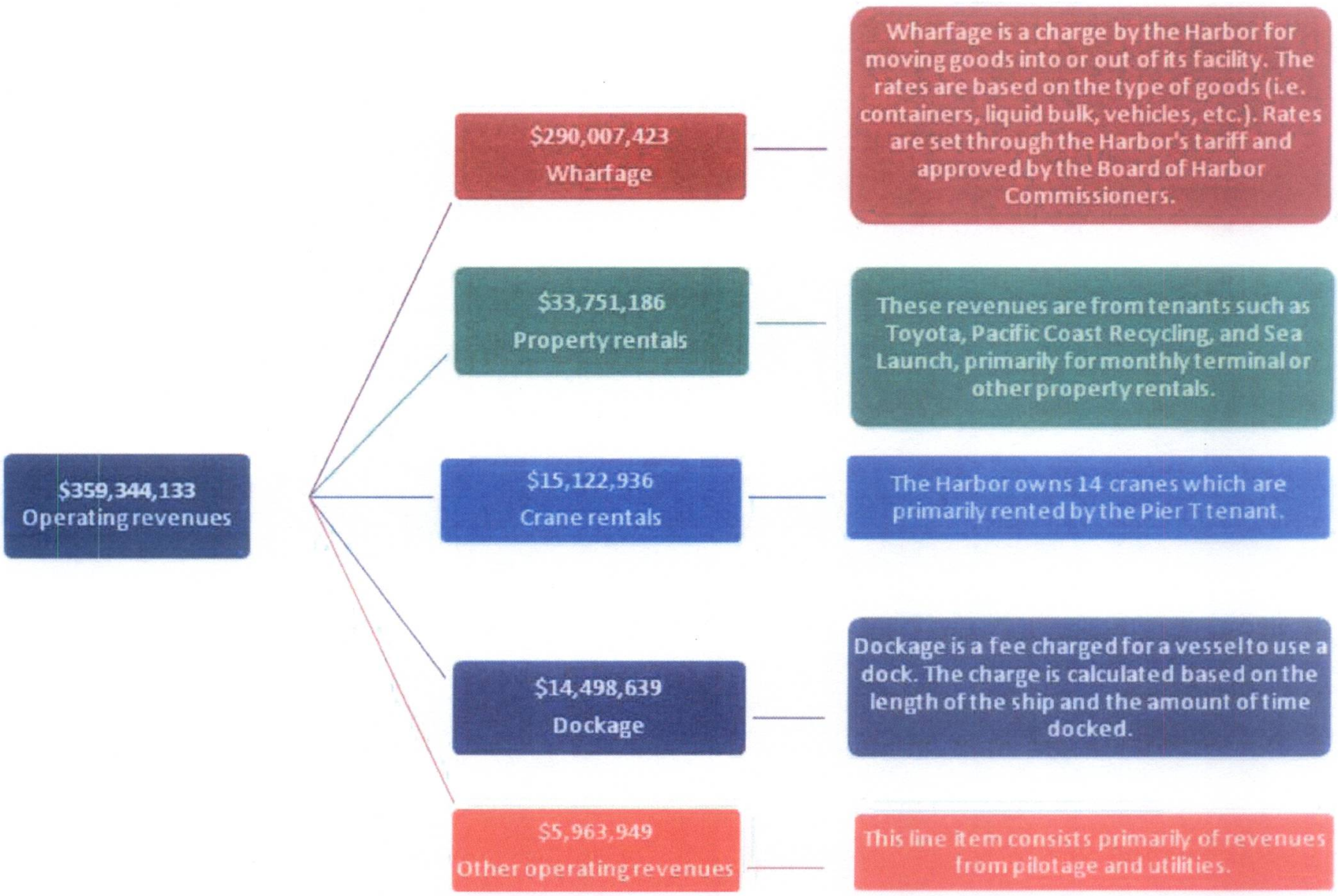
Section I – FY 2008 Components of Increase in Net Assets

Below is a summary of the Harbor's calculation of change in net assets for FY 2008, as well as the calculation for the related transfer to the TOF.

	FY 2008
Total Harbor operating revenues	$ 359,344,133
Operating expenses before depreciation and amortization	(116,165,917)
Depreciation and amortization	(79,496,947)
Nonoperating income	9,475,677
Capital grants	3,742,240
Transfers to the TOF	(16,059,464)
Increase in Net Assets	$ 160,839,722
Ten percent transfer rate	10%
Transfer to TOF due during FY 2010	$ 16,083,972

Total Harbor Operating Revenues

FY 2008 operating revenues were comprised of the following:



Operating Expenses

FY 2008 operating expenses consisted of the following:

Operating Expenses	FY 2008
Facility Maintenance	$ 7,870,391
Infrastructure Maintenance	45,556,412
Fire and Safety	21,353,046
Other Indirect Operating Expenses	6,660,266
General and Administrative	34,725,802
Total operating expenses	**$ 116,165,917**

Facility Maintenance - $7,870,391

These are the costs to repair or update facilities occupied by tenants. The majority of these costs pertain to work performed on the container terminals. In particular, $5.4 million of these costs relate to moving oil and gas pipelines to a deeper location for the Harbor's Pier G future projects, in addition to costs to enhance their electrical supply.

Infrastructure Maintenance - $45,556,412

These are charges the Harbor incurred to repair and maintain its own facilities, as opposed to tenant-occupied facilities. Significant expenditures include the following: 1) $19.6 million of remediation expense pertaining to the IR Site 7 cleanup project; 2) $8.5 million of expenses pertaining to the Gerald Desmond Bridge; and 3) $4.0 million of utilities expense (most of which is re-billed to the Harbor's tenants). Additional charges also include housekeeping, street and storm drain maintenance, air and water quality programs, etc.

Fire and Safety - $21,353,046

These costs partially consist of $3.6 million and $10.9 million billed by the City of Long Beach for police and fire services, respectively. Also included in this expense category is $6.8 million of the Harbor's own security expense.

Other Indirect Operating Expenses- $6,660,266

This category primarily consists of salaries, benefits and supplies for certain engineering, trade development, and property services activities.

General and Administrative - $34,725,802

These expenses are predominantly salaries, benefits, supplies and services for the following Harbor divisions: executives, finance, administration, management information services, engineering, maintenance, and planning.

