

Ed Harrington testimony to SEC – September 21, 2010

Good Afternoon. Thank you for the opportunity to testify today.

My name is Ed Harrington and I am the General Manger of the San Francisco Public Utilities Commission. The PUC is a department of the City and County of San Francisco. We provide water service to 2.5 million customers in San Francisco, San Mateo Alameda and Santa Clara counties. We also provide wastewater, stormwater and power services in San Francisco.

From 1991 to 2008 I was the Controller for the City and County of San Francisco providing financial oversight for a City with an annual budget in excess of \$6 billion and more than 28,000 staff.

I am an active member of the Government Finance Officers Association and was the president of GFOA several years ago. While my comments have not been approved by GFOA, I believe they represent the feelings of GFOA and most local and state officials.

I also serve on the Financial Accounting Foundation's Board of Trustees, but my comments do not represent in any way the position of the FAF, FASB or GASB.

Now, let's talk about Internal Controls.

Unlike private companies, our government structure is based on internal control--the separation of powers into executive, legislative and judiciary branches is fundamentally about segregation of duties, and in many cases overlapping checks and balances with Boards, Commissions, Councils, not to mention ever present internal and external auditors, and often Bond and Treasury Oversight committees.

Internal controls are ingrained in the basics of how governments do business. Anyone in government who has tried to purchase anything or hire anyone can tell you that we sometimes give up efficiency in return for transparency, process and control.

And we carry those preventive and detective internal controls into how we account for transactions, roll them together into financial reports and disclose information about our financial condition. Auditors of state and local government financial statements audit those internal controls so they can rely on information that comes from our accounting systems. These focused reviews of internal controls have increased dramatically since the issuance of the AICPA Statements of Auditing Standards 104-111 in 2006.

To assist our members and the public, GFOA issues numerous publications and best practices addressing internal controls in government finance which will be included in my written submission. Just to give you a flavor of the resources we provide, I will mention a few:

We have books and pamphlets titled:

An Elected Official's Guide to Internal Controls and Fraud Prevention.

Evaluating Internal Controls: A Local Government Manager's Guide.

Disclosure Guidelines for State and Local Government

An Elected Official's Guide to Debt Management.

Over the years we have adopted many Best Practice statements, including ones covering topics such as:

Documentation of Accounting Policies and Procedures;

Enhancing Management Involvement with Internal Controls

Improving the Timeliness of Financial Reports, and

Understanding your Continuing Disclosure Responsibilities..

At the local level at the San Francisco PUC we have implemented multiple layers of review to ensure the timely and accurate dissemination of financial information. It begins with process narratives and adopted policies and procedures that both document and govern our work. Our internal processes also include tracking tables and multiple reviews for compliance, source binders and reference binders for documentation.

Certain items, like cash management, are reviewed on a daily basis by while other information, like outstanding debt, is reviewed on a weekly or monthly basis. Some disclosure information is dictated by 15c-2-12 while other disclosure is required by our various indentures, letter of credit agreements, financial guarantee agreements and the like. Specific information not required to be posted to EMMA is provided to interested parties through various outlets.

In addition to the basic disclosure items, such as our annual continuing disclosure documents, budget, and audited financial statements, we produce quarterly reports on major topics where we have significant debt such as our \$4.6 billion water system rebuild. We report to numerous public boards and committees--often mandated by our local voter-approved charter--such as our Revenue Bond Oversight Committee and Citizens Advisory Committee.

That does not mean we or any agency is perfect. Even with the best internal controls people can make mistakes. And people can intentionally mislead investors and others. While rare, this has happened in the government sector and the SEC correctly has authority to go after fraud should that take place.

On the other hand, we do not believe the SEC needs to have a larger role in municipal finance. Which brings me to the larger issue and why you are holding these hearings.

From a grossly simplified view of newspaper reports and speeches, it appears that the SEC is concerned about the financial health of state and local governments, especially when it comes to pensions, and you believe making us issue quarterly and more timely annual financial reports will make the world safe for investors. Let's talk about why that approach is flawed.

First, it assumes the only way investors get information is through official financial statements.

Have any of you seen the most recent financial statements for the State of California?

Probably not.

Has this stopped you from having about an opinion about its financial strength? No, because you hear about it every day in newspapers and through various other media.

Governments have public hearings, websites, sunshine laws and requirements and lots of ways to provide financial information. The financial condition of private companies is information that is not readily available to the public and to investors and that is why the SEC appropriately requires publishing information in the corporate world. Information about the financial condition of local and state government is constantly available to the public and to investors.

The second problem is your assumption that the most important financial publication for governments is a financial statement. In most cases, it is actually the budget--a jurisdiction's largest forward-looking policy document. There are a couple hundred press stories a year about San Francisco's financial health—none of them relate to the financial statements—all of them relate to our budget.

Open, public budget hearings and documents tell an investor what the projected health of a state or local government is expected to be up to a year before any quarterly report you could require might be issued. Unlike the corporate world, these budget documents are important because they are both publicly available and legally controlling.

San Francisco also adopts a 5 year financial plan that includes forecasts of pension payments and other obligations and a 10 year capital plan, clearly giving investors and others advance notice of our financial health.

The third issue seems to be a fear of a dramatic, unforeseen turnaround in the financial strength of a public entity. It doesn't really happen that way. Most governments are like aircraft carriers—it takes us a long time to turn.

In our case at the PUC, investors buy our bonds (and we have sold over \$1 billion worth in the last 3 months) because we are selling an essential-service commodity—water, to geographically diverse areas, which include relatively affluent consumers, with relatively low to moderate rates and a demonstrated willingness to raise those rates when needed. None of those things is likely to change at any fast clip. And if there is a large immediate change in our fortunes, you already require us to make that disclosure under our obligations in 15c2-12.

The fourth issue relates to your concern about investors being protected—as if that is not a primary concern of ours in government. When the markets you regulate failed over the last few years, investors rushed to our market—a classic “flight to quality”-- because governments rarely tend to go bankrupt, default or stop paying our debts.

It is so rare that people who can't even pronounce Vallejo know it went bankrupt last year—and they are still paying their debt. Even though the San Diego disclosure problems happened in 2002-03, it is still your poster child because so little has happened since then--and I don't believe any investor in San Diego ever missed a payment.

There are over 87, 000 government entities in the United States. In California, over 800 separate governmental entities have issued debt this year alone. And with all of this activity, I can count on one hand the number of investment grade government bonds that have failed to pay investors. We know we have to rely on capital markets to continue to maintain our assets. So we prioritize debt payments and we make them. It would be great if you could say that about the industries you currently regulate.

Finally, the problems in local government right now revolve around a lack of money to finance pension and other costs. Clearly part of that problem stems from decisions state and local governments have made.

The other reason our pension plan funding status has fallen dramatically and our revenues are falling short comes right back to both regulatory and market failures. Because of the failure of the capital markets that you and your sister agencies regulate, most of our pension plans have lost as much as 30% of their value causing much of our pension crunch. Our general fund taxes and revenues are down because of the failure of our market economies. If you and your sister agencies could instill the same confidence in the capital markets that investors apparently have now under existing checks and balances in municipal bond markets, we would all be better off.

I would encourage you to focus your value added abilities on the private sector which has more to benefit and less on an already efficient government market which has an almost perfect record of taking care of investors.

Thank you.