BLUE RIBBON COMMITTEE REPORT
ON
CITY OF SAN DIEGO FINANCES
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EXECUTIVE SUMMARY

BACKGROUND

In Mayor Dick Murphy's January 8, 2001 State of the City Address entitled "A Vision for San Diego in the Year 2020: A City Worthy of our Affection", he outlined ten goals for the City to focus on over the next four years. A concern raised by the Mayor was whether the City could afford to do the ten goals. As a result, Mayor Murphy announced he would convene a Blue Ribbon Committee on City Finances to perform an independent evaluation on the City's current fiscal health and make any appropriate recommendations. Furthermore, the Mayor stated that he would ask the City's independent Auditor and Comptroller Ed Ryan to provide staff support to the Committee. On April 27, 2001, the Mayor announced the following nine appointments to the Blue Ribbon Committee.

Members of Blue Ribbon Committee on City Finances

- **Joe Craver-Chair**
  President and Chief Executive Officer
  Galaxie Management, Inc.

- **April Boling-Vice Chair**
  Certified Public Accountant

- **Mary Ball**
  President, San Diego County Taxpayers Association

- **William McCurine, Jr.**
  Attorney, Partner
  Solomon, Ward, Seidenwurm & Smith, LLP

- **Andrew Poat**
  Former Chief Deputy Director, CALTRANS

- **April Riel**
  Certified Public Accountant, Certified Fraud Examiner, MPA

- **Victor Vilaplana**
  Attorney, Seltzer Caplan McMahon Vitek

- **Richard Vortmann**
  President, National Steel and Shipbuilding Company (NASSCO)

- **Linc Ward**
  Chair, Zero-Based Management Review (ZBMR) of the Select Committee

Staff support to the Blue Ribbon Committee included Ed Ryan, City Auditor and Comptroller, Terri Aja Webster, Assistant City Auditor and Comptroller, and Marian Thompson, Executive Secretary.

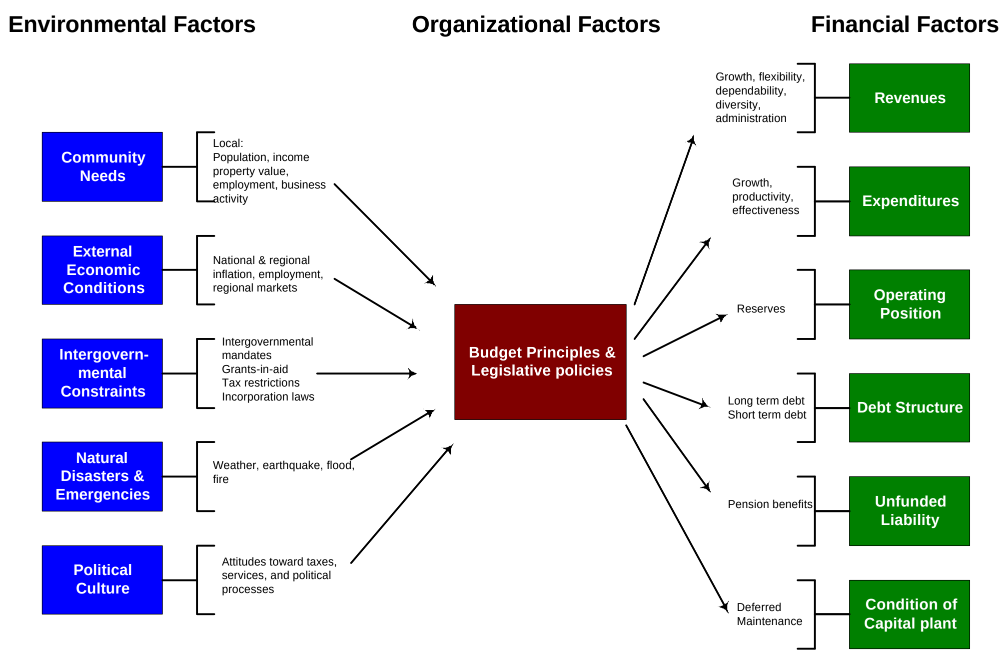
OBJECTIVES

The objectives of the Blue Ribbon Committee on City Finances were as follows:

- *Perform an independent evaluation of the fiscal health of the City of San Diego,*
- *Review the budgeting principles of the City of San Diego, and*
- *Report findings and recommendations to Mayor Dick Murphy.*

The term "*fiscal health*" refers to the City's ability to maintain existing service levels, withstand local and regional economic disruptions, and meet the demands of natural growth, decline, and change. In evaluating the City's fiscal health, the Committee began by defining and evaluating a variety of financial and economic indicators and obtaining an understanding of the fiscal process. Requests were made to City staff to provide specific financial information, some of which are included in the attachments to this report. In addition, members of the Committee met with the City Manager who provided an overview of the annual budget process and the financial policies and procedures.