Depreciation and Amortization

Depreciation is the gradual reduction of the value of a fixed asset and gradual application of this cost to the expenses of a business over the useful life of the asset. The Harbor's depreciable assets and related depreciation expense have not fluctuated significantly in recent years. However, the Harbor's construction projects over the next several years will result in a marked increase in depreciation expense. It is the Harbor's intent that this increase in depreciation expense be more than offset by increases in operating revenues for non-infrastructure projects. *For additional information, see Major Construction Projects and Gerald Desmond Bridge in Section III.*

Nonoperating Income

Nonoperating income (expense) is income (expense) derived from a source other than an entity's regular business activities. The Harbor is in the business of providing port facilities and related services to enable vessels to transport their goods into and out of the United States. As such, revenues and expenses not associated with those business activities are classified as nonoperating. The table below breaks down the categories of nonoperating revenues and expenses, as well as the related FY 2008 amount. Significant line items are discussed in more detail below the table.

Nonoperating Income (Expense)		FY 2008
Investment income, net	$	33,346,928
Interest expense		(46,390,956)
Income from Harbor oil operations		31,153,305
Loss on disposition of capital assets		(254,540)
Income from equity in joint ventures		4,440,935
Clean Air Action Plan, net		(13,866,798)
Other income, net		1,046,803
Net nonoperating income	**$**	**9,475,677**

Investment Income, Net - $33,346,928

The Harbor pools its available cash with that of the City. Investment income consists primarily of interest earned on the City's pooled cash, which is managed by the City Treasurer. In FY 2008, investment income was reduced by a $9.2 million loss on a commercial paper investment held with Lehman Brothers.

Interest Expense - $46,390,956

The Harbor had an average outstanding debt balance of approximately $1.0 billion during FY 2008, primarily in bond indebtedness. The cost of borrowing associated with that debt totaled $46.4 million during the fiscal year.

Income from Harbor Oil Operations - $31,153,305

There are certain oil assets located on Harbor property. Those assets are managed by TOPKO, the same contractor that operates the City's other oil assets. A summary of the revenues and expenses pertaining to Oil Operations is presented below:

Income from Oil Operations		FY 2008
Revenue	$	87,026,769
TOPKO expenses		(39,930,229)
Environmental remediation		(14,546,308)
Depletion and other expenses		(1,396,927)
Income (net) from oil operations	**$**	**31,153,305**

Environmental remediation expenses pertained to the Pier A West project, which is discussed in more detail in Section III.

Income from Equity in Joint Ventures - $4,440,935

The Harbor and the Harbor Department of the City of Los Angeles (the Venturers) entered into a joint venture agreement to form the Intermodal Container Transfer Facility

Joint Powers Authority (ICTF) for the purposes of financing and constructing an intermodal container transfer facility to transfer cargo containers between trucks and railroad cars. The facility has been leased to a tenant, who developed and assumed operational responsibility for the facility. The Venturers' share net income and equity distributions from ICTF equally. The Harbor's 50% share of ICTF's FY 2008 net income was $4.4 million.

Clean Air Action Plan, net - $13,866,798

See Section II and Section III for a description of this program and details of the related net expenses.

Capital Grants

The Harbor receives federal funding for certain qualifying projects. In FY 2008, the majority of the Harbor's grant revenues pertained to the following projects:

- Portside landside video surveillance project - $1.5 million
- Pier F security enhancement - $0.6 million
- Portwide surveillance camera project - $0.7 million

Transfers to the Tidelands Operating Fund

The amount reflected in this line item is 10% of FY 2007's increase in net assets. This amount was paid to the City in quarterly installments during FY 2009.

Section II – Trend Analysis FY 2003 – FY 2008

As part of our informational analysis, we reviewed the Harbor's financial statements from FY 2003 to FY 2008 to identify fluctuations between years. A summary of our review is provided below. Additionally, we identified specific transactions/activities that caused significant fluctuations. Those activities are further discussed in Section III of the report.

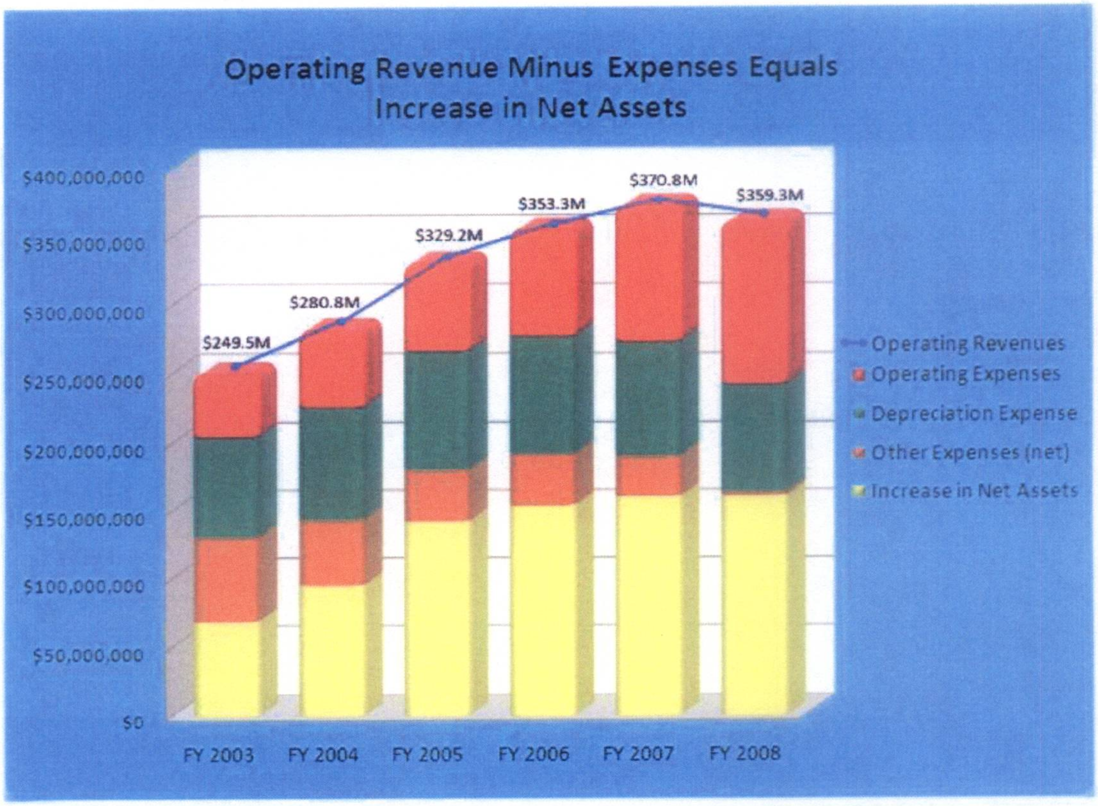
In reviewing the Harbor's financial statements for FY 2003 through FY 2008 we noted the following:

