OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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IBA Review of the Mayor's Five-Year Financial Outlook for FY 2012 – 2016

OVERVIEW

The Mayor issued the Five-Year Financial Outlook for Fiscal Years 2012-2016 on February 7, 2011. It represents the fifth iteration in the series of long-term financial outlooks developed under Mayor Sanders.

The Mayor's Outlook and the IBA's review were presented to the Budget and Finance Committee on February 9, 2011. The Committee voted to forward the items to the City Council with requests for additional information from Financial Management (FM) and the IBA.

The Budget Committee requested FM to:

- Adjust the Outlook to include the Ballpark Debt transfer and other budget corrections
- Provide details on new facilities (with associated costs and FTEs)
- Provide explanation on how the new facilities were selected
- Estimate impacts of fiscal reforms, department consolidations, organizational flattening and service reductions

The Budget Committee requested the IBA to:

- Develop a more candid and complete assessment, including:
    - calculation of the deferred maintenance deficit
    - incorporation of vacancy factor and step increases
    - unfunded portion of the Main Library project
    - additional details as identified in the IBA presentation

The FY 2012-2016 Outlook reflects significant deficits in each year of the forecast period, though amounts are lessened compared to previous versions. Annual deficits range from $56.7 million in FY 2012 improving to $8.8 million in FY 2016. When adjusted for the impact of the payment by the Redevelopment Agency for the Ballpark

Debt in the amount of $11.3 million beginning in Fiscal Year 2014, the deficits are reduced accordingly in Fiscal Years 2014 and 2015 and a surplus of $2.5 million results in Fiscal Year 2016.

The Outlook describes that the Mayor is committed to bringing the Five-Year Outlook into balance by FY 2013 and a status of the ten fiscal reforms is provided. However, not all reforms can be completed in time to achieve the benefit of deficit reduction for the FY 2012 budget. In addition, some Council priorities are not addressed.

The IBA's review and analysis typically relies on comparisons with prior year actual results, and current year projections, however, neither of these were available, though should be forthcoming shortly. The unavailability of this data hampered our review efforts, especially our ability to check for reasonableness compared to current year experience.

This report begins with a high-level review of the State Budget Impacts and General Fund revenue projections, focusing primarily on areas of concern, and significant changes that warranted further review. General Fund expenditures are then discussed, including pension and retiree health costs, and new facilities and significant funding areas, such as deferred maintenance. The report concludes with discussion of the IBA's Outlook Scenario as requested by the Budget and Finance Committee, which reflects additional needs and a more likely depiction of the budgetary situation that will need to be addressed over the next five years.

STATE BUDGET IMPACTS

The Outlook notes the elimination of redevelopment agencies as proposed by Governor Brown could have a negative impact on the General Fund by eliminating tax-sharing agreements and related payments, and by discouraging investment that could strengthen City sales tax and transient occupancy tax revenues. It is important to note that some positive impacts to the General Fund may ultimately result from the elimination proposal, due to the allocation of tax increment revenues back to local agencies which could occur starting as soon as FY 2013. The IBA and Financial Management staff will work together to monitor and analyze the redevelopment proposals as they continue to develop at the State level, and measure the impacts to San Diego and its General Fund.

In the event tax extensions proposed by the Governor for state sales, vehicle registration and income taxes are not approved by voters, it is possible that State funding for public safety grants could be eliminated. Initial information shows that discontinuation of this funding could result in the loss of $1.65 million in grant funding for the Police Department, which has been utilized to provide funding for computer, radio and other equipment, among other items, for police officers. At this time it is not clear if elimination of this funding will directly impact the City's General Fund.

GENERAL FUND REVENUE

The Five-Year Financial Outlook projects General Fund revenue to increase $135.7 million, or 12.6% over the forecast period. Much of this increase is attributed to growth in four major General Fund revenues: property tax, sales tax, transient occupancy tax, and franchise fees, which in total comprise at least 69% of the total General Fund revenue during the five year period.

Overall, the projections are in line with current economic forecasts, but the IBA has concerns on whether Property Tax projections are too optimistic in light of forecasts of a likely gradual multi-year recovery from the current recession.

Property Tax
Varying factors will impact Property Tax revenues, leading to possible negative growth in FY 2012, and a slower than forecasted recovery in the outer years of the forecast. Because of these impacts, the pessimistic forecast for Property Tax in the Outlook may be a more appropriate estimate of future receipts.

The California Consumer Price Index (CCPI) that is applied as assessed valuation growth for properties that have not changed ownership or had structural improvements in the past year is 0.753 for the FY 2012 property tax roll. This growth rate is applied to approximately 70% of properties. Although it demonstrates improvement from the negative CPI of 0.2 for FY 2011 property tax roll, it may not be enough growth to offset other factors that can negatively impact the forecast.