During this stage the Committee identified many indicators, which directly or indirectly affect the fiscal health of the City. These indicators were either environmental, organizational, or financial. Environmental factors such as population, unemployment, recession, and natural disasters are all non-controllable factors, which externally influence the City by creating demands and providing resources. This has a direct effect on organizational factors such as management practices and legislative policies. How well the City follows and addresses its budgeting principles relates directly to how well the City is responding to environmental factors. Finally, the financial factors reflect the condition of the City's finances, which is the primary focus of our report. Below is an illustration of the factors affecting the fiscal health of the City:



As indicated, the primary focus of our review was to examine the financial factors. In doing so, the Committee selected six key fiscal areas to examine. In addition, the Committee reviewed the City's Budget Principles for compliance and adequacy. Below are the major areas addressed in this report:

I. General Reserves and Insurance

II. Long Term Debt

III. Retirement Benefits and Unfunded Pension Liabilities

IV. General Deferred Maintenance and Unfunded Procurement

V. Water, Wastewater, Storm Water and Multiple Species Conservation Program

VI. Revenues and Expenditures

VII. Principles of Budgeting and Finance

The Committee's analysis of the major areas involved interviews with City staff, reliance on financial information provided by City staff, review of the City's Fiscal Year 2002 budget, credit research reports from the independent rating agencies of Moody's and Standard and Poor's as well as comparative data from other large cities nationwide, and other financial information obtained. The City's financial statements are audited annually by an independent Certified Public Accounting Firm, Calderon, Jaham and Osborn. The City has received an unqualified (clean) audit opinion during the last ten years.

FINDINGS AND RECOMMENDATIONS

The Committee found that in general the City of San Diego is fiscally sound. As shown in Attachment 1, the City has been recognized Statewide and Nationally for its achievements. However, the Committee identified several areas of concern and if not adequately dealt with, they could have a significant effect on the fiscal health of the City in future years. Below are the Committee's findings and recommendations in each of the major areas:

I. General Reserves and Insurance

The Committee found that as of June 30, 2001, the City's General Reserves were $30.5 million or approximately 4% of the total General Fund Revenues. This represents a substantial increase in reserves over the last 5 years. While reserves may never be sufficient to cover such one-time occurrences as large judgments or physical catastrophes, they should be sufficient to cover unplanned circumstances such as short-term economic downturns. The Committee was informed that the City maintains adequate insurance: worker's compensation, certain group health benefits and long-term disability, earthquake, general liability, and automobile liability insurance.

> <u>*Recommendation 1*</u>*: Evaluate and determine what an adequate reserve level is for the City. At this time, the Committee recommends increasing the reserves to be between 7 to 10% of General Fund Revenues.*

II. Long Term Debt

The Committee found that historically and currently, the City's total debt outstanding as well as total debt compared to all tax property valuations have been well below the median as compared to other major cities. The City's debt service has remained constant as compared to expenditures and revenues and is expected to increase only minimally with the addition of the proposed Ballpark, Fire Stations, and Library System bond issuances. The outside Rating Agency firms of Moody's, Standard and Poor's and Fitch evaluate the City's fiscal health in great detail and have consistently given the City high ratings which reflects a variety of very strong general credit characteristics such as the ability to repay long term debt, a diversified economy, moderate debt burden and strong financial management. See Attachments 2 and 3.

The Committee has no recommendations in this area and applauds City Management for its judicious use of debt.

III. Retirement Benefits and Unfunded Pension Liabilities

The Committee is very concerned that the City is not paying out of its current year's budget the full cost being incurred by its current workforce for their future pension and retiree health benefits. The City is not paying approximately $6-8 million a year for future pension benefits. As a result, a portion of the cost of today's City workforce will be paid by future year's taxpayers. Further, this non-discretionary item in the budget has been growing steadily and will continue to grow in the future.

> <u>Recommendation 2</u>*: Change the City's funding strategy to one that results in the City fully funding its future obligations earned today which includes the pension benefits as well as health benefits.*

> <u>Recommendation 3</u>*: Obtain a current and comprehensive analysis of projected pension expenses and revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances.*

IV. General Deferred Maintenance and Unfunded Procurement

The Committee estimates the City's unfunded deferred maintenance to be in excess of $300 million in the areas of Streets, Alleys, Sidewalks, Street Light and Traffic Signals, Bridges, Buildings and Structures, Fleet, and Coastal Infrastructure and Facilities. Information provided to the Committee was preliminary or inconsistent with other reports obtained by the Committee. As a result, the Committee was unable to accurately quantify the backlog of unfunded deferred maintenance. The Committee believes, however, that the current level of funding is not reducing the backlog and is, instead, contributing to its increase.

The Committee was advised that the City has approximately $170 million in Information Technology needs which is mainly unfunded procurement. These Information Technology needs result from a combination of technology improvement and early anticipation of future needs over the next 2-5 years.

> <u>Recommendation 4</u>*: The City Manager should establish a process so that all deferred maintenance and unfunded procurement information is developed, aggregated, consistent, complete, non-duplicative, rated for priority, and is available on call for budgetary decisions.*

> <u>Recommendation 5</u>*: The City Manager should prepare and present a public report during the annual budget hearings identifying the cumulative deferred maintenance backlog and unfunded procurement needs which includes asset descriptions, dollar requirements, and categorized by level of need with funding sources.*

> <u>Recommendation 6</u>*: The City's policy with respect to funding deferred maintenance and Information Technology procurement should be revised to increase expenditures in these crucial areas. While the Committee notes some improvement in addressing deferred maintenance needs in some specific areas, other areas continue to deteriorate.*

V. Water, Wastewater, Storm Water, and Multiple Species Conservation Program

The Committee found four major fiscal areas of future need. The four areas are water, wastewater, storm water, and multiple species conservation program. Findings in these areas are discussed below.

a. Water

Overall, the Committee found the main areas of concern to be water storage, price and infrastructure needs. Action plans and financing plans are in place to address these concerns. These plans include a combination of bond issues and rate increases. An annual 6% rate increase is projected for a five-year period beginning in 2002. The Committee believes, if the City follows through with these plans and constantly monitors compliance with mandatory requirements, the City's fiscal health will not be impacted.

b. Wastewater

The City has a viable plan for its Wastewater System. The plan will adequately cope with the expected growth in population, while steadily reducing the number of spills. However, it must be noted that the plan necessitates a 7.5% rate increase every year for four years. Additionally, the plan assumes continued "rollover" extensions of the 5-year waivers from the EPA on the treatment process.