- Operating revenues have increased 44% since FY 2003. [However, FY 2009 operating revenues decreased $48 million (13%) from FY 2008, resulting from the poor economy and its impact on the shipping industry];
- Operating expenses before depreciation have almost tripled since FY 2003, in part due to one-time expenses in FY 2008 (see discussion below of one-time items included in FY 2008);
- Depreciation expense has remained relatively constant;
- Other expenses (net) consist of net nonoperating expense, grant revenues, and transfers to the City of Long Beach;

- Net nonoperating expense has consistently decreased from $53.5 million of <u>expense</u> in FY 2003 to $9.5 million of <u>revenue</u> in FY 2008 (see discussion below);
- Grant revenues vary each year depending on project activity. Annual grant revenues ranged from a low of $0.5 million in FY 2003 to a high of $10.0 million in FY 2007;
- Transfers to the City of Long Beach (City) are calculated as 10% of the previous year's increase in net assets and ranged from a low of $6.8 million in FY 2004 to a high of $16 million in FY 2008; and

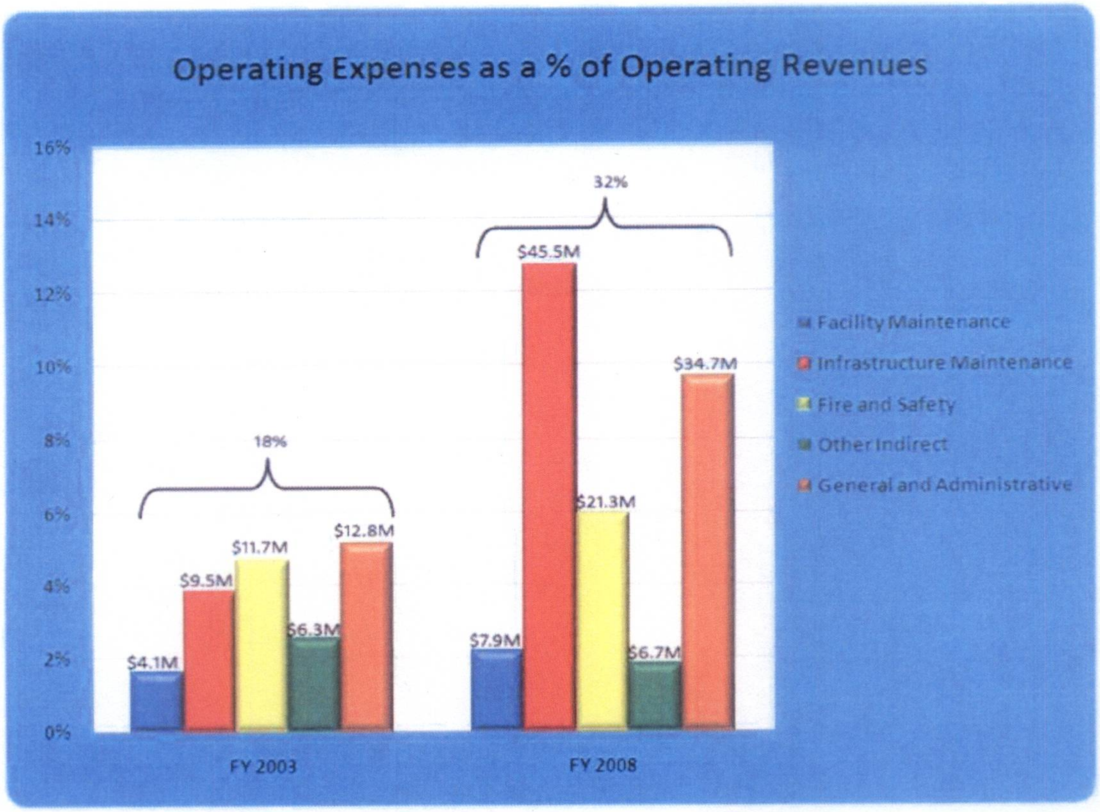
- Increase in net assets has increased 135% from $68.5 million in FY 2003 to $160.8 million in FY 2008, as illustrated in the graph below.

<u>Increase in Net Assets</u>



<u>Operating Expenses</u>

Operating expenses as a percentage of operating revenues have increased from 18% in FY 2003 to 32% in FY 2008, in part due to one-time expense items in FY 2008 as discussed below. As illustrated below, the operating expenses that have increased the most are infrastructure maintenance, fire and safety, and general and administrative.



The increases were primarily due to the following one-time items:

Infrastructure Maintenance

- An accrual of $19.6 million for environmental remediation costs for Installation Restoration Site 7; and
- Maintenance costs in the amount of $8.5 million associated with the Gerald Desmond Bridge.

Refer to Section III of the report for additional information on environmental remediation related to Installation Restoration Site 7 and the Gerald Desmond Bridge.

Fire and Safety

- The expenses related to fire and safety consist primarily of costs charged by the City for police and fire services. Fire and safety costs have consistently increased from $8.8 million in FY 2003 to $14.5 million in FY 2008; and
- The costs for in-house Harbor Security have gradually increased from $2.8 million in FY 2003 to $6.8 million in FY 2008. Union-negotiated salary adjustments and additional personnel contribute to this increase.

General and Administrative

- The expenses related to salaries, wages, and benefits have increased by $9.5 million from FY 2003 to FY 2008, largely as a result of union-negotiated salary increases and a 10% increase in permanent staff.
- The expenses related to general communications (excluding salaries, wages, and benefits) have increased by $2.4 million, from $0.5 million in FY 2003 to $2.9 million in FY 2008. This increase is primarily the result of promoting the "Green Port Policy" (an aggressive, comprehensive and coordinated approach to reduce the negative impacts of Harbor operations);
- The expenses related to management information services (excluding salaries, wages, and benefits) have increased by $3.3 million, from $0.5 million in FY 2003 to $3.8 million in FY 2008, as a result of the Harbor's five-year Information Management Business Plan approved by the Board of Harbor Commissioners; and
- The fees related to legal services have increased by $1.5 million due to legal action related to the Clean Trucks Program.

