PUBLIC BRIEFING

ON

THE COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) FOR FY 2004

Before the
Committee of the Whole
Council of the District of Columbia

The Honorable Linda Cropp, Chairman

February 2, 2005; 9:00 a.m.
Council Chamber

Testimony of
Natwar M. Gandhi
Chief Financial Officer
Government of the District of Columbia

Good morning, Chairman Cropp and members of the Committee of the Whole. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia Government. With me are deputy chief financial officers with whom you are familiar: Anthony Pompa of the Office of Financial Operations and Systems, Julia Friedman of the Office of Revenue Analysis, and Bert Molina of the Office of Budget and Planning. It is our pleasure to be here today to discuss the 2004 Comprehensive Annual Financial Report (CAFR). As it has come to be expected, this report was submitted on a timely basis, with an unqualified, “clean” audit opinion from the independent auditors, and reflects a healthy surplus.

OVERVIEW OF THE FY 2004 CAFR

The FY 2004 CAFR highlights the District’s excellent financial position. The rebuilding of the financial management infrastructure is virtually complete and functions well in support of the District’s elected leaders whose commitment to maintaining fiscal balance is clear. We have enjoyed eight consecutive balanced budgets with an equal number of clean audit opinions. We have a fund balance and cash reserves that are a far cry from the mid-1990s, substantially improved bond ratings and well-deserved respect in the financial markets.

The CAFR process is now routine with little concern over its timely issuance or whether the District will receive an unqualified or clean audit opinion. All of this shows that we, as a jurisdiction, can manage our financial operations well and also take care of emergencies as they arise.

However, there remain structural issues that result in poor infrastructure – such as substandard school buildings, roads, and bridges. Also, we have a much higher tax burden and higher per capita borrowing than other jurisdictions. These are hurdles that continue to challenge the District even in the course of profound financial achievement.

Local Fund Budget

The Fiscal Year (FY) 2004 CAFR indicates that the District had a surplus in local funds of $230.5 million. On the expenditure side, I am pleased to report that no District agency's expenditures exceeded its budget for any fund type. Additionally, there has been active monitoring of agency spending by the Board of Review for Anti-Deficiency Violations, and the year-end results bear that out.

The surplus is primarily the result of final tax revenues exceeding the original estimates used in formulating the budget, a process that began in the autumn of

2002. If you recall, at that time it was the eve of the Iraq war, our hospitality industry was still struggling to recover from the events of September 11th and the sniper killings, the stock market was down, and we had just had a second straight year of decline in our individual income tax revenue. Needless to say, it was a time of great economic uncertainty that guided our forecast of estimated revenues. As it turns out, FY 2004 was an economic turning point for the District and the economy, and revenue, staged a remarkable recovery. As the economic picture improved, we revised the revenue estimate three times, reflecting a substantial growth in revenues; therefore, the actual revenue should not be a surprise to anyone. Furthermore, the improved revenue picture has been incorporated into our financial plan for FY 2005-FY 2008 through the tax policy changes implemented throughout the year.

Growth in Estimates of Tax Revenue, FY 2004
($ in thousands)

Release Date of Estimate:	Feb-2003	Feb-2004	Jun-2004	Nov-2004	Actual FY 2004
Estimates: Total Tax	$ 3,373,372	$ 3,471,217	$ 3,561,295	$ 3,630,849	$3,665,194
Change in Estimate		$ 97,845	$ 90,078	$ 69,554	
Cumulative Change in Estimate		$ 97,845	$ 187,923	$ 257,477	
Pct Variance Estimate w/ Actual: Total Tax	8.0%	5.3%	2.8%	0.9%	
Months from Estimate to end FY 2004	21	9	4	NA	

There were unprecedented increases in tax revenue in FY 2004. Compared to FY 2003, tax revenues grew in FY 2004 by 11.3%, including a 22% growth in deed recordation and transfer tax collections (after dedicating 15% of the collections to the Housing Production Trust Fund), a 15% growth in real property tax revenue, and a 12% growth in individual income tax revenue. Real estate-based taxes generated half of the tax revenue growth in FY 2004, yet they account for only about 1/3 of all tax revenues in the District. The strong real estate market is evidenced by an increase in the average price of single family and condominium housing sales to over $500,000, an increase of over $112,000 in just two years. Withholdings were also up 7% from the prior year, by $60 million, and tax payments with tax returns increased by $32 million over the prior year.

As evidenced by the graph of quarterly tax receipts (*Attachment 1*), the District's revenue stream is quite volatile and subject to market forces (like the stock market and the national recession), to sudden national and local events (like September 11th, war, and sniper attacks) and to local economic forces. In estimating revenues, the District's record for FY 2004 is much like that of states and the federal government (see graph 1 in *Attachment 2)*. The fact that local real estate markets heated up progressively during the year–and reached unprecedented heights, even after rising interest rates early in the period–led to underestimates of locality-type revenues. This explosion of activity is illustrated in graphs 2 and 3, also in Attachment 2.

The District's revenue estimates must be somewhat conservative as a matter of both necessity and good financial management. Having successfully completed one financial control period, the District's leadership is very clear about not risking a second. Financial control, however well-intentioned, still means the loss of basic freedoms granted under Home Rule. Conservative estimates are at the heart of a balanced budget and adequate cash flow and, hence, at the heart of avoiding a second control period. *The District must end every fiscal year with a surplus*.