Assuming the City maintains the waiver status, stays on track for an expanded replacement program and achieves the support of the public for future rate increase and bonds issues, the City's fiscal health will not be impacted.

c. Storm Water

The Committee recognizes that the new Storm Water mandate presents a new concern to the fiscal health of the City. The City is in the process of working with public agencies to clarify the City's future costs and explore funding alternatives. In addition the City has an estimated $143 million in general deferred maintenance for storm drains that needs to be addressed.

d. Multiple Species Conservation Program (MSCP)

The Committee recognizes that the amount of MSCP future cost to the City is uncertain. Therefore, it is difficult to make a conclusion other than it appears that there could be a continued upward pressure of million of dollars per year on City finances. A strong effort to secure grants for this purpose is needed to minimize the cost to the City.

VI. Revenues and Expenditures

The Committee found that between 1997 to 2001 total general fund revenues have increased by 38% from $514 million to $710 million, and is budgeted for Fiscal Year 2002 to be $710 million, adjusted to a financial reporting basis. Revenues per capita have been increasing over the years but continue to be lower than other large cities. In regards to expenditures, the Committee found that between the Fiscal Years 1997 and 2001 total General Fund expenses increased 34% from $521 million to $700 million, averaging 7.7% growth per year. Budgeted increases through the Fiscal Year 2002 will bring expenses to $745 million. The 5-year increase per annum averages 7.4%. Expenses per capita are lower than other large cities in the State and Nation.

In order to maintain the City's current service levels and address the various issues raised in this report, the City must pursue across-the-board efficiency efforts, as well as increase its current revenue base, and seek alternate revenue sources.

> Recommendation 7: *Expand the current revenue sources and seek additional sources of revenue.*
>
> Recommendation 8: *Seek ways to reduce expenditures either through improved operational efficiencies or elimination of specific services in deference to higher priority needs.*

VII. Principles of Budgeting and Finance

The Committee found five of the six present City budget principles to be sound and recommends changing the remaining principle. Also, the Committee recommends the City follow two additional principles. Findings are discussed below.

a. Present Budget Principles

1. Ongoing Expenditures Should Be Supported By Ongoing Revenues

The Committee strongly supports this principle, and urges its more constant adherence.

2. The General Fund Should Maintain A 3% Reserve Of General Fund Revenue

As discussed in Section I, the Committee recommends this principle be changed to reflect a requirement of 7-10% of General Fund revenue in total General Reserves (the current principle reflects only the General Fund portion of the General Reserves).

3. Capital Projects Should Identify All Future Cost Considerations And Financial Impacts

The Committee supports this principle, and finds that the current 12 year capital budget does generally identify some, but not all, ongoing costs.

4. Include Direct And Indirect Costs For Each Enterprise Fund

The Committee supports continued adherence to this principle and recommends the Mayor and Council direct the City Manager to review and formulate recommendations on the Right of Way fee as they relate to direct or indirect costs for the Water and Sewer Funds.

5. Activities Supported By User Fees Should Be Fully Cost Recoverable

The Committee recommends the City continue to respect the broad intent of this principle, particularly for the Enterprise Funds, but might want to consider amending the policy as it relates to the General Fund if current practice and public policy warrants it.

6. Discretionary General Fund Revenues Should Not Be Earmarked

This principle is not being followed in the case of the Library Ordinance whereby a percent of General Fund appropriations are to be earmarked for Libraries regardless of other competing needs such as deferred maintenance. The Committee supports adequate funding for libraries but recommends following this budget principle and maximizing the City's revenue flexibility.

b. Proposed Principles

<u>Recommendation 9</u>: *The City should follow its existing six budget principles and add two additional budget principles:*

> *Proposed Principle #7: Budget development should be guided by a long term, or strategic budget plan proposed by the Manager and adopted by the Council.*
>
> *Proposed Principle #8: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.*

Follow-up Issues

To ensure that the City prepares a long-range financial plan to adequately address the issues contained in this report in a timely manner, the Committee recommends that the City submit a report to the Blue Ribbon Committee which addresses the City's progress on each of the recommendations. The Committee will reconvene to review the report and the progress the City has made in regards to the recommendations made in this report.

<u>Recommendation 10</u>: *Submit a report in March of 2003 addressed to the Blue Ribbon Committee on Finances summarizing the progress on each recommendation contained in this report.*

CONCLUSION

The City is basically fiscally sound. San Diego operates within a restricted revenue base, its revenues per capita are lower than most major cities in the United States. San Diego operates within the restrictions of the Peoples Ordinance-adopted in a different era which precludes the collection of fees for residential trash collection. The City does not utilize some revenue sources such as Utility User Tax, Residential Trash Collection Fees, and Water/Sewer Utility Right-of-Way fee used by other California cities to offset the restrictions of Proposition 13.

