SOUNDTRANSIT

Summary Minutes

Finance and Audit Committee Meeting
October 24, 2019

Call to order

The meeting was called to order at 11:35 a.m. by Committee Chair Nancy Backus, in the Ruth Fisher Boardroom, 401 South Jackson Street, Seattle, Washington.

Roll call of members

Chair	Vice Chair
(P) Nancy Backus, Auburn Mayor	(A) Bruce Dammeier, Pierce County Executive

Board Members	
(A) Dow Constantine, King County Executive (A) Jenny Durkan, Seattle Mayor (P) John Marchione, Redmond Mayor (P) Joe McDermott, King County Councilmember	(A) Roger Millar, WSDOT Secretary (P) Patty Rubstello, WSDOT Alternate (A) Dave Somers, Snohomish County Executive

Katie Flores, Board Administrator, announced that a quorum of the Committee was not present at roll call.

Report of the Chair

Chair Backus noted that the Committee would continue with the items which did not need a quorum until more committee members arrived.

CEO Report

Overview of the Budget Process

Chief executive officer Peter Rogoff informed the committee that the Budget Process started at the beginning of October, consistent with the new committee structure adopted by the Board at the end of 2018. In October, the Board of Directors would receive an introductory overview of the Financial Plan and Proposed Budget, while the Finance and Audit Committee would receive an in-depth presentation of the agency’s financial projections on revenues, costs, and capital plan affordability.

Review of the budget would wrap up in December when the Executive, Rider Experience and Operations, and System Expansion Committees all forward their portions of the budget to the Finance and Audit Committee, which would then review the forwarded budget as a whole and finally forward it to the Board of Directors for final adoption at its December meeting.

Public comment

Alex Tsimerman

Special Topics for Discussion

Preliminary Financial Plan Presentation

Tracy Butler, Chief Financial Officer, informed the committee that her presentation would introduce the Boardmembers to the agency's most recent long range financial plan and the Proposed 2020 Budget.

The Long Range Financial Plan is a 25 year plan encompassing Sound Move, ST2, and ST3. It is important to note that while Sound Move and the bulk of ST2 capital projects are complete or nearing completion, operating, maintenance, and state of good repair expenses still exist for those programs.

Tax revenues constitute approximately 66 percent of the agency's planned sources of funds. The remaining sources include fares, bonds, grant revenues, TIFIA loans and interest earnings. The agency's capital expenses account for approximately 53 percent of the agency's planned fund uses. State of good repair and operations and maintenance expenses contribute to approximately 30 percent of the agency's planned fund use. Debt service, reserves, and other minor expenses make up the remaining uses.

Projections are guided primarily by the Board adopted financial policies and voter approved package. Within those parameters, other inputs come from program costs provided by engineer estimates, key planning assumptions, independent revenue and inflation forecasts from third party industry experts, and budget and audited financials.

Ms. Butler noted that 2019 long range financial plan projections yielded three key takeaways. In short, those takeaways were: first, higher capital cost forecasts are partially offset by higher projected tax revenue with the remainder funded with additional debt; second, the updated operating budget process slows spending growth; and third, available debt capacity remains largely unchanged from 2018, with capacity remaining more constrained during the peak period of ST3 delivery. Ms. Butler explained that she would speak to each of the key takeaways in detail.

The first takeaway is that higher capital cost forecasts are partially offset by higher projected tax revenue. For the entire long range financial plan, spanning from 2017 to 2041, total project size increased over 2018 projections by $1.7 billion to a total of $97.9 billion. The change is driven by higher forecasted tax revenues of $1 billion, most of which is a product of sales tax growth, and $700 million of additional borrowing to offset higher projected project costs, increased debt service fees, and reserve contributions. In total, projected sources of funds have increased in all major categories over 2018 projections. Tax revenues are projected at $988 million, or 1.6 percent higher, debt is projected at $711 million, or 4.1 percent higher, federal grants are projected at $32 million, or 0.4 percent higher, and fares are projected at $65 million, or one percent higher. In total, projected uses of funds have also increased over 2018 projections. Capital and state of good repair expenses increased by $1.2 billion, or 2.2 percent, operating expenses decreased by $87 million, or 0.4 percent, and debt service increased by $282 million, or 1.8 percent. Ms. Butler highlighted the $1.2 billion increase in capital cost forecasts, mentioning that a slight decrease in the national consumer price index inflation for construction markets was majorly offset by an increase in local construction market conditions.