The District's original binding estimates for any fiscal year are made 21 months before that year will end—a very long time period that itself requires a conservative approach. The estimates do change over time, but the expenditure budget can change only with federal approval; this is how the District varies from all other jurisdictions in budget preparation. If revenues fall, emergency measures are needed to keep the budget in balance. Conservative estimation reduces the magnitude of these potential adjustments. It should be noted that, even with conservative revenue estimates, actual surpluses over the last three years have been modest, as indicated below:

YEAR	GAAP SURPLUS	PERCENT OF GENERAL FUND EXPENDITURES
2001	$77 million	1.3%
2002	$27 million	0.7%
2003	$32 million	0.8%

As you can see, these surpluses reflect an average of $45 million, or around 1%, of the total budget for the District of Columbia.

General Fund and Fund Balance

The General Fund results also reflect the favorable Local Fund results, as well as all other revenues and expenditures. Total General Fund revenue was $4.4 billion in FY 2004, exceeding revised budget estimates by $267 million or 6.4%. General Fund expenditures were $111 million lower than estimated, for a variance of 2.7%. The $317.6 million General Fund surplus represented 7.1% of actual General Fund revenues, with the differences driven largely by the variances in Local Fund.

As presented in the FY 2004 CAFR, the District ended the year with a General Fund Balance of $1.2 billion (see *Attachment 3)*. This means that since the beginning of FY 1997, when the General Fund Balance was a negative $518 million, the District's General Fund Balance has increased by an average of $200 million per year. This fund balance clearly indicates the healthy financial position of the District.

However, it is important that we truly understand the components of the fund balance. The principal components are $239.2 million for debt service, $194.7 million in purpose restricted funds, and $316.6 million in designations for post-retirement health benefits liability, pay go capital and FY 2005 appropriations.

Another important component of the fund balance is $285.4 million in Congressionally-mandated cash reserves and $53.8 million of undesignated and unreserved funds. Together, these last two amounts represent a cushion of one month's spending for the District, which is considered prudent financial management to be held in reserve. In sum, this leaves $42 million of fund balance, or only 3%, for the Mayor and Council to use in FY 2005 and beyond, as they deem appropriate (see *Attachment 4)*.

Bond Ratings

At the beginning of 1997, the ratings the District received from the three major bond rating agencies were B, Ba and BB. These were below investment grade, or “junk bond”, ratings. Today, due to many reasons, not the least of which is our healthy reserves, the ratings are A, A2 and A- (Standard and Poor’s, Moody’s, and Fitch, respectively), which are considered to be sound investment grade ratings. These improved ratings help reduce the District’s borrowing costs. Our financial advisors estimate that the effect of the upgrades on our recent bond and note sales was an annual savings of more than $1 million in debt service and fees. These upgrades will also benefit future bond issues. For example, if the District were to issue $300 million in general obligation bonds, the savings in debt service alone are estimated at $2.6 million over the life of the bonds.

Cash Reserves

Three credit rating agencies cited the District’s Emergency/Contingency Cash Reserves as a positive factor in their analysis and decision to upgrade the District’s ratings (see *Attachment 5)*. Other cities and states have similar emergency/cash reserve requirements but we know of no other city with such a strong cash funded requirement. Among states, most have some form of relatively flexible cash reserve or “rainy day” fund:

- The average size of these funds is approximately 5 percent of budget;
- Most states have no replenishment requirement, but 6 states require the funds to be replenished over the course of 2, 3, or 5 years; and

- In 21 states, the reserve funds can be used when the state faces a deficit for any reason, and in most other states the funds can be used in the event of a revenue shortfall.

The cash reserve requirements constrain the District's flexibility to manage its cash flow. During the development of the FY 2005 budget, in recognition of the District's improved financial condition, Congress agreed to make changes to the District's cash reserve requirements. The impact of the changes will reduce the overall requirement from seven to six percent (two percent Emergency and four percent Contingency); modify the requirement for replenishment from one year to two years with no less than 50 percent being paid back in the first fiscal year after use; remove from the calculation of the percent of cash reserve those expenditures associated with debt service for which a separate reserve is already maintained under the District's Home Rule Act; and change the basis of the calculation of the emergency and contingency cash reserves from local fund expenditures as proposed in the District's upcoming fiscal year budget, to local fund expenditures as calculated in the Comprehensive Annual Financial Report. These changes will modestly reduce the amounts set aside for emergencies while still providing a reasonable cushion to protect the fiscal position of the District and distinguish it among other major cities and states.

FINANCIAL MANAGEMENT IMPROVEMENTS

Yellow Book Report

The District continues to make great strides in financial management. A clear indication of this can be found in the Independent Auditors Report on Compliance and on Internal Control over Financial Reporting. This document, commonly called the "yellow book" report, lists no material weaknesses and only two reportable conditions. Material weaknesses and, to a lesser degree, reportable conditions are significant deficiencies in the design or operation of internal control over financial reporting. This is the first time since before the control period that the District was not reported to have any material weaknesses, the more significant category of deficiency. For FY 2001, the District was found to have three material weaknesses and six reportable conditions. To have finally eliminated all material weaknesses and to have reduced the number of reportable conditions to two is most noteworthy for what it reveals about the vast improvements in the financial infrastructure of the District. We will, nevertheless, continue to strive for further improvements.

Budget Execution: Grants Management

Grants administration continued to improve throughout FY 2004. District agencies spent approximately $1.630 billion in federal operating grants (including

Medicaid) in FY 2004, up about 12 percent from $1.455 billion in FY 2003. The Office of Budget and Planning processed over 1,000 grant budget modifications during the year for Council approval.

As we have noted in the past, most unspent grant budget authority at year-end is for grants that continue in the following year. In FY 2004, the revised federal grant budget was about $1.90 billion, while spending, as noted above, was $1.63 billion. Of the approximately $270 million in unspent budget authority, about $4.7 million represents lapsed grants—that is, grants that expired and were not extended. Budget authority for the remaining $265 million will be re-established in FY 2005. As always, we are working diligently with agencies to ensure grants are fully spent to the extent possible.