Properties that received Prop 8 temporary reassessments to reflect market conditions may not increase in value on the roll due to relative flat growth in market values since the reassessments were conducted.

More recent information from the County Assessor's Office conveys that although the number of appeals filed has declined, refunded amounts resulting from assessment appeals will increase in FY 2011 due to the resolution of prior year appeals. These reassessments will lower values in the property tax roll for FY 2012 and beyond. Despite the fact that commercial property comprises only approximately 30% of properties in the City, the magnitude of commercial reassessments will negatively impact overall assessed valuation growth. Commercial property is property expected to be in distress for up to three more years.
The IBA Outlook Scenario reflects the impact of utilizing the "pessimistic" estimates for Property Tax over the course of the Outlook, which would reduce revenues, and thus increase the deficit, by $3.8 million in FY 2012, and escalating each year to $21.0 million in FY 2016.

Sales Tax

Sales Tax revenues have demonstrated performance over projections thus far in the fiscal year. The current base year projection for sales tax reflects 2.0% growth over previous year performance for the remainder of the fiscal year. The most recent quarter receipts (reflecting sales activity July –September 2010) demonstrated growth of 4.3% over the previous year, which bodes well for even higher sales tax receipts than forecasted in the Outlook.

Fines, Forfeitures and Penalties

In November 2010, the Council authorized an increase in parking citation fees for State-mandated surcharges previously paid by General Fund. At that time, it was estimated to save the General Fund $1.75 million in FY 2011 mid-year, and $3.5 million in FY 2012 and beyond. The Outlook reflects annual revenue of $3.2 million annually, which is reduced $300,000 from earlier estimates. The IBA understands that these estimates are currently under review by the Police Department, and may revert to the $3.5 million level in the FY 2012 Proposed Budget.

Interest Earnings

Estimated interest earnings are projected to grow by approximately 360% over a three-year period from $1.7 million in FY 2012 to $6.1 million in FY 2014. The forecasted increase is based on the expected stabilization/recovery of the financial markets and anticipation that the yield on the Pooled Investment Fund will gradually increase to its historical long-term average over the next few years. In the current low interest rate environment, the yield on pooled assets fell to approximately 1% in December 2010. It is reasonable to expect that interest earnings will increase as the pool's short-term investments are reinvested at marginally higher rates.

TOT Fund/Special Promotional Programs

Per the Municipal Code, 5 ½ cents of the City's 10 ½ cent TOT levy are deposited directly into the General Fund, while 5 cents are deposited in the TOT Fund and allocated via the Special Promotional Programs budget. Of the 5 cents deposited in the TOT Fund, the Municipal Code requires that 4 cents be used for the purposes of promoting the City, while the remaining 1 cent can be used for any purpose as directed by the Council. For the past several years, this discretionary 1 cent of TOT funding has been transferred back to the General Fund.

In FY 2009, the City also began allocating a portion of the 4 cents required to be used for promotion to the General Fund for "promotional-related" expenditures, such as park and facility maintenance in popular tourist areas. In FY 2011, approximately $10.3 million was allocated to the General Fund for various promotion-related expenditures. The Five-Year Outlook assumes that this practice will continue, and that any "excess" funding in the TOT Fund will be allocated to the General Fund in this manner. In each year of the forecast period, the amount of excess funding is determined by the overall growth in TOT revenue, as well as adjustments in other TOT funding obligations. The Outlook includes the following significant adjustments in TOT funding commitments:

- A $3.5 million reduction in the allocation for debt service on the Mission Bay/Balboa Park Improvement Bonds in FY 2012 due to retirement of the Series 1996A issuance;

- A $4.5 million increase in the allocation for debt service on the Convention Center Expansion Bonds in FY 2015 due to expiration of the annual contribution from the Port District.

In addition, the Outlook also included an $11.3 million increase in the allocation for PETCO Park debt service in FY 2014 due to the termination of payments from the Redevelopment Agency under the Second Amendment to the Ballpark Cooperation Agreement. However, on February 8, 2011, the City Council and Agency Board approved the Third Amendment to the Ballpark Cooperation Agreement, which will extend the Agency's payments through FY 2032. As discussed at the Budget & Finance Committee on February 9, the Committee requested that the Outlook be revised to reflect this action. As a result, TOT allocations in FY 2014 – FY 2016 for debt service will be reduced, and then increases to TOT transfers will result in increased revenues to the General Fund, improving the deficit in each year.

GENERAL FUND EXPENDITURES

General Fund expenditures increase $81.8 million over the five year period as shown in the Outlook. The largest area of increase is Retirement/Pension of $63 million, which comprises over 77% of the total increase. The next largest increase is due to two planned bond issuances for deferred capital projects ($14.8 million) in the "Other" expenditure category.