The second takeaway is that the agency's updated operating budget process slows spending growth. In total, operating projections are slightly lower than the 2018 projection. The expenses are projected at $87 million lower, or 0.3%. The decrease is driven primarily by the agency's implementation of tight, affordability based operating targets and a lower projected Consumer Price Index offset by increases for taking control of the Downtown Seattle Transit Tunnel, vertical conveyance maintenance cost increases, and projected increases in security expenses.

The third takeaway is that the available debt capacity remains largely unchanged from 2018 and that the capacity will become more constrained during the peak period of ST3 delivery. The agency's debt capacity is defined by the 1.5 percent of the assessed valuation of property within the district. Growth of that assessed value determines how much additional capacity the agency has left to fund the program. In 2018's projection, the year in which the agency's debt capacity was at its lowest was 2032, with an available capacity of approximately $2.9 billion. The continued growth of the economy has led to increased property values, and thus a slightly higher debt capacity in that lowest point of debt capacity of $3 billion. At the same time, the need to increase borrowing will extend that low point over several years. If that information is expressed as a percentage of remaining debt capacity per five years of expenditures, it reveals that the capacity falls below 20 percent, representing a moderately high risk beginning in 2029.

Boardmember Marchione asked whether this analysis took into account other debt constraints such as coverage ratios. Ms. Butler informed him that it did not because current projections predict that this constraint limit will be hit first before the others reach a concerning level. Chief executive officer Rogoff added that the other constraints would be added to future presentations in the interest of keeping the Board informed of the agency's trajectory. He added that when the agency reaches the 20 percent of capacity level its credit rating will be downgraded, increasing interest payments which will in turn reduce the debt capacity further.

At a higher level, it is important to note that the agency remains in a strong financial condition. The voter approved plan remains affordable based on current projections, operating expenses, state of good repair, and reserves are fully funded, and the agency's financial condition is consistent with its AAA rating from two ratings agencies. However, key risks must be considered. A large risk is that of a near-term recession. If this occurs, loss of tax revenues and property values will reduce the agency's debt capacity. Other key risks are continued cost pressure on the capital program and cost growth for third party services. One or a combination of these risks would threaten Sound Transit's ability to deliver the program as planned. As an example, Ms. Butler explained a hypothetical near-term recession of similar magnitude to the 2001 dot-com recession. In that scenario, the agency would reach its debt capacity limit and lose its affordability by 2031. That scenario also assumed that property values were not affected. If the recession were to affect property values, the agency would need to look at potential program adjustment as early as 2029.

The risks facing the agency may be concerning, but proactive steps can be taken now to mitigate negative impacts. For example, maintaining scope discipline is imperative, as decisions made at any one point can have major impacts on the future. Also containing operating expense growth will help ensure program affordability. The agency can look to expand funding sources through expanding partnerships in the public and private sector. Finally, optimizing the financing strategy will help minimize borrowing costs.

Budget Methodology and Preliminary Budget Presentation

Ms. Butler continued the presentation transitioning to budget methodology. She explained that the purpose of the agency's budget methodology is to achieve efficiencies and fiscal discipline by effectively managing operating expenses and to maintain financial sustainability to deliver the voter-approved plan. She mentioned that one of the considerations for this methodology is that operating costs often have more of an impact in the long-run than capital costs, as they repeat year- after-year.

The past budgeting process was an incremental approach, in which historical spending trends and inflation were prioritized. The new process incorporates the long-run financial plan's projections and identified risks and constraints as well as looking to the agency's new five year strategic plan, which helps prioritize resource allocation. Ms. Butler illustrated the effectiveness of the agency's new methodology by comparing 2019 operating budget performance against 2016 through 2018. The comparison showed that Sound Transit's performance increased, from between 92 percent and 94 percent to 98 percent. This is the first time in Sound Transit history that the agency has reached this level of efficiency. When projected throughout the length of the long-term financial plan, the new methodology is predicts a total budget reduction of approximately $325 million.