San Diego, as with any governmental entity, has fiscal demands, which exceed current funding sources. While other cities have entered into higher levels of debt, San Diego has maintained an acceptable level of debt, and as a result has retained a positive credit rating over the years. Over the next few years, the City proposes increases in debt. These increases are planned to be mitigated by growth in existing revenue sources such that debt service as a percentage of revenues is only increasing by less than 1 percentage point.

However, there are some serious concerns, which the Committee felt needed to be brought into full focus and addressed by the City Council. These issues were long in their creation and certainly were not the product of the current City leaders. Nonetheless the incumbent Administration must publicly recognize the issues and develop to a plan deal with them.

First and foremost, operating within the restrictions identified above, decisions have been made over the years to defer physical infrastructure requirements in favor of more visible or other pressing needs. While this is a difficult issue to accurately quantify, City staff estimates unfunded deferred maintenance exceeds $300 million. Deferred maintenance is a somewhat illusive issue in that reasonable people can differ on what is truly "needed" versus what is "nice to have". Similarly with Information Technology, what is truly needed in this rapidly changing world versus what is truly cost justified is often debated. But in any event, the City must visibly acknowledge this serious problem, accurately quantify it, and develop a financial plan to remedy the problem over a specified period of time.

The second concern is that, analogous to the "deferred maintenance", the City is likewise partially deferring until later years the recognition of currently incurred cost for pensions and retiree health benefits (i.e. earned by current employee to be collected in later years). The City is not having current year's taxpayers pay for all the pension and retiree health benefit costs that are earned in that year. This is placing a growing burden on future years' taxpayers.

Third, the City has been prudent over the last five years in recognizing the need for a reserve for unplanned "crises". As a result, reserves have gradually been built over the last few "boom" economic years, but the magnitude of it is still significantly less than other municipalities find prudent. The Committee encourages the City to continue to build these reserves up to at level of 7-10% of General Fund Revenues.

A further concern is the current economic conditions both locally and statewide. The current recession can have a material impact on City revenue in the near term. This means a concerted effort must be made now to control expenses and further improve operating efficiencies.

The Committee feels it is incumbent on the City to develop a long range financial and operations plan to address the issues raised in this report and to fully apprise the public of the issues and of the plans. It is anticipated that the financial plan would include a combination of increasing the current revenue base, obtaining additional revenue sources, and controlling/reducing expenditures.

Finally, the Committee requests that the City respond to the recommendations contained in this report in March of 2003, at which date, the Blue Ribbon Committee will reconvene to evaluate the City's progress on each recommendation.

In conclusion, the Committee believes San Diego has earned the self-proclaimed title of America's Finest City and that the City is poised to perpetuate that title. How well the City deals with the issues raised in this report will play heavily in how deserved that title will be in the future as well as the Mayor's goal of being a *"City worthy of our affection."*

BLUE RIBBON COMMITTEE ON CITY FINANCES
SUMMARY OF RECOMMENDATIONS

Financial Factors

Committee Recommendations

Operating Position (Reserves)

Recommendation 1: Evaluate and determine what an adequate reserve level is for the City. At this time the committee recommends increasing the reserves to be between 7 to 10% of General Fund Revenues.

Debt Structure (Long-term and Short-term Debt)

Unfunded Liability (Pension Benefits)

Recommendation 2: Change the City's funding strategy to one that results in the City fully funding its future obligations earned today which includes the pension benefits as well as health benefits.

Recommendation 3: Obtain a current and comprehensive analysis of projected pension expenses and revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances.

Condition of Capital Plant Deferred Maintenance

Recommendation 4: The City Manager should establish a process so that all deferred maintenance and unfunded procurement information is developed, aggregated, consistent, complete, non-duplicative, rated for priority, and is available on call for budgetary decisions.

Recommendation 5: The City Manager should prepare and present a public report during the annual budget hearings identifying the cumulative deferred maintenance backlog and unfunded procurement needs which includes asset descriptions, dollar requirements, and categorized by level of need with funding sources.

Recommendation 6: The City's policy with respect to funding deferred maintenance and Information Technology procurement should be revised to increase expenditures in these crucial areas. While the Committee notes some improvement in addressing deferred maintenance needs in some specific areas, other areas continue to deteriorate.

Revenues & Expenses

Recommendation 7: Expand the current revenue sources and seek additional sources of revenues.

Recommendation 8: Seek ways to reduce expenditures either through improved operational efficiencies or elimination of specific services in deference to higher priority needs.

Organizational Factors

Budget Principles

Recommendation 9: The City should follow its existing six budget principles and add two additional budget principles:
Proposed Principle #7: Budget development should be guided by a long term, or strategic budget plan proposed by the Manager and adopted by the Council.
Proposed Principle #8: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.

Follow-up Recommendation

Recommendation 10: Submit a report in March of 2003 addressed to the Blue Ribbon Committee on Finances summarizing the progress on each recommendation contained in this report.