Salaries and Wages
The Outlook reflects no salary increases or restoral of the previous 6% compensation reduction for next five years. Assuming no salary increases will be negotiated and agreed to over a five-year period could be considered unrealistic for financial planning purposes. Consideration should be given to assessing the impact of potential salary increases to provide a reasonable forecast of General Fund requirements over the next five years.

The IBA Outlook Scenario shows the impact of a potential salary increase option, reflecting 2% annual increases for all employee groups in FY 2013 and again in FY 2015. An added impact related to the variable fringe benefits as a result of higher salaries of approximately 20% has been included in the estimates, which total approximately $10 million annually in FY 2013 and FY 2014, doubling to $20 million in FY 2015 and FY 2016. This does not consider the added future costs to the pension system.

The Outlook discusses Vacancy Savings, though no longer reflects amounts as a separate line item. The annual Vacancy Savings has been adjusted by $1.7 million to correct the current FY 2011 budgeted amount which has been said to have excessively reduced the

Park and Recreation, and Library Department budgets, negatively impacting their ability to stay within budgeted levels. Unfortunately, these estimates could not be isolated or properly evaluated given the limited information.

Annual Leave Liability

Annual Leave Liability, previously referred to as funding of "Deferred Retirement Option Plan (DROP) participant leave balances", "terminal leave", or "Accrued Leave Liability" represents the cost for annual leave that an employee has accrued and must be paid upon their departure from the City. Annual Leave Liability reflects the annual payment for all forms of departure, including termination, resignation, retirement, and/or retirement of DROP participants. The estimates included in the Outlook are based on the actual number of DROP participants, expected leave dates, and respective leave balances.

In the past, departments absorbed this expense when it occurred. However, as shown in FY 2009, the General Fund experienced increased costs for this purpose, and reserve funds were needed to supplement the budget of the Fire-Rescue Department. The annual amounts for Annual Leave Liability have been significantly reduced from $16 million to $6.3 million in FY 2014, compared to the prior Outlook.

Retirement/Pension

In January 2011, the San Diego City Employees' Retirement System (SDCERS) actuary presented the June 30, 2010 actuarial valuation for the City. The valuation reveals that the City's June 30, 2010 Unfunded Actuarial Liability (UAL) is $2.15 billion, up from $2.11 billion at June 30, 2009.

The City's FY 2012 Annual Required Contribution (ARC), which is based on the June 30, 2010 valuation, totals $231.2 million – an increase of $2.1 million over the FY 2011 ARC of $229.1 million. The impact to the General Fund is an increase of $1.6 million – from $177.6 million to $179.2 million.

Notable reductions built into the FY 2012 ARC include those resulting from the following: a general salary freeze assumption for FY 2011, anticipated corrections of underpriced purchased service contracts, payment of the remainder of the McGuigan settlement, and negotiated pension plan changes effective July 1, 2009.

The total reduction incorporated within the FY 2012 ARC for the FY 2011 general salary freeze is approximately $8 to $9 million (a more exact figure could not be obtained). SDCERS' actuary (Cheiron) has provided ARC projections through FY 2040, with the general salary freeze assumption included only for FY 2011. Thereafter, the general 4% salary increase assumption is applied. Subsequent years' ARC reductions are anticipated if the salary freeze assumption were to be applied beyond FY 2011. For example, Cheiron's current projection for the FY 2013 ARC of $256.6 million would be reduced if the general salary freeze assumption was applied for FY 2012, rather than applying the 4% salary increase assumption. Likewise, the general salary freeze assumption application to all years in the Five-Year Outlook would have the impact of reducing each year's ARC.

Also included in the FY 2012 ARC is a reduction based on anticipated SDCERS corrections of underpriced purchased service contracts that occurred during the 2003 "window period." These contracts must be corrected pursuant to a court order, which was upheld on appeal. The related reduction to the FY 2012 ARC equals $8.8 million, which includes $4.4 million that is associated with the FY 2011 ARC but was not incorporated in the FY 2011 ARC. For further information on these underpriced purchased service contracts, see page one of the June 30, 2010 Actuarial Valuation for the City of San Diego, "Section I, Board Summary," under the "Valuation Basis" section.

During FY 2010, the residual amount owed to the pension system resulting from the McGuigan settlement, approximately $38.3 million, was financed and paid to the pension system. The related FY 2012 ARC reduction is estimated to be $3 to $4 million (a more exact figure could not be obtained. Note that the four-year debt service payments on the financing related to the McGuigan settlement are approximately $9.0 million annually, of which $7.9 million would be paid from the General Fund. The annual $7.9 million in debt service payments is incorporated into the Five-Year Outlook (in Attachment I) as a separate line item from the regular estimated pension payments.