Mr. Rogoff added that the new methodology has been a major culture shift throughout the agency, and staff has adjusted quickly, allowing for such results.

Business Items

Patty Rubstello, alternate representative for Boardmember Millar joined the meeting, convening a quorum.

June 20, 2019, Finance and Audit Committee minutes

It was moved by Boardmember McDermott seconded by Boardmember Marchione and carried by unanimous vote that the minutes of June 20, 2019, Finance and Audit Committee Meeting be approved as presented.

Special Topics for Discussion Continued

Budget Methodology and Preliminary Budget Presentation Continued

Ann Sheridan, Budget Director, detailed the sources and uses of funds for the proposed 2020 Budget. The agency is proposing $3.1 billion in both sources and uses for the year. She highlighted the sources of funds specifically, noting that retail sales and use tax constitutes around 47 percent of that figure. Another notable source of funds is the agency's unrestricted cash balance, which represents approximately 19 percent of proposed 2020 revenues. System Expansion projects compose around 74 percent of the agency's uses of funds, while other uses such as debt service, transit modes, and other projects, contribute to the rest.

Revenues and funding sources, as discussed earlier in the presentation, are propelled mostly by taxes. Tax revenues were up by around four percent due to the strong local economy. The "other" category of funding sources is significantly lower in 2020, because the agency is not planning on borrowing funds, as it did in 2019.

Budgeted project expenses total around $2.5 Billion with non-system expansion portions of that budgeted amount making up only $232 million. Some of the important projects included in that non-system expansion portion are Downtown Seattle Transit Tunnel improvements, replacement and fleet expansion of ST Express busses, the Passenger Information Management System, Operations and Maintenance Facility renovations, vertical conveyances modernization, and administrative information technology improvements. Of the $2.5 billion budgeted for project expenses, $2.3 billion is allocated for system expansion projects. Link projects are the vast majority of these expenses at around 75 percent. Other contributors include Sounder access projects and maintenance base, and Regional Express and Stride expenses.

The Operations budget allocation is $370 million which is a seven percent increase over 2019. Purchased transportation is up 4.9 percent, or $9.4 million. Boardmember McDermott asked for clarification regarding this item. Ms. Sheridan explained that this represents expenses paid to partner agencies which operate Sound Transit vehicles. Mr. Rogoff added that this particular cost is the most difficult to control, as the costs are simply passed along by the partner agencies. Personnel and administration increased by $7.2 million. Insurance expenses increased $3.5 million largely due to a hardening market and the Downtown Seattle Transit Tunnel ownership transfer. Safety and security increased by $2.6 million, and elevator and escalator maintenance increased by $1.9 million.

Remaining expenses include debt service, which accounts for the majority of this category, tax collection and fees, contributions, and the agency's contingency.

Ms. Sheridan discussed the next steps for the budget process and then answered Boardmember questions.

Quarterly Financial Reports

Quarterly Financial Performance Report.

Ms. Butler informed the committee that August year-to-date performance information showed that the agency is approximately two percent above budget for revenue and capital spending is projected to end the year below budget by 13 percent. Operating expenses are tracking to budget with projected to end the year below budget by three percent.

Agency Asset and Liability Management Report

Ms. Butler then presented the Agency Asset Liability Management Report. She informed the committee that due to slower spending on capital, the agency is realizing a cash balance increase. As a result, interest income performance is around $10 million above budget. No borrowing is planned for 2020, however the last TIFIA loan for Federal Way master credit agreement is expected to be closed in December 2019.

Internal Audit Update

Gana Byambaa, Acting Internal Audit Director, presented the Internal Audit Status Update.

Internal Audits Completed

Continuous Process Improvement Program

Ms. Byambaa introduced Kayla Schoonhoven, staff internal auditor, who presented the audit results. The audit objective was to determine whether the agency has effective controls to ensure timely benefits realization following the implementation of the Continuous Process Improvement program, and to ensure continuous benefits through regular management monitoring. The audit examined management controls in place as of May 2019 and concluded that the agency has effective controls to reasonably ensure that Continuous Process Improvements realize benefits in a timely manner following implementation and continue to realize benefits through regular management monitoring.