Budget Execution: Systems Improvements

We remain committed to monitoring and controlling expenditures through the use of new budget and accounting systems. In FY 2003, the District began implementing various improvements in financial management: the local anti-deficiency law to deter agency overspending and the CFO$ource to allow agency directors and finance staff to track spending versus budget more quickly. In

FY 2004, we developed the CFO$ource executive-level "dashboard" to provide operating budget, contract performance, and other management information to agency directors, and other managers to more effectively manage their budgets and programs. With the success of the "dashboard" in providing information for decision making, we recently rolled out the latest release of the CFO$ource Dashboard to provide more detailed information on purchase orders. We will continue to improve our financial management systems.

LOOKING AHEAD

Other Post-employment Benefits (OPEB)

District law requires the District government to provide health and life insurance benefits to retirees first employed by the District after September 30, 1987 ("Other Postemployment Benefits" or OPEB). Under the law, the District pays 75% of the cost of health insurance, and up to 33% of the cost of life insurance for retirees. The District also pays 75% of the premium for retirees' spouse and dependent health insurance coverage. (Employees and retirees of the District government first employed before October 1, 1987 are eligible for Federal health and life insurance benefits).

As opposed to retirement plans in other cities and states, the District's retirement plan is a new one for the District government, and we have very few recent retirees we currently pay for. However, the District's liability is going to grow rapidly. As of October 1, 2004, the actuarial liability was calculated at $483 million, which is projected to grow to $1.5 billion over the next 10 years (see *Attachment 6)*. Other established retirement plans do not have that sort of growth.

In the face of this rapid growth, we only have $38 million currently set aside in this fund. To address this looming liability, management has designated an additional $200 million be set aside from the FY 2004 fund balance. This will help alleviate the impact on the FY 2008 budget and forward.

Capital Projects Fund

The District improved its spending rates on capital projects from 2002 to 2004 and agencies continue to make substantial improvements in the implementation of their respective projects. Although more capital projects have been completed, there is currently a fund shortage of $250 million. This shortage is partly due to the timing difference between spending and borrowing and unfortunately also reflects spending at faster rates than bond proceeds are deposited. For this reason, as one step in eliminating the shortage, management has designated $40 million of the

General Fund Balance towards the capital projects fund. Other initiatives which will continue to reduce the shortage, in subsequent fiscal years, include a combination of operating transfers from the General Fund, reductions in capital budget authority and lower annual spending in capital programs.

Continuing Financial Stability

In summary, what do I see in the future for the District and its ability to sustain all that it has accomplished in the past eight years? In many respects I see a very bright future. The City's elected leadership possesses a steadfast commitment to fiscal responsibility that is becoming widely recognized, most notably in the financial markets where the District is enjoying its highest bond ratings in more than a decade. The District's leaders also realize that District taxpayers carry a heavy tax burden compared to other jurisdictions. In response to this, as the outlook for revenue improved across FY 2004, policy leaders responded with a number of tax reductions and rollbacks. The 25% cap on increases in real property tax on owner-occupied housing was reduced to 12%. The 1.5% tax rate on deed recordation and on deed transfers was rolled back to 1.1% as of October 1, 2004. The next stage of the Tax Parity Act was implemented, dropping the top individual income tax rate (which starts at incomes of $30,000 and above and reaches 40% of District tax payers), from 9.3% to 9.0%, effective January 1, 2005, and the 11% tax rate on gross receipts of public utilities and toll telecommunications businesses was rolled-back to 10%, effective January 2005. The effect of these tax reductions and rollbacks will be to save taxpayers more than $900 million over the next 5 years.

Structural Imbalance

But, there are major challenges. Even with the District's strong financial position, we still struggle with the structural imbalances that were recently validated by the General Accounting Office. Unlike many of the other problems that the District has faced and resolved in recent years, this is a problem that the District cannot solve on its own. It must receive assistance from the federal government. The District has proven that it has the resources and ability to manage its service delivery responsibilities. It is in the area of maintaining the infrastructure of the District that the assistance is needed. The District cannot "borrow" its way out of this problem. Our debt policy and sound fiscal management dictate that we are at our debt limit; our per capita debt is the highest among any major city in the country. Much of our property and much of the income earned in the District cannot be taxed, leaving our residents with one of the highest tax burdens in the Nation. Specifically, the District cannot tax non-resident earnings. This means we cannot tax the income of workers who commute into the District who account for 2/3rds of the income earned within the District. Also, a disproportionate amount of real property within the District is owned by tax exempt entities, including the government, educational and religious institutions, and not-for-profits. Furthermore, we are unable to tax, in any way, the city's largest employer: the federal government. Additionally, of the 10 largest non-governmental employers in the District, not one pays franchise taxes and only one pays property taxes. This imbalance places an undue burden on the citizens of the District and has resulted in the highest per capita debt burden of any major city in the nation. The assistance from the federal government is the only solution that I can offer at this time. We must continue to call on Congress and the President to recognize the remarkable improvement in fiscal stability and independence that the nation's capital has made in the post-control period, and ask for a reasonable level of financial assistance to resolve the larger infrastructure problem.