Lastly, the FY 2012 ARC includes savings from negotiated pension plan changes effective July 1, 2009. The most recent estimates associated with these pension plan changes show an ARC savings that increases from $1 million in FY 2012 to $3.9 million in FY 2016. Pension plan changes are discussed further in the section entitled, "Current Pension Plan Changes," below.

The pension forecast for FY 2012 through FY 2016 is based on projections from SDCERS' actuary, Cheiron.

Pension Forecast (in millions)	**FY 2011 Budget**	**FY 2012 Forecast**	**FY 2013 Forecast**	**FY 2014 Forecast**	**FY 2015 Forecast**	**FY 2016 Forecast**
Citywide Payment	$ 229.2	$ 231.2	$ 256.6	$ 276.2	$ 294.7	$ 312.5
Increase from FY 2011	*N/A*	*$ 2.0*	*$ 27.4*	*$ 47.0*	*$ 65.5*	*$ 83.3*
General Fund Payment	177.6	179.2	198.9	214.1	228.4	242.2
Increase from FY 2011	*N/A*	*$ 1.6*	*$ 21.3*	*$ 36.5*	*$ 50.8*	*$ 64.6*

Current Pension Plan Changes

For General Members hired on or after July 1, 2009, the defined benefit pension plan has been modified (referred to as Tier 2 of the pension plan): the benefit cap decreased from 90% to 80% of final compensation; final compensation was redefined as the average of the three highest years during membership, rather than the highest one year period; and retirement calculation factors were adjusted.

Furthermore, General Members hired on or after July 1, 2009 will not be eligible for the Supplemental Pension Savings Plan, but will be entered into the new Defined Contribution pension plan, which will be funded by a 1% employee contribution and 1% City contribution.

For sworn police officers hired on or after July 1, 2009 (Tier 2 pension), the Defined Benefit pension plan's retirement factors changed, so that an employee will not be entitled to a retirement factor of 3% until he or she reaches the age of 55. For employees hired before July 1, 2009, the 3% factor is available once an employee reaches the age of 50.

<u>OPEB – Retiree Health</u>

The OPEB (Other Post Employment Benefits) Annual Required Contribution (ARC) for FY 2012 is $98.5 million. However, payment of the full ARC is not legally required. The FY 2012 forecasted retiree health contribution of $57.8 million is 59% of the FY 2012 ARC.

The FY 2012 ARC of $98.5 million decreased by $21.8 million compared with the FY 2011 ARC of $120.3 million. One significant reason for the decrease is in the following assumptions.

- For the June 30, 2009 valuation, upon which the FY 2011 ARC is based, the retiree health benefit escalator was suspended at the FY 2009 benefit level ($8,880 per year) between July 1, 2009 and June 30, 2011 for all unions and unrepresented employees.

- For the June 30, 2010 valuation, upon which the FY 2012 ARC is based, the retiree health benefit escalator was suspended at the FY 2009 benefit level ($8,880 per year) between July 1, 2009 and June 30, 2011 for all unions and unrepresented employees, except POA and Local 127 – for which the suspension is assumed in perpetuity (i.e. the escalator is eliminated).

- The difference between the two valuations is as follows: in the June 30, 2009 valuation, the suspension of the escalator is for only two years for POA and Local 127; and in the June 30, 2010 valuation, the suspension is in perpetuity for POA and Local 127.

The other significant reason for the decrease in the ARC is there are less lives to value in the June 30, 2010 valuation data. The number of lives in the retiree health system decreased by 1,205, and the system is closed to new members as of July 1, 2005.

The City is currently preparing for negotiations with all of its labor unions regarding the appropriate level of retiree health benefit. It is anticipated that there will be agreement on a new benefit level that will be effective July 1, 2011. Regardless of the outcome, the City anticipates budgeting $57.8 million for all years in the Five-Year Outlook.

If the retiree health benefit were to remain at its current level, it is anticipated that the ARC would increase during the Five-Year Outlook, from its FY 2012 level of $98.5 million. With only $57.8 million anticipated to be budgeted each year, there would be an underfunding of the ARC during each year of the Outlook. Inclusion of the General Fund portion of the FY 2012 ARC underfunding ($28.3 million) would bring the FY 2012 deficit to $85.0 million. Note that as of the date of this report, the IBA was unable to obtain ARC projections, based on the current benefit level, for years after FY 2012.