Net Nonoperating Expenses

Net nonoperating expenses is the summation of seven different revenues and expenses as follows:

Net Nonoperating Expenses	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Nonoperating Income (Expense)						
Investment Income, net	$ 13,626,935	$ 13,450,318	$ 17,964,410	$ 28,301,965	$ 43,374,260	$33,346,928
Interest Expense	(51,068,784)	(60,544,653)	(57,447,850)	(54,109,749)	(53,072,903)	(46,390,956)
Income (Loss) from Harbor Oil Operations	(2,586,886)	1,806,653	13,540,959	6,125,571	(21,070,305)	31,153,305
(Loss) Gain on Disposition of Capital Assets	(11,337,368)	(93,464)	(399,737)	(1,391,831)	179	(254,540)
Income from Equity in Joint Venture	3,717,188	2,795,157	3,535,373	4,301,663	4,674,546	4,440,935
Clean Air Action Plan, net	-	-	-	-	-	(13,866,798)
Other (Expense) Income, net	(5,943,835)	(4,971,896)	(8,118,298)	(9,596,403)	1,267,487	1,046,803
Net Nonoperating (Expense) Income	$(53,592,750)	$(47,557,885)	$(30,925,143)	$(26,368,784)	$(24,826,736)	$ 9,475,677

As illustrated above, interest expense and income from equity in joint venture have remained relatively constant throughout the years. Loss on disposition of capital Assets also has remained relatively constant with the exception of FY 2003 activity, which is attributed to the retirement of six cranes in February 2003. Investment income, oil operations, Clean Air Action Plan, and other (expense) income fluctuated significantly and are discussed in detail below.

Investment Income

- The steady increase from FY 2003 to FY 2007 was a result of an increase in interest rates combined with an increase in cash balances; and
- The $10 million decrease in FY 2008 was due to the loss in the City's cash pool on a commercial paper investment held with Lehman Brothers ($9.0 million), as well as lower interest rates in the latter part of the fiscal year. [Furthermore, it is

anticipated that investment income will continue to decline. FY 2009 investment income decreased by $14.8 million from FY 2008, primarily as a result of significantly lower interest rates (from an average of 4.1% in FY 2008 to an average of 1.6% in FY 2009)].

Oil Operations

As mentioned in Section I, there are certain oil assets located on Harbor property. A summary of the revenues and expenses pertaining to oil operations is presented below:

Oil Operations	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Revenue	$ 19,685,861	$ 28,306,586	$ 40,845,247	$ 57,618,158	$ 57,317,334	$ 87,026,769
TOPKO Expenses	(16,673,005)	(20,183,862)	(24,267,313)	(32,342,462)	(40,915,305)	(39,930,229)
Environmental Remediation	-	-	-	(17,720,000)	(35,970,000)	(14,546,308)
Depletion and Other Expenses	(5,599,742)	(6,316,071)	(3,036,976)	(1,430,125)	(1,502,333)	(1,396,927)
Total (Loss) Income	**$ (2,586,886)**	**$ 1,806,653**	**$ 13,540,959**	**$ 6,125,571**	**$(21,070,305)**	**$ 31,153,305**

- The increase in income in FY 2005 was solely due to higher crude oil prices, resulting in a $12.5 million increase in oil revenues;
- The decrease in income in FY 2006 was due to an accrual of $17.7 million related to the closure of the "Bug Farm," a bio-remediation site on Pier A West;
- The significant loss in FY 2007 was primarily due to the net result of an expense accrual of $47.7 million for environmental remediation liability for Pier A West and the reversal of $11.7 million of the prior year expense accrual for the "Bug Farm" due to lower than estimated costs; and
- The significant increase in income in FY 2008 was the net result of higher crude oil prices that resulted in a $29.7 million increase in oil revenues and a decrease of remediation expenses by $21.4 million.

Refer to Section III of the report for additional information on environmental remediation.

Clean Air Action Plan (CAAP)

- $5.2 million of the FY 2008 expense pertains to costs associated with hiring contractors to start the Clean Trucks Program, as well as hiring a third party to manage the Clean Trucks Program operations and collect revenues; and
- The Harbor also accrued $8.0 million in FY 2008 related to an agreement with the Port of Los Angeles to share the costs incurred for funding LNG-fueled trucks purchased during FY 2008 but not invoiced by the Port of Los Angeles until 2009. This corresponds to 43 trucks, which was the Harbor's share of the purchase.

Refer to Section III of the report for additional information on CAAP.

Other (Expense) Income

- The expense in FY 2005 is primarily due to a write-off of $5.0 million for an account receivable balance, pending litigation at the time. A subsequent settlement of $4.1 million was received in FY 2007, as described below. In addition, there was a $2.5 million adjustment as a catch-up for sick leave accrual;

- The expense in FY 2006 is primarily due to $9.6 million of costs associated with the consolidation and closure of the U.S. Naval Base; and
- The income in FY 2007 was the net result of $4.1 million collected from an account receivable that was previously written off in FY 2005 and $3.0 million of design and environmental costs associated with the cancellation of the Liquefied Natural Gas (LNG) terminal project at Pier T.

Refer to Section III of the report for additional information on the LNG terminal project.

Section III – Observations and Pertinent Issues

The objective of our analysis was to provide an informational presentation. While performing our analysis, certain issues came to our attention that we believe may have a significant impact on future transfers to the TOF. These issues are outlined in the section below and may provide value in consideration and/or expectations of future transfers to the TOF.

Timing of Transfer

Pursuant to the City Charter Section 1209(c)(4), "at the beginning of a fiscal year" the Harbor may transfer up to "10% of the net income of the Harbor Department as shown on the most recent available independently audited financial statements." Although the Charter states that the transfer is to occur at the beginning of the fiscal year, the City Council adopts the annual resolution requesting the 10% transfer in "equal quarterly installments." By requesting the transfers occur over a nine-month period rather than in one lump sum transfer at the beginning of the fiscal year, the City lost approximately $0.1 million in interest income during FY 2009. Current interest earnings are down due to a poor economy. However, reflecting back on FY 2007 and FY 2008, the City lost interest income of up to $0.2 million and $0.3 million, respectively.