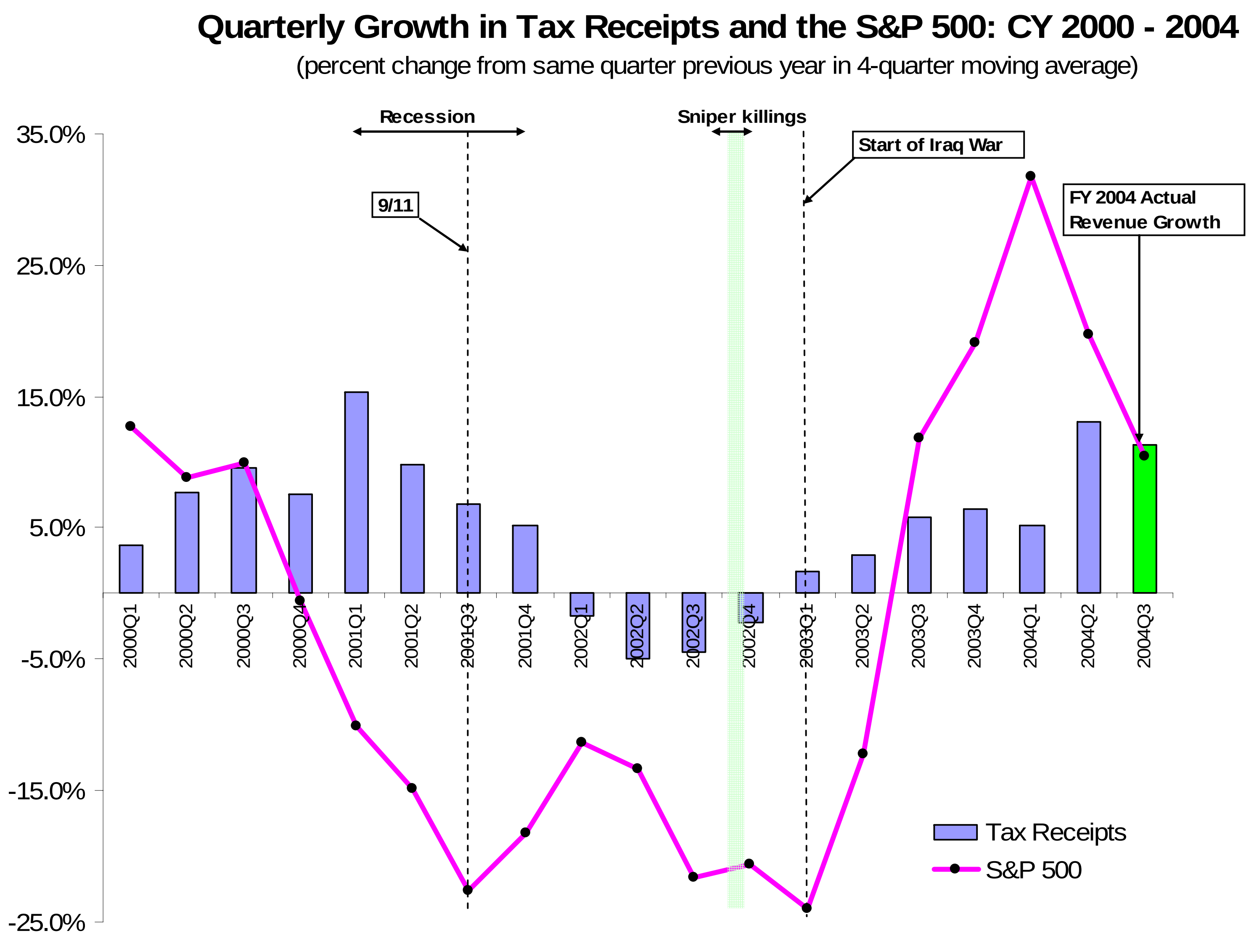
CONCLUSION

I want to take this opportunity to thank the many employees, from both the financial and program areas, who have worked so long and hard to ensure the successful closure of the District's books and the maintenance of the high-quality records required for an unqualified audit opinion. In particular, I want to commend Tony Pompa, the DC Controller, his deputy, Bill Slack, and the rest of the team at the Office of Financial Operations and Systems, for their hard work and dedication. I would also like to thank the rest of my senior management team and their staff: Bert Molina, Dr. Julia Friedman, Anthony Calhoun, Dan Black, Barbara Jumper, Henry Mosely, Deloras Shepherd, Pamela Graham, Steward Beckham, John Musso, and Chris LaCour. The District owes them its thanks.

I also want to thank the public accounting firm of KPMG and their subcontractors, Bert Smith, TCBA, and Gardiner Kamiya. Their highly professional staffs worked equally long and hard during the past few months to successfully complete this audit. In particular, I want to commend Karyn Molnar, Howard Simanoff, and Hamida Karama for their efforts.

Let me also extend my deepest thanks to the Mayor; to you, Mrs. Cropp; to Mr. Evans; to the Council; and to the Inspector General for their guidance, support and oversight of the process over the past few months. Their leadership and commitment to fiscal prudence was an essential part of this successful endeavor.