I. GENERAL RESERVES AND INSURANCE

A. GENERAL RESERVES

Reserves are an integral part of the City's fiscal health. The size of a local government's reserve balance can affect its ability to withstand financial emergencies. It is important for the City of San Diego to have sufficient funds in reserve that are available in a time of fiscal crisis. While reserves may never be sufficient to cover one-time occurrences such as large judgments or physical catastrophes, they should be sufficient to cover unplanned circumstances such as short-term economic downturns.

It is important to distinguish between General Reserves and the General Fund Reserve. General Reserves are total funds set aside and are readily available in the event of a crisis. The General Fund Reserve is an amount set aside within the General Fund and is only one component of the total reserves. At the start of Fiscal Year 2002, total General Reserves are $30.5 million as summarized below:

General Fund Reserve	$19.5 million
Convention Center Reserve	6.9 million*
MTDB/Trolley Reserve	2.1 million*
GASB 31 Reserve	2.0 million*
Total General Reserves	$30.5 million (a)

(a) Upon issuance of the Downtown Ballpark Development Project lease revenue bonds, this total will increase to approximately $35.9 million as a result of replenishing the Balboa Park Reserve and creating a Ballpark Reserve. In Fiscal Year 2004, an additional $4.7 million will be added to the Ballpark Reserve.

*These reserves are not restricted and may be used for general purposes.

The City's General Reserves of $30.5 million, is approximately 4% of the Fiscal Year 2002 General Fund revenues. Historically, the General Reserves have more than doubled since 1997. The table below shows the total balance of the General Reserves at June 30th for the last five years. As illustrated, these reserves have been steadily increasing.

FISCAL YEAR	GENERAL RESERVES BALANCE (MILLIONS)[1]
2001	$30.5
2000	$26.3
1999	$16.4
1998	$14.8
1997	$12.5

The Committee applauds the fact that the City has increased general reserves substantially in recent years and recommends the City continue to increase general reserves until they are in the 7-10% range of General Fund revenues.

1. Includes the General Fund Reserve, Convention Center Reserve, MTDB/Trolley Reserve, Balboa Park Reserve and GASB 31 Reserve

B. INSURANCE

The City has a risk management program for nonrecurring liabilities, which is managed by its own Risk Management Department. The City is 100% self-insured for all claims involving worker's compensation, and certain group health benefits and long-term disability. For general and automobile liability, the City is self-insured up to $1,000,000 per occurrence and has excess liability insurance through a Comprehensive Liability Insurance program for claims exceeding $1,000,000 up to a maximum of $54,000,000 per occurrence effective August 9, 2001. In addition, for those capital assets (e.g., buildings and structures) for which insurance is appropriate, the City also has insurance coverage, which covers nearly all City-owned buildings for the replacement value of the building or structure. Earthquake insurance has also been secured for selected buildings and structures according to criteria established by the City. (Buildings built by means of a bond issue have earthquake coverage.) The City's Risk Management Department, in conjunction with the City Attorney's Office, determine the probable cost of claims against the City for any given year. The City has carried excess liability insurance for the past eleven (11) fiscal years for which period the City has not settled any claim exceeding its excess liability insurance coverage of $54,000,000. The Risk Management Department and the City Attorney's Office have evaluated all current outstanding claims against the City.[2]

Conclusion

The Committee found that as of June 30, 2001, the City's General Reserves were $30.5 million or approximately 4% of the total General Fund Revenues. While reserves may never be sufficient to cover such one-time occurrences as large judgments or physical catastrophes, they should be sufficient to cover unplanned circumstances such as short-term economic downturns. The Committee also found that the City has adequate insurance to cover such items as: worker's compensation, certain group health benefits and long-term disability, earthquake, general liability, and automobile insurance.

> Recommendation 1*: Evaluate and determine what an adequate reserve level is for the City. At this time, the Committee recommends increasing the reserves to be between 7 to 10% of General Fund Revenues.*

[2] There is an outstanding judgment against the City in excess of its policy limits, which is currently on appeal.

II. LONG TERM DEBT

The Committee reviewed the City's Long Term Debt with the objective to:

- *Review and obtain an understanding of the City's current Long Term Debt Obligations*
- *Review the City's Debt Service and the impact of the proposed bond issuances for the Ballpark, Fire Stations, and Library System*

Our review was limited to an analysis of the City's General long-term debt. The City's water and sewer bonds, which are paid directly by user fees, are not included in this analysis.

A. CURRENT GENERAL LONG TERM DEBT

The City's General long-term debt as of June 30, 2001 was $452 million consisting of General Obligations Bonds (14%), Lease Revenue Bonds (73%), and Certificates of Participation (13%). General Obligation Bonds are bonds subject to the approval of a two-thirds vote and secured by the City's full faith and credit. Lease Revenue Bonds and Certificates of Participation obligations of the City are secured by an installment sale agreement or by a lease-back arrangement with a public entity lease. The City pledges general operating revenues to pay the lease payments.