Capitalized Interest

Prior to FY 2009, the Harbor's policy was to capitalize bond interest only for construction projects funded by specific debt issuances. It did not capitalize interest expense for construction projects without specific borrowings. As a result of this policy, the Harbor did not capitalize any interest from FY 2003 through FY 2008, since there was no borrowing designated for specific projects. At the end of the FY 2008 audit, the external auditor suggested the Harbor capitalize interest expense as long as there is debt outstanding and construction in progress. This change in policy would have resulted in an estimated $3 million of capitalized interest in FY 2008. However, because the suggestion was made near the completion of the audit, and the amount was not material to the Harbor's financial statements, the accounting entry was not made.

Beginning in FY 2009, the Harbor revised its policy to capitalize interest as long as there is construction in progress and outstanding debt, regardless of whether the projects are directly funded by the outstanding debt. This will effectively spread a portion of interest expense over a number of years, rather than incur it in a single year.

In FY 2009, the Harbor capitalized $2.1 million of interest expense. However, the Harbor performed its calculation based on FY 2009 additions, rather than all outstanding construction in progress. As such, approximately $3.1 million in additional interest costs could have been capitalized. Although that amount is not material to the Harbor's financial statements from an audit perspective, the effect on the transfer to the TOF is significant.

Additionally, during the course of our procedures, it came to our attention that the City's other enterprise funds are not capitalizing interest costs related to construction in progress. The City should enforce compliance with generally accepted accounting principles by requiring the other enterprise funds to capitalize interest on qualifying construction in progress.

Clean Air Action Plan

In November 2006, the Ports of Long Beach and Los Angeles (collectively, Ports) approved the San Pedro Bay Clean Air Action Plan (CAAP). The $2 billion CAAP committed the Ports to implement a comprehensive plan to reduce both health-risk and mass emissions associated with port operations, resulting in an overall reduction of pollution by 45% over the next five years. There are several funding sources associated with the implementation of the CAAP including:

- costs borne by the industries/terminals;
- costs borne by the Ports in developing required infrastructure, funding incentives, and implementing control measures; and
- costs borne by regulatory agencies to fund incentives.

The Harbor's initial funding commitment was $240 million over five years, with the intention that the full commitment will be expensed. As of September 30, 2008, the Harbor had designated $211 million of its unrestricted net assets towards this commitment. It should be noted that those funds are internally designated for the CAAP, rather than legally obligated and have since been reduced dramatically, because the drayage industry stepped up and replaced its own trucks without Harbor subsidies. Also, see information below regarding the recent significant decrease in anticipated future expenditures for the Clean Trucks Program.

As part of the CAAP, both Ports adopted and implemented the Clean Truck Program (CTP) in order to reduce truck-related air pollution. The CTP will facilitate the replacement of the trucks operating into and out of the Ports. The Harbor offers three options: lease to own; grants for an engine retrofit; and loan subsidy for the purchase of clean trucks. To assist with funding of the CTP, a Clean Truck Fee has been imposed and is payable by the end cargo owner. Expenses for the CTP comprised the majority of the planned CAAP expenses mentioned above. However, the Harbor has represented that due to the trucking industry's voluntary replacement of its own trucks without use of a Harbor subsidy, the Harbor's future anticipated expenditures pertaining to the CTP have decreased dramatically.

Future Funding Considerations:

- As a result of starting collection on February 18, 2009, Clean Truck Fee revenues are expected to peak in FY 2009 at $29 million;
- In FY 2008, net expense pertaining to the CAAP was $13.9 million; and
- In FY 2009 net revenue pertaining to the CAAP was $13.3 million.

Gerald Desmond Bridge

The Gerald Desmond Bridge was built in 1969 and has developed serious safety and maintenance issues. The Harbor intends to build a replacement bridge. The new bridge will be higher, to allow additional clearance for ships, and will also be wider, to ease the flow of cars and trucks that use the bridge. The Gerald Desmond Bridge carries 15% of the nation's imports. A safe, uncongested bridge is critical to the Harbor's continued success. Construction is anticipated to begin in 2010 and is scheduled for completion by 2016.

The project is estimated to cost up to $1.1 billion. The Harbor anticipates that funding of the project will come primarily from federal and state grants, but matching funds of up to 10% may be required of the Harbor. As of September 30, 2008, the Harbor's restricted net assets earmarked for this project were $52 million. The Harbor is reviewing other options to reduce cost, including project delivery (e.g. design-build) and other financing methods.

The Harbor is in current discussions to transfer both the new and old GD Bridge over to the State of California (State). The transfer would convert the bridges and roadways from Harbor maintenance to State maintenance. If this were to occur, the book value of the asset (net of accumulated depreciation) would be expensed at the time of transfer. The old bridge is fully depreciated; as such, there would be no expense at the time of transfer.

The Harbor's practice has been to depreciate its net capital expenditures spent on assets constructed for others (i.e., not intended to be retained by the Harbor) over a ten-year period. The Harbor anticipates that this same methodology will be used regarding construction of the new bridge. After the ten-year depreciation period expires, the bridge could be transferred to the State with no further impact on net assets.

Additionally, in order for the transfer of the old bridge to occur, the State requires certain improvements be performed before it will be accepted as a State Highway. Improvements required by the State are outlined below in three phases.

- Phase I included a seismic retrofit and repair of the foundations and superstructure at a cost of approximately $16 million. Phase I was completed in prior years. Phase I was capitalized at time of completion and to date, has been fully depreciated;
- Phase II included modifying the bridge from four to five lanes by moving the sidewalks on the south side to the outside of the existing structure, moving the middle barriers, and re-striping the lanes at a cost of $8.5 million. Phase II is complete and was expensed in FY 2008 classified as Infrastructure Maintenance; and
- Phase III includes repainting of the entire bridge at an estimated net cost to the Harbor of $28 million. The Harbor is attempting to gain State exemption from having to perform Phase III since the old bridge will be demolished upon completion of the new bridge.