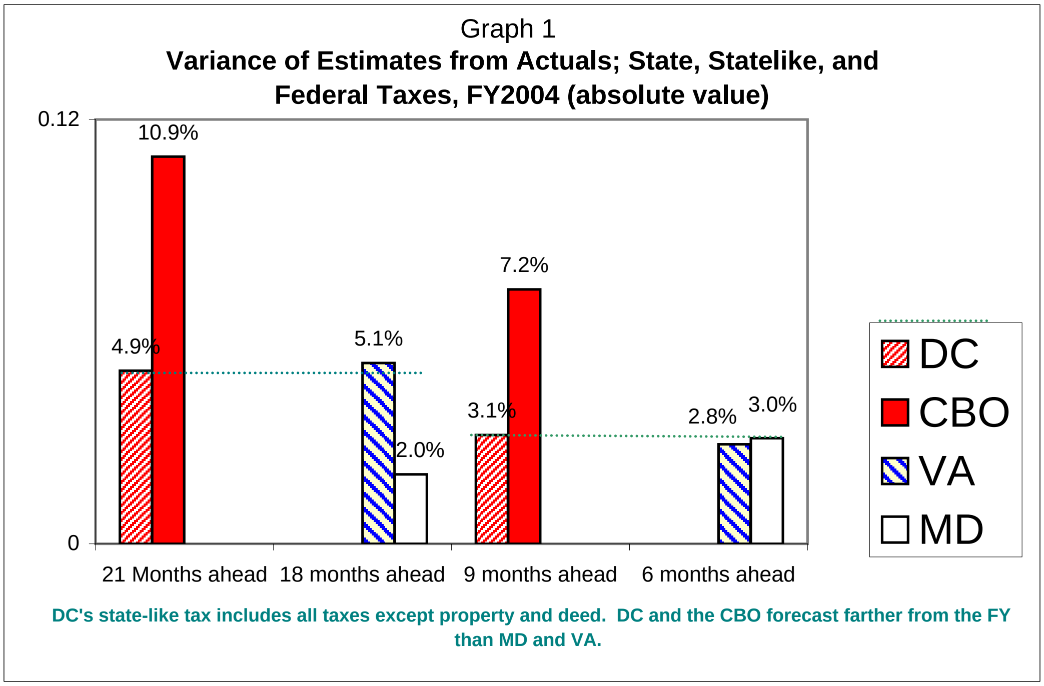
This concludes my remarks. I would be pleased to answer any questions you may have.



ATTACHMENT 1

Facts about D.C.'s revenue surplus for FY2004:

1. D.C.'s revenue estimating activity and accuracy is not unusual, as shown in the chart below, for state/federal-like taxes.

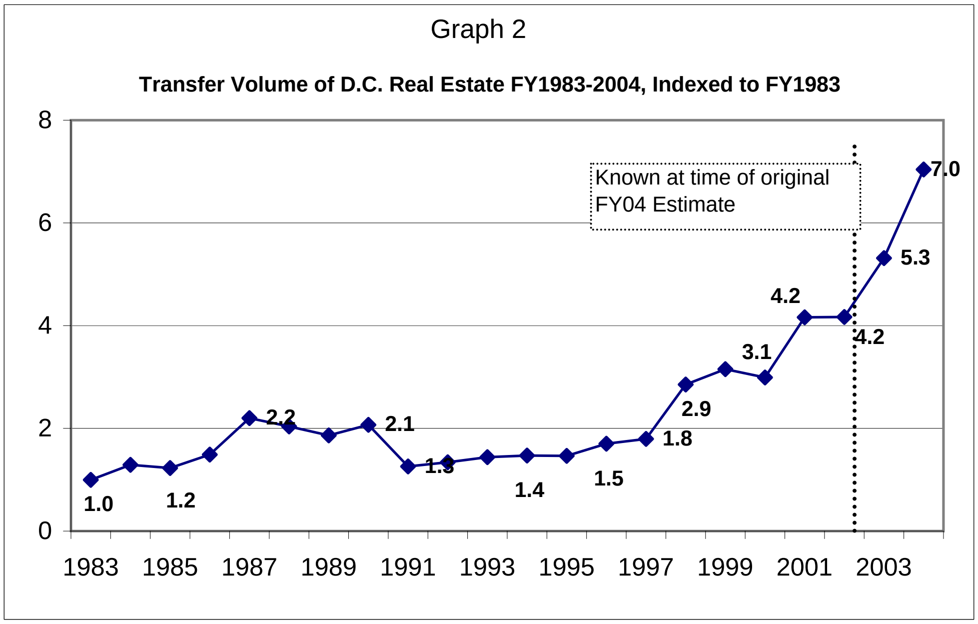


When compared to the Congressional Budget Office Estimates, D.C.'s estimate of state/federal-like tax revenue performs better.

Maryland and Virginia estimates are closer to the fiscal year. D.C.'s performance is as good as VA and, at DC's 9-month mark, comparable to MD at 6-months.

2. In FY2004, the estimates of LOCAL tax revenues (not needed by the States of MD and VA or by the US) were very difficult to calibrate.

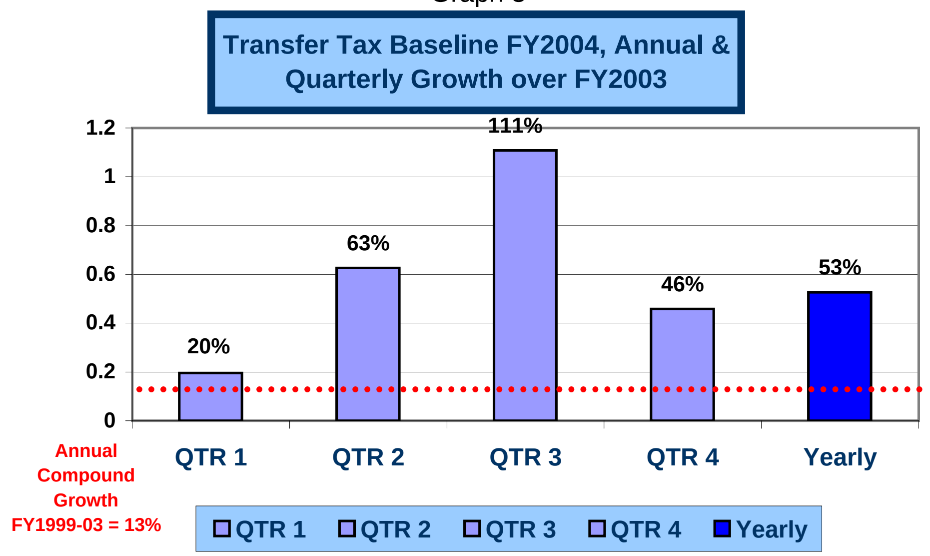
Overall, the volume of transactions in real estate was astonishing in FY2004, and not possible to predict in advance.