According to the City's Budget Policy, the Outlook should "include the following amounts for each of the forecast's five years for retiree health care: the Annual Required Contribution (ARC); pay-as-you-go costs; and the unfunded liability, based on the following two scenarios:

1. Based on current funding strategy of pay-as-you-go amount plus some additional amount for pre-funding future liability for retiree health (lower than the ARC).
2. Based on payment of the full ARC each year."

While payment of the full Annual Required Contribution (ARC) for retiree health care costs is not legally required, Guiding Principle #10 calls for a plan to fully fund the Retiree Health Care ARC.

Additional amounts needed for full ARC payment without reforms:

	City-wide	General Fund
FY 2012 OPEB ARC without reforms:	$98.5 million	$68.5 million
Current Amount in Outlook:	$57.8 million	$40.2 million
Additional needed to fund ARC	$40.7 million	**$28.3 million**

The IBA Outlook Scenario includes the impact of payment of the full ARC for Retiree Health Care, assuming the ARC remains unchanged for each year of the Outlook period, and without any reforms or changes to the level of benefits.

Ninth Council District

The Outlook includes $325,000 for the ninth Council District operating budget in Fiscal Year 2013 and $650,000 in annualized expenses starting in Fiscal Year 2014. It is unclear if the Outlook includes expenses related to the build out of the Tenth floor in the City Administration Building to accommodate the new district. The Council Administration Director is currently working with the Engineering & Capital Projects department to review options for the build out and develop an estimate to complete.

Non Personnel Expenditures

The expenditure categories of Supplies, Contracts, and Information Technology have zero annual growth or inflation applied in each year of the Outlook. Funding has been eliminated due to one-time expenses that no longer require funding, and additional amounts are said to be included for election costs. No savings appear to be assumed for Information Technology as a result of the competitive process which is underway. The Energy & Utilities categories reflect annual growth of 5%, which is consistent with prior Outlooks.

Though not described in the Outlook, funding for Community Plan Updates has been increased from $800,000 annually from prior Outlook versions to:

- $1.2 million in FY2012
- $2.8 million in FY2013
- $2.15 million in FY2014
- $250,000 in FY2015

The "Other" category includes transfers, and debt payments, including Mission Bay Lease Revenues, and some transfers to Reserves.

Mission Bay Lease Revenues

Mission Bay lease revenues are projected to grow by two percent annually. Proposition C, approved November 2008, amended the City Charter to establish a threshold amount of Mission Bay lease revenue to be deposited in the General Fund, and specifies how excess funds shall be allocated. From FY 2010 to FY2014 the General Fund threshold is $23 million; in FY 2015 and continuing thereafter, the threshold is lowered to $20 million.

Excess Mission Bay lease revenues are allocated to the Mission Bay Park and Regional Park Improvement Funds according to formula; increasing transfers are reflected in the Outlook reaching $9.1 million in FY 2016.

Reserves

The Outlook includes funding to meet reserve policy goals, consistent with revised policy currently awaiting approval by the City Council. A total of $14.1 million is required in FY 2012, declining to $12.0 million in FY 2016. The General Fund policy goal is to reach 8% by FY 2013. The Public Liability & Workers' Compensation policy goals are to reach 50% of claims by FY 2014.

New Facilities

The New Facilities List was not provided in the Outlook as it has been in past. The New Facilities List typically shows the specific facilities and locations with project completions planned for each year of the Outlook. In addition, the number of full-time equivalents and personnel and non-personnel costs for each facility is usually included.

In response to questions regarding New Facilities, the IBA learned that various Park and Recreation locations are planned to come on-line in each fiscal year, including:

- W Lewis & Falcon St
- Linda Vista Terrace
- Del Mar Mesa
- Treena Mesa
- Pacific Breezes Community Park

In addition, it is planned that the Bayside Fire Station will open for operation starting in FY 2013.

The Budget and Finance Committee requested that FM provide a listing of New Facilities as has been done in prior years, including the number of positions and related costs.

New Facilities – Main Library

With respect to the Main Library project, it appears that no changes to the Outlook since the last version have been incorporated, and it continues to be scheduled to open in FY 2014. The Outlook assumes no net General Fund impact, with additional operating costs anticipated to be offset with private donations and new revenue. The Budget and Finance Committee requested that a line item be included in the IBA Outlook Scenario as a reminder of potential impacts to the General Fund due to a possible shortfall in donation receipts for completion of project construction, or for other unfunded operational needs. However, sufficient information is not available to adequately estimate additional funding needs within the time available to complete this report. It is important to note that the City is not contractually obligated to fund or complete the second construction phase which has been assigned to be funded solely from donations.

SIGNIFICANT POLICY AREAS

The Outlook includes funding for several significant policy areas that continue to be priorities, including pension funding, OPEB, deferred maintenance, reserve funding, and Stormwater Compliance. Several of these policy areas, such as pension and OPEB, have been discussed previously. This section provides an overview of other significant policy areas, including items not discussed in the Outlook, specifically Fire-Rescue Restorations, and the Civic Center.