Future Funding Considerations:

- Beginning in approximately FY 2017, an estimated $5.2 million of annual depreciation expense for ten years, if the Harbor were to use a $52 million net contribution of its own funds for the new bridge.

Major Construction Projects

To remain competitive, the Harbor is continuously working to improve the efficiency of the Harbor's facilities while protecting the environment. Included below are major capital projects in the beginning phases or due to start in the near future:

Pier G Modernization – A multi-year $800 million project including renovation and modernization of the International Transportation Service (ITS) container terminal. Currently, construction of a new terminal administration complex is underway and building is set to start soon on a new maintenance and repair facility and a new on-dock rail yard. Shore-to-ship power facilities and additional dock space are also being added.

Middle Harbor Redevelopment Project (Middle Harbor) – A 10-year, $750 million project including modernization of two aging shipping terminals. The program will add on-dock rail capacity, shore-to-ship power hookups and allow the new terminal to move twice the cargo with half the air pollution. Phase I construction is scheduled to begin in 2010.

Pier S Container Terminal – A proposal to build a new terminal at the Harbor on existing vacant land. The terminal would cost $650 million to construct and would be built with the latest in clean-air technology and cargo-movement efficiencies. This project is currently in the EIR phase. In addition to the cost of the construction of the new terminal, to date the Harbor has spent $109 million developing the land.

On Dock Rail Support Facility – A proposal to redevelop an existing rail yard on Pier B and to remove rail bottlenecks and provide rail storage tracks in the port. The facility would allow additional on-dock rail use at the port, reducing truck trips. Harbor staff is currently developing the draft environmental impact report on the proposal, and the estimated project cost is $200 million. A portion of this construction will be funded through grants with matching contribution requirements. At September 30, 2009, the Harbor had restricted net assets totaling $89.7 million pertaining to these required matching contributions.

Long Beach Harbor Dredging – The US Army Corps of Engineers and the Harbor will commence in 2010 with a $40 million dredging project to add navigation in and around the port. Remediation of IR Site 7 represents $20 million of the dredging project. Pier G and Catalina Express make up the remainder of the project.

Future Funding Considerations:

- Once a capital project is complete and put into service, it will be reported as a long-term asset on the Harbor's financial records;
- When the asset is capitalized, the total cost will be depreciated over the useful life of the asset;
- The Harbor's intent is for the revenue associated with capital projects to exceed the cost of those projects, resulting in a positive net impact on the change in net assets; and
- Improvements performed to existing infrastructure mitigate future costs of maintaining that infrastructure.

Financing Major Capital Projects

Net assets is the difference between total assets and total liabilities. The change in net assets represents either an improvement or deterioration of the Harbor's financial condition. In FY 2008, the Harbor held $2.3 billion in total net assets, $637 million of which were unrestricted. In order for net assets to be considered 'restricted' they must be subject to external restrictions, as opposed to internal designations. Unrestricted net assets are used to fund continuing operations. At the end of FY 2008, the Harbor had $726 million in unrestricted cash. The Harbor's internal policy is to retain a minimum of the prior year's operating expense in unrestricted cash (approximately $100 million).

In addition to partially funding the major construction activities mentioned above, unrestricted cash and net assets assist with funding Harbor operations and other planned projects, such as the Clean Air Action Plan, replacement of the Gerald Desmond Bridge, etc.

Due to the significance of the planned construction projects over the next ten years, the Harbor intends to incur new debt of up to $1 billion between 2012 and 2019. However, at the same time, the Harbor will pay down over $500 million of its existing debt in scheduled principal payments. In addition, the Harbor redeemed $134 million of revenue bonds in late FY 2008 and $29 million in commercial paper in early FY 2009 because of the financial markets' turmoil at that time. Therefore, the additional debt the Harbor will be incurring for its $3 billion construction program, over the debt level that existed in FY 2008, will be approximately $337 million. Conceptually, the increase in debt and capital assets will cause an increase in interest expense and depreciation expense. However, the Harbor intends that the revenue associated with these capital projects will exceed the cost of those projects, resulting in a positive overall impact to net assets.

Additionally, the Harbor has taken advantage of the American Recovery and Reinvestment Act and restructured its debt in FY 2010. It issued $201 million of Series 2010A Harbor Revenue Bonds. At the same time, it redeemed an equivalent amount of Series 2000A, thus realizing a net present value savings of $20.4 million, net of all expenses and cost of issuance. It also issued $158 million in Series 2010B Harbor Revenue Refunding Bonds to replace an equivalent amount of bonds tendered, and realized an additional $4 million in net present value savings after all expenses and cost of issuance.

Accounting for Major Capital Projects

The Harbor's Capital Asset Policy states that it will capitalize assets if it is a "non-consumable, tangible item, valued at a single amount greater than $5,000 and with a useful life of more than one year." The policy further states, "Capital assets that are construction related... are capitalized as work in progress... Construction costs include all direct costs associated with the project that are incurred during the period when planning for the construction begins and ends when the construction project is substantially complete. Costs also include any overhead directly attributable to the construction or development activity." This policy is consistent with the City's policy.

There has been discussion regarding whether the Harbor has expensed items that could have been capitalized. It is important to remember that the annual transfer is based on the audited financial statements, and that the external auditors attest that the financial statements are *materially* correct, based on their testwork. The extent of their testwork depends in part on their assessment of materiality. Capital asset additions and related expenses are items typically reviewed in a financial audit. However, each transaction is not necessarily examined. As such, Harbor transactions that may be significant *to the TOF* because of their effect on the annual transfer may not be significant *to the Harbor* and therefore may not be tested by the external auditors. An audit, of course, cannot test all transactions; otherwise, it would be prohibitively expensive. This is precisely why the auditors set a level of materiality, to allow for an efficient audit and at the same time afford the users of the audited financial statements the ability to place reliance on them.

Environmental Remediation

The Harbor has had 2 large environmental remediation projects in recent years: 1) remediation of property purchased in 1994 from Union Pacific Resources Company (subsequently acquired by Anadarko Petroleum); and 2) cleanup of the in-water sediments of the West Basin (IR Site 7) pertaining to former U.S. Navy property. The Anadarko project was completed in FY 2009; therefore, IR Site 7 is the only currently ongoing project related to environmental remediation.