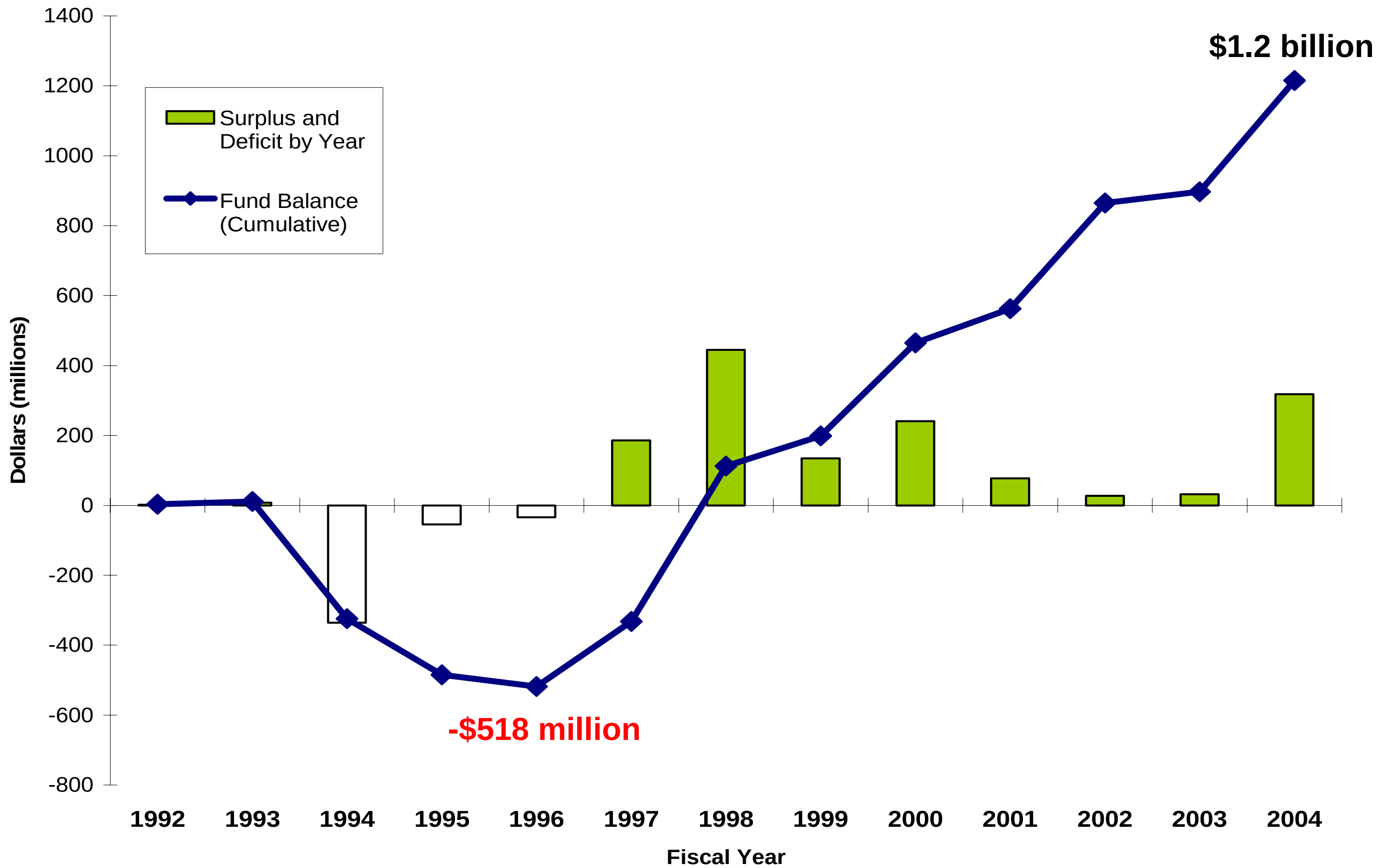
Activity in the real estate market was driven by 1) the continuing rise in price of housing and number of housing sales and 2) the market for commercial property and, particularly, 3) purchases of commercial property for investment purposes by buyers from all over the world. Ownership of some commercial buildings turned over several time in FY2004.

Like industry analysts, OCFO/ORA has found it difficult to determine how long this transactions expansion will continue. For FY2004, the estimates increased as we observed the activity in the market.

Graph 3



General Fund Balance History



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
S&P:	A-	A-	A-	BBB-	B	B	BB	BBB	BBB	BBB+	BBB+	A-	A
Moody's:	Baa	Baa	Baa	Ba	Ba	Ba2	Ba1	Ba1	Baa3	Baa3	Baa1	Baa1	A2
Fitch:		A-	BBB+	BB	BB	BB	BB+	BB+	BBB	BBB	BBB+	A-	A-