Stormwater Compliance

In FY 2011, $35.2 million was budgeted for the Storm Water Division in the newly created Transportation and Storm Water Department. Funding is expected to remain at this level and will be reassessed when a new Municipal Permit is issued in FY 2013.

As indicated in the Outlook, the Storm Water Division believes it will remain in compliance with the existing Municipal Permit based on current funding levels. The Municipal Permit was issued by the San Diego Regional Water Quality Control Board and became effective on March 24, 2008. It has a five-year life span and expires in FY 2013- one year into the Outlook’s forecast period. Once the new Municipal Permit is issued, the City may become subject to additional regulations.

Storm Water funding is being closely monitored through the out-years as any additional regulations that are imposed may require added costs to the City. After new regulations are implemented, if there is concern regarding the Division's ability to remain in compliance then appropriate budget adjustments may need to take place.

The Storm Water Division currently collects a storm drain fee from water and sewer utility customers in order to help subsidize the cost to the General Fund of storm water operations. In FY 2010 the revenue from the current rates was approximately $6 million. This constitutes about 17% of the Division's operating budget. If an increase to the cost of complying with the permit occurred as a result of additional regulations, it may place a greater strain on the General Fund.

To explore the option of a storm drain fee adjustment a Cost of Service Study must first be completed. This study determines a storm water rate structure that is adequate to fund the City's costs of repairing and rehabilitating the storm water drainage infrastructure and complying with the City's municipal permit as well as ensuring compliance with Proposition 218 requirements. The Storm Water Division indicated during the FY 2011 City Council budget review that a Cost of Service Study was underway and results were expected in December 2010.

Fire-Rescue Restorations

At the January 26, 2010 PS&NS Committee meeting, the Mayor's Office communicated that there are no plans to restore the rolling brownouts in FY 2011. For FY 2012 and beyond, the Mayor's Office is working with the Fire-Rescue Department on a strategy to potentially phase-in the restoration overtime. The details of such a gradual phase-in are not available at this time. Any level of restorations will add to the deficit in the years of the phase-in the Five-Year Outlook. The FY 2011 reduction associated with the implementation of the rolling brownouts was $11.5 million. The restoration of each browned-out engine company would require an additional $1.4 million in funding resources.

The IBA Outlook Scenario provides an option reflecting a potential phase-in of two engine companies in FY 2012, four in FY 2013, and eight in FY 2014 and beyond, returning the Fire-Rescue Department to full strength, and restoring $11.5 million in total for each year by FY 2014.

Civic Center

In the May 2009 Facilities Condition Assessment of the Civic Center facilities, AECOM identified $19.5 million in critical deficiencies (including the City Administration Building (CAB) fire sprinklers) that would need to be addressed to keep the Civic Center Facilities operational for five years and an additional $20.5 million that would need to be required to extend its life to ten years. The previous Outlook included $5.5 million in FY 2011 for asbestos spot removal and the installation of fire sprinklers in CAB; however, this was removed during the FY 2011 budget process.

The current Outlook has not reinstated the funding for the fire sprinklers and does not include funding to address the other critical deficiencies. During the discussion at the

February 7, 2011 City Council meeting on extending the required compliance date for sprinkler retrofits for CAB, the Chief Operating Officer stated that the new Civic Center project is no longer being pursued and that funding for the CAB fire sprinklers will come from infrastructure bond proceeds. It is unclear if this funding source will be considered for the other critical deficiencies and how and when these deficiencies will be addressed.

The previous Outlook had indicated that sprinkler costs were <u>not</u> an eligible expenditure of the deferred capital bonds. Additional information will be needed to assess if bond funding is a viable option. In the event that the fire sprinklers are deemed to be an eligible use of the bond funds, a policy decision regarding the prioritization of the projects to be funded from the deferred capital bonds will be necessary. The CAB fire sprinklers were not originally anticipated to be funded from bond funds, and the redirection of bonds for this purpose would come at the expense of other planned projects which will then become unfunded, or postponed. An evaluation of the best use of the limited bond funds and prioritization of specific streets, facilities, and storm drains projects could assist in this effort.

The IBA Outlook Scenario reflects the addition of funding in the amount of $4.2 million for the CAB fire sprinkler project in FY 2012 to come from the General Fund, in the event it is determined that the fire sprinklers are ineligible for bond funds, or if other deferred capital projects are considered more critical to receive bond proceeds. In addition, the other critical deficiencies previously identified in the amount of $15.3 million have been incorporated into the IBA Outlook Scenario in FY 2013.