	Principal Outstanding June 30, 2001	**Funding Source**
General Obligation Bonds		
1994 Open Space Park Facility Refunding	$45,520,000	Property Tax & Franchise Fees
1991 Public Safety Communications	$18,075,000	Property Tax
General Obligation Bonds	**$63,595,000**	
Certificates of Participation		
1993 Balboa Park/Mission Bay Improvements	$21,040,000	Transient Occupancy Tax
1996A Balboa Park/Mission Bay Improvements	$26,975,000	Transient Occupancy Tax
1996B Balboa Park/Mission Bay Improvements	$10,720,000	Transient Occupancy Tax
1991 Misdemeanor/Pre-arraignment Detention Facility	$ 1,900,000	Sales Tax
Total Certificates of Participation	**$60,635,000**	
Lease Revenue Bonds		
1993 City/MTDB Authority Old Town Trolley Extension	$16,430,000	Transient Occupancy Tax
1994 City/MTDB Authority Refunding Bayside Trolley and 1994 City/MTDB Authority Refunding –Police Improvements	$40,505,000	Transient Occupancy Tax Sales Tax
1996 Qualcomm Stadium Improvements	$65,905,000	Stadium Revenues
1998 Convention Center Expansion Authority	$205,000,000	Transient Occupancy Tax
Total Lease Revenue Bonds	**$327,840,000**	
Total General Obligation/General Purpose Bonds	**$452,070,000**	

Source: City of San Diego Comprehensive Annual Financial Report, 6/30/01

The City is proposing bond issuances for the following three major projects:

Project	Fiscal Year	Proposed Principal (1)	Funding Source
Ballpark/Redevelopment District	2002	$224,790,000	Transient Occupancy Tax
Fire Station Improvement Phase 1	2002	$ 18,465,000	Sales Tax
Library System	2003/2004	$149,175,000	Transient Occupancy Tax
	Total	**$392,430,000**	

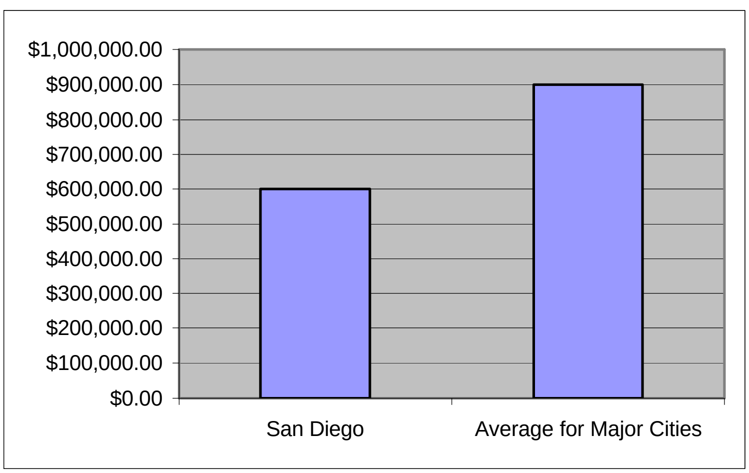
Footnote (1): The proposed issuance sizes were as of June 22, 2001. The final figures will likely be somewhat different. As an example, the Ballpark Redevelopment District will likely drop by approximately $55 million. However, since the Library financing will now be system wide, it will likely increase by a similar amount.

1) Legal Debt Limit

Section 90 of the City Charter prohibits the City from issuing general bonded indebtedness in excess of the 10% of the Assessed Value of all Real and Personal Property in the City. As of June 30, 2000, the debt limit for General Fund bond was $2.1 billion. As of June 2000, the City was well below the legal limit and is expected to continue to be below the limit with the proposed bond issuances described above. It should be noted that lease obligations do not count towards that limit since, by legal definition, they are not long term debt of the City but rather are subject to annual appropriation.

2) Comparison Of Total Debt (Including Lease Revenue, Certificates Of Participation, and Tax Allocation Bonds) To Other Major Cities

As of August 2000, the average debt for the Nation's largest populated cities was $900 million. The City's debt was below the average with total debt at $600 million.

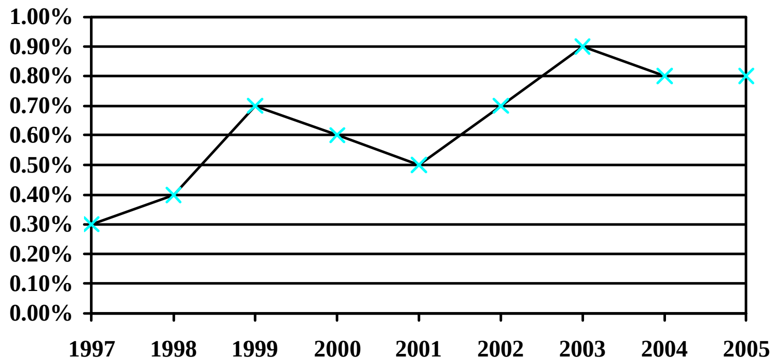


Source: Moody – The Nation's Largest Cities: Comparative Data, August 2000

3) Net Direct Bonded Long-Term Debt as Compared to Assessed Valuation

The City's debt levels as a percentage of all assessed taxable property in the City of San Diego excluding Redevelopment Projects was well below the median as compared to other major metropolitan California cities. The median debt as compared to assessed value in Fiscal Year 1999 was 1.1%. As illustrated below, the City's direct debt remained and is forecasted to remain below 1% through Fiscal Year 2005. See Attachment 4.

Long-Term Debt as a Percent of Assessed Valuation
Fiscal Years 1997-2005



B. DEBT SERVICE ANALYSIS

Debt service is the amount of principal and interest allocated each year for the payment of long-term debt. Our analysis included comparing yearly debt service to revenues and to expenditures. The City's debt service in Fiscal Year 1997 was $20 million. It increased to $40 million in Fiscal Year 2000 and is expected to increase to $60 million by Fiscal Year 2005.