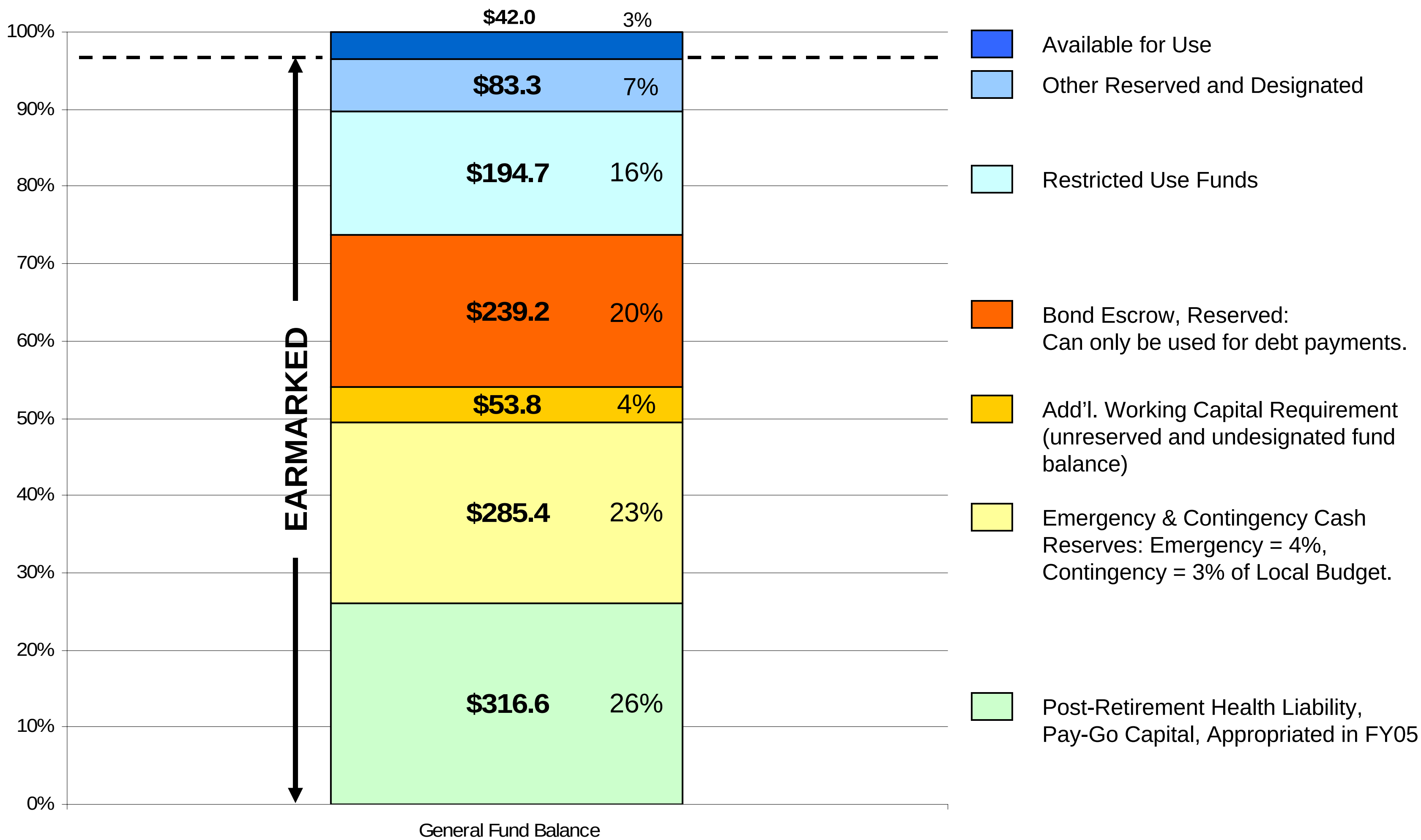
Control Period

Revitalization Act

ATTACHMENT 3

FY 2004 General Fund Balance

($ in millions)