Construction Configuration Management

Ms. Byambaa introduced Soon Kwon, senior internal auditor, to present the results of this audit. The audit objective was to determine whether the agency has effective controls to ensure as-built drawings as input to subsequent change configuration management are complete and timely compiled following the completion of construction projects, and to ensure that all operational configuration changes are completely identified, properly authorized and efficiently managed in compliance with applicable agency policies. The audit examined management controls in place as of April, 2019. It concluded that the agency has effective controls over operational configuration, but controls over complete and timely compilation of as-built drawings following construction as input to subsequent change configuration management were not adequate.

Boardmember Marchione asked if this was the responsibility of Sound Transit staff or the contractors. Mr. Rogoff informed him that both parties are responsible. Final submission of as-built drawings takes place at the very end of a project when much of the staff involved in the project have moved on. Ron Lewis, Director of Design, Engineering, and Construction Management, confirmed Mr. Rogoff's statement, and added that in practice, project teams have milestones in which most of a project's work is complete but punch-list work continues afterward. The as-built drawings are not made available, however, until the last punch-list item is complete. In response to the audit findings, staff will use better technology to obtain as-built drawings as they are changed.

Construction Progress Payment Processing

Ms. Byambaa introduced Travis Carbon, senior internal auditor, to present the results of this audit. The audit objective was to determine whether the agency has effective controls over the construction progress payment process in compliance with contractual agreements and applicable agency policies and procedures. Specific objectives included ensuring proper monitoring of the work progress to justify the payment requested and to ensure proper review of progress payment supporting documents to determine completeness and accuracy. The scope of the review was the performance period as of May 2019.

The audit found that management controls over construction progress payment process are effective to reasonably ensure proper monitoring of the work progress payment supporting documents to determine completeness and accuracy.

Partner Cost Monitoring - King County Metro

Ms. Byambaa presented the audit results. The objective of this audit was to determine whether the agency has effective controls to ensure King County Metro costs allocated to Sound Transit are allowable, allocable and reasonable, and to ensure that King County Metro costs allocated to Sound Transit are actual costs.

The audit concluded that the agency controls are not designed well to ensure King County Metro costs are actual, allowable, allocable, and reasonable. There was one finding in the Audit which was that Sound Transit controls over King County Metro's Cost Allocation Model review are limited and should be strengthened.

Boardmember McDermott asked if staff was working to address the findings of the Audit. Chair Backus explained that a full list of management responses was included within the Audit Report. Mr. Rogoff added that controls are strengthened and expenses which the agency does not agree with were removed during the recent Intergovernmental Agreement with King County Metro.

<u>Review Progress on the Internal Audit Work Plan</u>

The internal audits that are currently in progress are:

- Partner Cost Monitoring – Pierce Transit
- Budgeting During Project Development
- Work Order Process at OMF
- QA/QC Assurance Program Review

Ms. Byambaa highlighted the first two audits, mentioning that they are hold-overs from 2018. Due staffing losses, the audits were not able to be completed. She assured the committee that work was continuing on the audits and she hoped to have them complete by the next Committee meeting.

2019 Performance Audit Update

Ms. Byambaa continued to provide an update on the Annual Performance Audits. At the February Finance and Audit Committee meeting, the two performance audits were approved by the Committee to be performed in 2019. The first was an Employee Performance Management Audit. Since that meeting, the agency procured a vendor, Moss Adams, and work commenced. The second audit, the State Auditor's Office, began in April 2019 and the results were expected to be published in 2020.

Executive session

None.

Other business

None.

Next meeting

Thursday, December 19, 2019
11:00 a.m. to 12:30 p.m.
Ruth Fisher Boardroom

Adjourn

The meeting adjourned at 12:56 p.m.

Nancy Backus

Nancy Backus
Finance and Audit Committee Chair

ATTEST:

Kathryn Flores

Kathryn Flores
Board Administrator

APPROVED on December 19, 2019. AM.