1. Effects of the Ballpark, Fire Station, and Library System Issuances on Debt Service

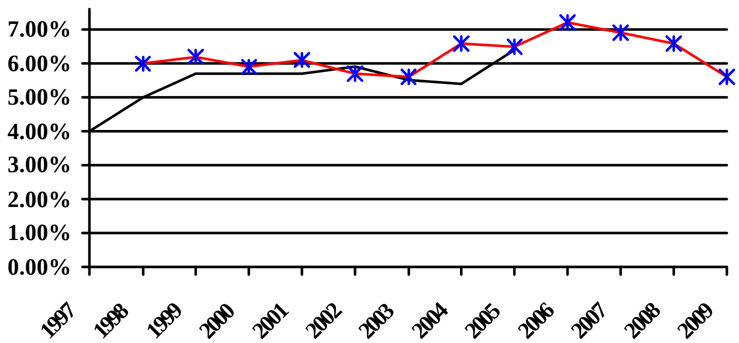
As a Percentage of Expenditures

The City's debt service between Fiscal Years 1998 to 2000 was approximately 6% of the total general fund expenditures. In Fiscal Year 2006, the percentage is estimated to increase to 7% with the issuances of the proposed bonds for Ballpark, Fire Stations and the Library System. As older bonds are paid off, it is projected that this percentage will decrease to 5% by year Fiscal Year 2009.

As a Percentage of Revenues

The City's net direct debt service levels as a percentage of general purpose revenues has remained relatively constant since Fiscal Year 1999 at 5.7%. By year Fiscal Year 2005, this percentage is forecasted to increase by less than one percentage point mainly due to the proposed issuances mentioned above. See Attachment 5.

Debt Service Analysis
Fiscal Years 1997-2009



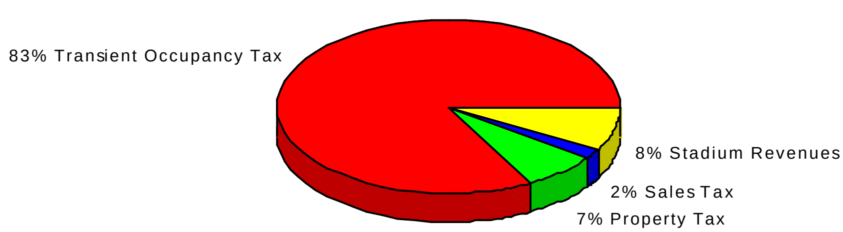
Top line reflects debt service as a percentage of expenditures, bottom line, which begins at 4% in Fiscal Year 1997, reflects debt service as a percentage of revenues.

C. FUNDING SOURCES OF DEBT SERVICE

Without pledging specific sources of revenue, except for general obligation bonds, the City attempts to identify sources of funds for repayment of general City debt service before it issues such debt.

As illustrated below, the primary expected revenue source for general City debt service, based on Fiscal Year 2003 estimated long-term debt is Transient Occupancy Tax, which comprises approximately 83% of the total. Property taxes consist of 7%, Stadium revenues, 8%, and Sales Tax 2% of these estimated payments.

Sources of Debt Service
Fiscal Year 2003



The fact that one expected revenue source is approximately 83% of the total was an early concern. Further inquiry and analysis revealed that the 20-year average annual growth rate for TOT revenues has been 11%. In addition, the amount of TOT revenues allocated to capital improvement debt service is only 33% of the total annual TOT. Further, there are other funding sources available for repayment of the bonds in the event TOT falls short. These are as follows:

- <u>City's Internal Stability Reserves</u> – A half of one year's debt service for each bond issue is set aside in these reserve accounts.

- <u>Other Revenue</u> – General Lease Obligation's debt service is a pledge against the City's general funds. As a consequence, any general fund source can be used. In each of the last four fiscal years, General Fund revenues exceeded budget by at least $22 million.

D. FAVORABLE BOND RATINGS

Our analysis included a review of the City's bond ratings by major Rating Agencies. Moody's ranked only six of the largest 32 cities in the nation higher (AAA) than the City of San Diego for its General Obligation rating and stated the "Key to the City's rating is its judicious use of debt, including careful identification of repayment of sources prior to debt issuance." Moody's rated the City's General Obligation Bonds with a Aa1 rating – high quality and very strong capacity to pay principal and interest.

Prior to the passage of Proposition 218 in 1996, Moody's rated the City AAA, the highest of any large city in California. In the aftermath of Proposition 218, Moody's lowered the rating of most California cities. one notch due to financial constraints imposed on all local governments in California. Consequently, the City's rating was lowered one notch to Aa1. Notwithstanding the reduction, the City of San Diego continues to have the highest rating among large California cities.

Standard and Poor's also gave the City a favorable rating. Its July 24, 2001 article stated "The City's very strong general credit characteristics, including a rebounding and diversified economy with improved property value growth; strong financial management; and a moderate debt burden, with manageable anticipated additional debt issuance."