Anadarko - In 1994, the Harbor purchased 720 acres of crude oil production field property from the Union Pacific Resources Company (UPRC). UPRC was acquired by Anadarko Petroleum (Anadarko) in 2000. The entire acquisition was comprised of four land parcels including Pier A, Pier S, Pier A West, and Pier A East.

Under the Purchase and Sale Agreement (PSA), the Harbor is responsible for carrying out required remediation work. In accordance with the PSA, Anadarko is obligated to reimburse the Harbor for remediation costs up to a maximum aggregate amount of $112.5 million for costs incurred through March 21, 2009. Under the PSA, Anadarko has no reimbursement obligations for costs incurred after March 21, 2009.

The Harbor represented that Anadarko had reimbursed them or otherwise contributed $80.4 million and that, to its knowledge, the site was mostly remediated by March 21, 2009. The Harbor's net expenses related to this property were over $80 million between FY 2007 and FY 2009. There are currently no additional outstanding orders to remediate from any oversight authority. Rescinding of the current order by the Regional Water Quality Board and Department of Toxic Substance Control is in progress.

IR Site 7 – In 1998, the Harbor and US Navy negotiated a 50-year lease that allowed the Harbor to use the former Naval Complex site prior to the actual transfer of property. As a part of this agreement, the Navy transferred responsibility for performing any necessary cleanup of the in-water sediments of IR Site 7 to the Harbor.

The Consent Agreement (Agreement) was entered into in 2005 by the Harbor and the California EPA Department of Toxic Substances Control (DTSC). The Agreement stipulated the Harbor's responsibility to complete the sediment cleanup, identified reporting requirements, required the Harbor to demonstrate long-term financial assurances for the operation of the site, and outlined statutory bases for the process. The Agreement also serves as a condition for transfer of the remaining 48 acres from the Navy to the Harbor.

Though the Agreement was signed in 2005, no liability was recorded until FY 2008, as the extent of remediation required had not yet been fully estimable. The Negative Declaration was completed in FY 2008 stating the project would have no significant impact on the environment. Therefore, in FY 2008 a design estimate was completed, and an estimate of the construction of the project was developed. As such, a $19.6 million accrual was recorded in FY 2008.

Future Funding Considerations:

- The design and construction estimate increased during FY 2009; therefore, an additional $0.5 million accrual was booked in FY 2009; and
- No significant costs related to IR Site 7 have been incurred to date.

Water Project

A study is underway to perform certain upgrades to the current water system within the Harbor district. The goal is to turn the Harbor's water system over to the City's Water Department. The transfer would convert the water system from Harbor maintenance to City Water Department maintenance.

APPENDIX A

MANAGEMENT'S RESPONSE

925 Harbor Plaza, Long Beach, CA 90802 Tel 562.437.0041 Fax 562.901.1725

The Port of
LONG BEACH
The Green Port

June 4, 2010

Laura L. Doud, City Auditor
City of Long Beach
333 West Ocean Boulevard
Long Beach, Ca 90802

Dear ~~Ms. Doud~~ Laura,

We thank you and your staff for conducting a thorough review of the Tidelands Transfer in a very professional manner. Your review complements the annual financial audit that is performed by KPMG, a big four independent auditing firm, which is contracted by your office. This letter includes additional information we hope will be helpful and addresses your recommendations.

The net income of the Port of Long Beach (POLB) has increased 162% from 1999 through 2008. However, the most severe recession since the great depression has negatively impacted the entire maritime industry and international trade. POLB was no exception and in fiscal 2009, POLB's containerized cargo volume decreased 22% over fiscal 2008. In the last five months, December to April, however, containerized cargo volume has increased on average 15%, year over year.

POLB faces strong competition for its discretionary, intermodal cargo, resulting in a diversion of cargo to other ports. With the expansion of the Panama Canal in 2014, development and channel deepening projects at the East Coast and Gulf Ports, as well as the growth of the Prince Rupert Port in British Columbia, this competition will continue to increase. Therefore, it is critical for POLB to improve its ability to compete in order to maintain its market share. As you know, market share, a strong balance sheet, and healthy income are important to maintain POLB's strong credit rating.

The continued success of POLB is vital to the City of Long Beach. Often, the Port is referred to as the economic engine of the City. More than one in eight jobs in Long Beach is tied to port activities. Even more important is the taxes the City collects from spending and property tax that result from these incomes. These taxes help pay for City services. POLB's ten-year, $4.5 billion capital program will create thousands of additional construction and permanent jobs in the local economy. A strong credit rating will allow us to borrow money at lower cost to finance these projects.

POLB management is attuned to the industry and is in constant contact with existing and potential customers. Marketing programs designed to bring incremental cargo to POLB are continually evaluated. At the same time, the cost of running the business is critically and constantly reviewed. This was especially the case as revenue started to dip as a result of the recession. Several cost cutting measures were introduced, including holding headcount steady, reducing non-personnel expenses, and successfully obtaining a 5% discount from the majority of our vendors.

POLB competes in the same geography with the Port of Los Angeles (POLA). The two ports are comparable in size, and have similar customer mix and business models. Therefore, it is pertinent to compare their financial results in any given year. In fiscal 2009, POLB's net income was almost triple that of POLA's. Below is a comparison of FY 2009 key financial metrics:

	Fiscal Year 2009 - all numbers are in thousands		
	POLB	POLA	POLB vs POLA Difference %
Container count	5,282 TEU's	7,262 TEU's	-27%
Total port operating revenues	$311,352	$402,224	-23%
Operating expenses before depreciation and amortization	($97,880)	($254,143)	-61%
Depreciation and other	($70,648)	($102,110)	-31%
Tidelands Transfer	($18,587)	$0	
Net income	$124,237	$45,971	170%

It is noteworthy to mention that POLA's operating revenues exhibit a direct correlation to the higher cargo volume it enjoys when compared with that of POLB's. However, POLA's operating expenses before depreciation are disproportionately higher than those of POLB's.