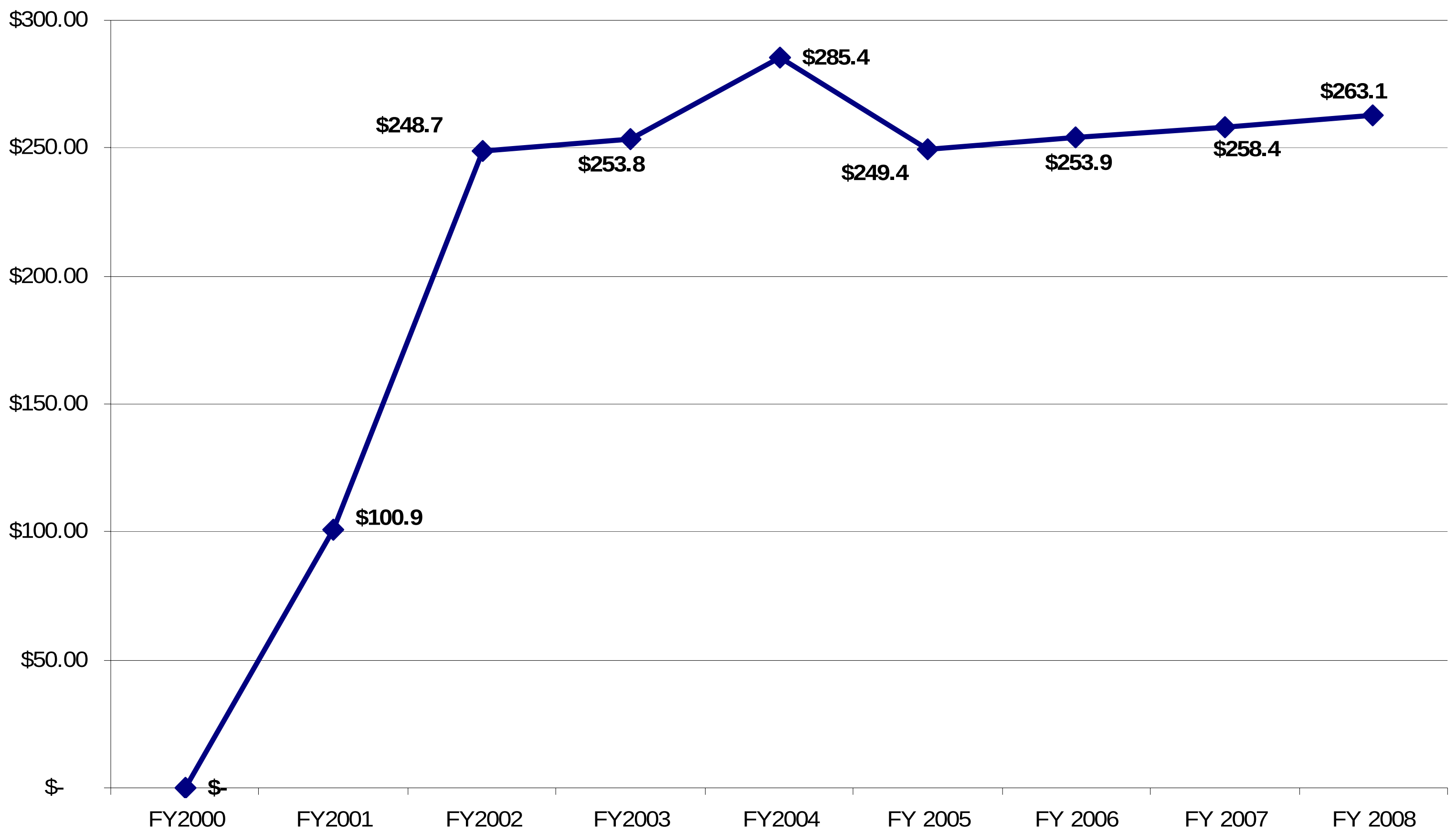


Total as of September 30, 2004: **$1,215.0 million**

ATTACHMENT 4

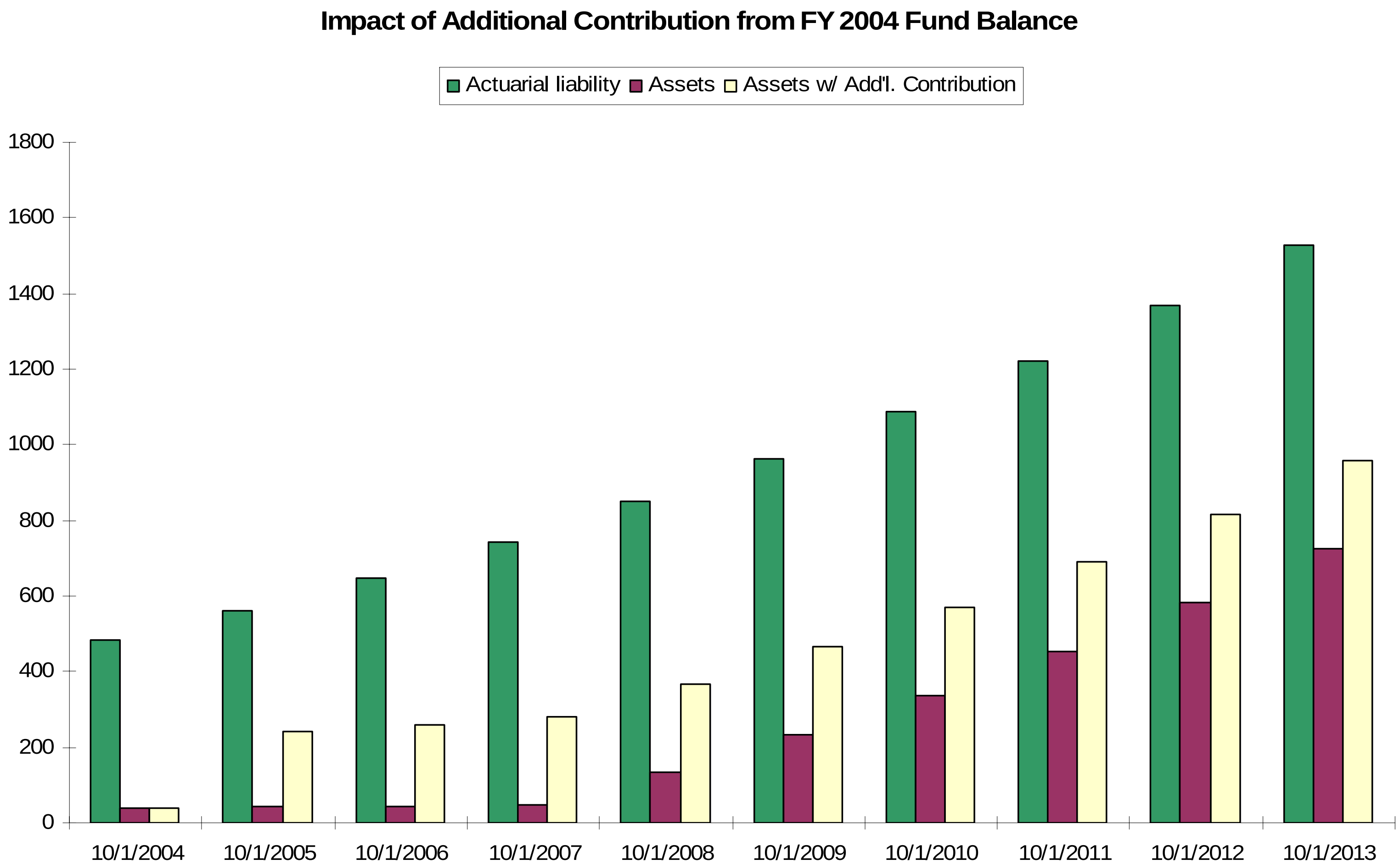
Emergency/Contingency Cash Reserves

($ in millions)



ATTACHMENT 5

Post-Employment Benefits



ATTACHMENT 6