Deferred Capital

To address the backlog in Deferred Capital expenses, the Outlook proposes to continue securing funding for projects by the issuance of long-term debt. The Outlook includes debt service payments for the first issuance executed in March 2009 and proposes two additional $100 million issuances in Fiscal Years 2012 and 2015. The prior Outlook projected the two additional bond issuances to occur in Fiscal Years 2011 and 2013. At the February 9, 2011 Budget and Finance Committee, staff stated that the delay in future bond issuances is in response to the current cash flow needs, and the status of balance of the March 2009 bond proceeds which are still on hand and not fully expended. The City Council may wish to further discuss with staff the planned timing to expend remaining bond funds and to identify and eliminate hindrances or obstacles which prevent projects from moving forward at a swifter pace.

The Outlook continues to describe the current backlog of deferred capital/infrastructure projects at approximately $800-$900 million. However, in the IBA's review of the FY2011 Proposed Budget, staff estimated "catch-up" funding to a "high level of service" for Streets, Facilities, and Storm Drains would require $563 million. A "High Service Level" is defined by staff as having 74% of streets in "Good" condition, 20% in "Fair" condition, and 5% in "Poor" Condition. Staff has indicated that based on current staffing and funding levels it might not be possible to obtain a "High Service Level" but this is a policy discussion that needs to occur with the City Council. The following table outlines the estimated "Catch-up" funding for these asset classes:

Asset Class	**Funding Amounts (Millions)**
Streets	$250.8
Facilities	$93.0
Storm Drains	$219.6
Total:	**$563.4**

This estimate did not include Sidewalks, Alleys, Qualcomm Stadium, Petco Park, Water and Sewer Infrastructure, and the Civic Center Plaza. Staff is continuing to refine the estimated funding backlog for deferred maintenance through updated assessment surveys. One recent example is that on January 11, 2011 the City Council approved funding for an updated citywide street assessment survey that also includes alleys.

Another item of note is the required "On-Going" funding required to maintain the City's Capital assets at a specified maintenance level. Based on information provided to the IBA for our review of the Fiscal Year 2011 Proposed Budget, staff estimated that the current budget includes $86.9 million for maintenance of the three significant asset classes. The $86.9 million is comprised of various funding sources including the General Fund, Proposition 42, Proposition 1B, TransNet, and Transient Occupancy Tax Funds. It is important to note that at the May 5, 2010 Budget Review Committee Meeting, the General Services Director when asked about the annual funding level for streets stated that the level of funding proposed in the Fiscal Year 2011 Proposed Budget was sufficient to allow the department to respond to day-to-day requests, but was not sufficient to prevent the maintenance backlog from increasing**.** It is unclear if the same is true for the other assets classes. In addition, many of the funding sources identified for "On-Going" maintenance are dependent upon the State and it is unclear what the impact would be to the City if this funding was discontinued.

It should be noted that one of the Structural Budget Deficit Elimination Guiding Principles approved by the City Council is to "develop a plan to fund deferred capital infrastructure and maintenance needs to reduce backlog and identify the level of funding necessary to prevent the problem from growing larger" (Principle #11). The current Outlook does not address this Principle with any specificity. Without identifying the required funding to address the "Catch-Up" and "On-Going" requirements, it is difficult to identify an overall annual deficit to the City.

The IBA Outlook Scenario addresses the impact of retaining the original timing and schedule of the next two bond issuances as shown in the prior Outlook, and includes the addition of debt payments in earlier years, if it is determined that projects are able to be hastened and borrowing can occur earlier as originally planned.

In addition, the IBA Outlook Scenario reflects funding in the amount of $72.6 million each year in order to provide the remaining funding of $363 million to reach the $563 million total identified in "catch-up" funding to address the backlog, in addition to the $200 million in bond proceeds.

POTENTIAL SOLUTIONS

The Outlook describes potential solutions that are expected to be implemented to mitigate the projected budget deficits, including organizational restructures, one-time cost savings, and the implementation of the ten fiscal reforms. The IBA agrees that many options continue to exist, and some are reforms that are underway that will result in savings over the Outlook period. However, many of these may not result in immediate cost savings or new resources that will be able to address the FY 2012 budget deficit. These options include: Managed Competition; Pension & Benefit Reforms; New Revenues, and User Fee Reviews and Adjustments.

IBA OUTLOOK SCENARIO

At the Budget and Finance Committee of February 9, 2011, the Committee voted to forward the Mayor's Five Year Outlook and the IBA's review to the City Council with requests for additional information from Financial Management (FM) and the IBA.