The specific recommendations listed in the audit report are addressed below:

Audit Recommendation	POLB Response
1. Consider whether or not the transfer should be deducted from the base upon which the maximum transfer amount is calculated.	The City Charter requires the use of net income as the base for calculating the transfer. The Tidelands Transfer is an expense to the Harbor Fund, no different than any other expense, when calculating net income.
2. The City Council should consider requesting that the annual transfer be made at the beginning of the fiscal year as stated in the City Charter, rather than quarterly over a nine-month period. This would improve the TOF's cash flow and afford it additional interest earnings. It should be noted that this recommendation has already been partially implemented, with the request from City Council to expedite the fourth and final payment for FY 2010.	In the past, the City Council requested the Tidelands Transfer in four equal installments. The Board of Harbor Commissioners will consider making the transfer to the Tidelands Operating Fund (TOF) in one lump sum instead of four quarterly transfers. The Harbor Commission has approved the City Council's request to accelerate the fourth quarterly payment in fiscal 2010.
3. Consider restructuring the requests for the annual transfer amount. For example, consider requesting a transfer amount due on October 1, 2010 based on 80% of the Harbor's unaudited change in net assets as of September 30, 2010, with the remaining 20% to be transferred to the TOF upon issuance of the Harbor's FY 2010 audited financial statements (usually issued in March of each year). This restructuring would eliminate the one-year lag between the operating results and the transfer payment to the TOF and would result in two transfers being made in FY 2011.	This recommendation of making two transfers in one fiscal year (on a one time basis) will be reviewed with the Board of Harbor Commissioners.

4. The City should enforce compliance with generally accepted accounting principles by requiring the other enterprise funds to capitalize interest on qualifying construction in progress. The Harbor changed its policy in FY 2009 to adopt a recommendation from the external auditors and represents it will ensure adherence to the policy in future years. Compliance with these accounting principles will result in a portion of interest expense being distributed over time, rather than expensed in one lump sum when incurred.	As noted in the audit report, none of the City's enterprise funds had been capitalizing interest after the borrowed construction funds have been spent. POLB revised its policy in fiscal 2009 following a recommendation by KPMG at the conclusion of the fiscal 2008 audit. KPMG concurred with the implementation of the policy in the fiscal 2009 financial statements. POLB will ensure compliance with the policy and accounting principles.
5. As mentioned above, due to the disparity in size of operations, an immaterial transaction to the Harbor that reduces its net assets may result in a material effect on the TOF. This potential disparity may be mitigated through voluntary actions agreed to by the Harbor, the City, and/or the City Auditor.	POLB's transfer to TOF has continued to increase over the past several years, yet TOF continues to experience economic difficulties. We request that the City Auditor conduct an audit of TOF and the funds it supports to substantiate that all the expenses charged are in compliance with the State of California Tidelands Trust rules.

If you have any questions, please do not hesitate to call.

Sincerely,

Richard D. Steinke
Executive Director
Port of Long Beach

RESOLUTION NO.

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF LONG BEACH MAKING CERTAIN FINDINGS AND DETERMINATIONS AND REQUESTING THE BOARD OF HARBOR COMMISSIONERS OF THE CITY OF LONG BEACH TO: APPROVE A TRANSFER FROM THE HARBOR REVENUE FUND TO THE TIDELAND OPERATING FUND PURSUANT TO THE PROVISIONS OF CITY CHARTER SECTION 1209(C)(4)

OFFICE OF THE CITY ATTORNEY
ROBERT E. SHANNON, City Attorney
333 West Ocean Boulevard, 11th Floor
Long Beach, CA 90802-4664

WHEREAS, City Charter Section 1209(c)(4) authorizes the transfer of monies deposited to the credit of the Harbor Revenue Fund to the Tideland Operating Fund under certain conditions; and

WHEREAS, the City Council finds and determines that the lawful obligations of the Tideland Operating Fund for the fiscal year commencing October 1, 2010 and ending September 30, 2011 will exceed the anticipated revenues to and available reserves of the Tideland Operating Funds by an amount exceeding $12,423,706 and

WHEREAS, the change in net assets of the Harbor Department for the fiscal year commencing October 1, 2008 and ending September 30, 2009 as shown on the financial statements prepared by the Harbor Department and audited by KPMG LLP, is the sum of $124,237,060 and ten percent (10%) thereof is the sum of $12,423,706;

NOW, THEREFORE, the City Council of the City of Long Beach resolves as follows:

Section 1. The lawful obligations of the Tideland Operating Fund for the fiscal year commencing October 1, 2010 and ending September 30, 2011 will exceed the total available reserves and anticipated revenues of the Tideland Operating Fund for the same period.

Section 2. That ten percent (10%) of the change in net assets of the Harbor Department as shown on the most recent available independently audited financial statements for the period ending September 30, 2009 is the sum of $12,423,706.

Section 3. That eighty (80%) percent of the Harbor Revenue Fund's unaudited change in net assets as of September 30, 2010 is currently estimated at $9,938,965, and to meet the lawful obligations of the Tideland Operating Fund, a transfer is being requested of this amount on October 1, 2010, with the remaining twenty (20) percent estimated at $2,484,741 transferred after March 31, 2011, with a reconciliation, as necessary, to reflect the final audited change in net assets as shown on the Harbor Department's independently audited financial statements for the period ending September 30, 2010.

Section 4. That consistent with the City Auditor's recommendation, the elimination of the previous year's transfer from the base upon which the annual transfer is calculated be considered, effective with the Harbor Department's Fiscal Year 2010 audited financial statements.

Section 5. The City Council by a vote of two-thirds (2/3) of all its members requests that the Board of Harbor Commissioners approve the transfer of the sums of $12,423,706 effective immediately; $9,938,965 effective October 1, 2010 and $2,484,741 after March 31, 2011 with any adjustment as required to reflect the final audited change in net assets as of September 30, 2011; and an additional $1.2 million after March 31, 2011 reflecting ten (10) percent of the prior year's transfer; from the Harbor Revenue Fund to the Tideland Operating Fund, which transfers shall be made by journal entry on the books of the City of Long Beach.

Section 6. This resolution shall take effect immediately upon its adoption by the City Council, and the City Clerk shall certify the vote adopting this resolution.

I hereby certify that the foregoing resolution was adopted by the City

OFFICE OF THE CITY ATTORNEY
ROBERT E. SHANNON, City Attorney
333 West Ocean Boulevard, 11th Floor
Long Beach, CA 90802-4664

Council of the City of Long Beach at its meeting of ________________, 2010, by the following vote:

Ayes:	Councilmembers:	____________________
		____________________
		____________________
		____________________
Noes:	Councilmembers:	____________________
		____________________
Absent:	Councilmembers:	____________________
		____________________

____

City Clerk

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