The Budget Committee requested the IBA to:

- Develop a more candid and complete assessment, including:
    - calculation of the deferred maintenance deficit
    - incorporation of vacancy factor and step increases
    - unfunded portion of the Main Library project
    - additional details as identified in the IBA presentation

In response to this request, the IBA developed the following Outlook Scenario to incorporate the impacts of potential changes to the Outlook, based on the pessimistic scenario for Property Tax revenues, and options for the inclusion of salary increases, the full payment of the retiree health care ARC, funding for CAB fire sprinklers and other critical deficiencies, and the phase-in of funding for Fire-Rescue engine company restorations. Inclusion of these estimates brings the FY 2012 deficit to $95.8 million, decreasing to $79.1 million in FY 2016.

Also shown in the IBA Outlook Scenario are options depicting the impact of keeping the original schedule of bond issuances, and incorporating additional funding to address the "catch-up" funding for deferred capital and infrastructure improvements.

General Fund - IBA Outlook Scenario (in millions)					
	FY 2012 Forecast	FY 2013 Forecast	FY 2014 Forecast	FY 2015 Forecast	FY 2016 Forecast
Five-Year Outlook Projected Deficit	**$ (56.7)**	**$ (61.9)**	**$ (54.9)**	**$ (33.1)**	**$ (8.8)**
Ballpark Debt (TOT)	$ -	$ -	$ 11.3	$ 11.3	$ 11.3
Five-Year Outlook Adjusted Deficit	**$ (56.7)**	**$ (61.9)**	**$ (43.6)**	**$ (21.8)**	**$ 2.5**
Revenue Scenarios					
Property Tax (pessimistic)	$ (3.8)	$ (7.7)	$ (11.9)	$ (16.3)	$ (21.0)
Five-Year Outlook Adjusted Deficit	**$ (60.5)**	**$ (69.6)**	**$ (55.5)**	**$ (38.1)**	**$ (18.5)**
Expenditure Scenarios					
Salary Increases (2% 2013 and 2% 2015)	$ -	$ (10.0)	$ (10.0)	$ (20.8)	$ (20.8)
Retiree Health Care Payment of Full ARC w/o reform	$ (28.3)	$ (28.3)	$ (28.3)	$ (28.3)	$ (28.3)
Fire-Rescue Restorations (2, 4, 8 engines)	$ (2.8)	$ (5.6)	$ (11.5)	$ (11.5)	$ (11.5)
City Hall Critical Deficiencies	$ (4.2)	$ (15.3)	$ -	$ -	$ -
Subtotal:	**$ (95.8)**	**$ (128.8)**	**$ (105.3)**	**$ (98.7)**	**$ (79.1)**

	FY 2012 Forecast	FY 2013 Forecast	FY 2014 Forecast	FY 2015 Forecast	FY 2016 Forecast
"Catch-Up" Funding for Three Main Asset Classes	$ (72.6)	$ (72.6)	$ (72.6)	$ (72.6)	$ (72.6)
"Ongoing" Funding Deferred Capital	*unknown*	*unknown*	*unknown*	*unknown*	*unknown*
Initial Payments for Original Schedule for Deferred Capital Bonds	$ (7.4)	$ -	$ (7.4)	$ (7.4)	$ -
Main Library Donation Shortfall	*unknown*	*unknown*	*unknown*	*unknown*	*unknown*
Additional Needs:	**$ (80.0)**	**$ (72.6)**	**$ (80.0)**	**$ (80.0)**	**$ (72.6)**

"Catch-Up" Funding assumes cash funding over five year period the remaining needs, after two $100 million bond issuances. ($563 million less $200 million = $363 million.) Three main asset classes includes streets, facilities and storm drains.

CONCLUSION

The Mayor's Five-Year Financial Outlook for FY 2012 – FY 2016:

- Does not reflect possible "pessimistic" property tax outlook
- Does not assume any increases in service levels
- Does not include any restoration of Fire-Rescue rolling brownouts
- Assumes retiree health care reform to reduce costs, or continuing practice of not paying full ARC for retiree health
- Assumes no salary increases for five years

The IBA developed an IBA Outlook Scenario to address these particular issues in order to reflect an estimate of the annual deficit incorporating these important areas, which will likely need to be addressed and may reflect a more accurate assessment of the City's financial situation.

The City Council adopted eleven Guiding Principles for Structural Budget Deficit Elimination in February 2010. Principle #4 states *"prepare a 5-year Outlook each year and provide numeric values for alternative budget balancing options based on input from City Council, Mayor and IBA; be prepared each year to discuss alternative budget balancing options with the Budget Committee or City Council should the Outlook suggest an ongoing structural deficit."*

The City Council may wish to discuss reasonable requests to be made of the Mayor to incorporate specific budget balancing options in the Five-Year Outlook, as agreed to in the Principles, and present them at a future meeting.

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