(See Attachments 2 and 3 for State and National rating comparisons and rating definitions)

Conclusion

The Committee found that, historically, the City's total debt outstanding, as well as total debt compared to assessed property valuation, has been well below the median of other major cities. The City's debt service has remained constant as compared to expenditures and revenues and is expected to increase only minimally with the proposed addition of the Ballpark, Fire Stations, and Library System bond issuances. Although the primary expected revenue source for approximately 83% of the general City debt service is TOT, the City has alternate funding sources to repay the debt. Finally, Moody's and Standard and Poor's in their detailed bond rating process gave the City of San Diego favorable ratings which reflects the City's ability to repay its long term debt obligations.

III. RETIREMENT BENEFITS AND UNFUNDED PENSION LIABILITIES

All full time City employees participate in the San Diego City Employee Retirement System (SDCERS), which is the City's Defined Benefit Pension Plan. As a defined benefit plan, retirement benefits are determined primarily by a member's age at retirement, the length of membership service and the member's final compensation earnable based on the highest one-year period.

The level of retiree benefits is a policy issue. The question to be addressed by the Committee is how these benefit policies affect the fiscal health of the City. The Committee did not address the issue of how the City's pension assets are invested.

Employee retirement benefit liabilities of the City comprise two issues:

- Pension Benefits
- Retiree Health Benefits

•

A. <u>PENSION BENEFITS</u>

The Committee has two concerns regarding the Retirement Benefit Liability:

1. *Whether the City is paying out of its current year's budget the full cost being incurred by its current workforce for their future pension and retiree health benefits.*

2. *Whether the budgetary process adequately comprehends the steadily growing annual expense obligation, particularly given the uncontrollable and non-discretionary nature of this liability.*

The potential risk is that policy makers grant benefit enhancements today (to satisfy employee concerns, to negotiate trade offs with unions, etc.), but avoid recognizing the actual annual cost of such by actuarially spreading the cost over years far out in the future, long after the individuals who made the policy decisions are gone. This is particularly acute where the retiree benefit enhancements are granted "retroactively", i.e. new improved benefits, which are applied to past, as well as future, years of service for active employees. This retroactive approach is the general practice of the City.

Major pension improvements (20% increase) were implemented in Fiscal Year 1997 and benefits were increased by another 12% in Fiscal Year 2000 as a result of a litigation settlement. San Diego County is in the final stages of approving major pension improvements, exceeding San Diego City benefits. This will undoubtedly lead to pressure for further increases for City employees.

The City's annual cash contribution expense for pension was $68 million for Fiscal Year 2001. This is one of the larger items in the City's overall budget. Further, this expense line item has been growing at about a 9% per year compound rate the last five years and at a much faster rate if measured back 10 years.

The chart below shows that the annual cash contribution to the Pension Trust Fund has been steadily increasing faster than the underlying payroll base. This is a serious concern.

Fiscal Year	Payroll Base (In millions) (a)	Cash Contribution to Pension Trust Fund (in millions) (b)	Cash Contribution as Percent of Payroll Base (b) / (a)[3]
1992	$313	$27.4	8.8%
1993	$321	$31.2	9.7%
1994	$338	$34.6	10.2%
1995	$351	$38.6	11.0%
1996	$365	$43.7	11.9%
1997	$383	$47.5	12.4%
1998	$399	$51.0	12.8%
1999	$425	$55.4	13.0%
2000	$449	$60.7	13.5%
2001	$479	$67.6	14.1%

The City has an unconventional actuarial driven plan that has the City's annual cash contribution for pension benefits (i.e. budget expense) to the SDCERS Trust Fund increasing a half percentage point of total payroll base each year until the actuarial formula is in balance. This half point step increase each year could go on for years, how many years depending on actual pension fund results versus actuarial assumptions.

The following example illustrates the magnitude of this situation:

- Fiscal Year 2001 expense was $68 million.

- If payroll dollars increase 6% per year, due to inflation plus staff growth, and the .5% increase in pension expense rate continues for at least five years, then Fiscal Year 2006 expense would be $106 million, a 57% or $38 million increase. And this is a non-discretionary item in the budget. Any improvements in pension benefit granted in the future, particularly if they apply to past service, will significantly exacerbate this problem.

B. RETIREE HEALTH BENEFITS

Of equal concern is the "unfunded" retiree medical liability. Retiree health benefits are, as of a 1996 citizen vote, effectively being paid out of the SDCERS Trust Fund on a cash incurred basis (as distinct from the expense being accrued and actuarially cash flow funded annually when the benefits are earned). Fiscal Year 2000 retiree health benefit expense was $5.4 million. Fiscal Year 2001 was $7.2 million, a 33% increase. While this expense line item is much smaller than the pension expense, it might be a false comfort and therefore misleading. The amount of the total unfunded retiree medical liability is not addressed in SDCERS or City financial documents. The actual annual, budgeted expenditure for this

[3] Resulting percentage varies from an actuarially mandated .5% per year increase due to varying amount of employee contributions paid for by the City.

binding obligation appears to be an "indirect" part of the actuarial computation to develop the annual pension cash contribution. The City's practice is in accordance with current Generally Accepted Government Accounting Principles (GAAP). However, 12 years ago GAAP was changed for private industry to require the recognition annually of the cost of future retiree health benefits being "earned" that year by the current work force. The reason for this accounting change was the growing concern over the very sizeable liabilities for future payments that were not being fully recognized.

The Committee recognizes the City has the potential for this same problem, i.e. a sizeable, growing liability for future payments. The City has a growing workforce, an early age for retirement (50 for Public Safety employees and 55 for General employees), a lengthening of life spans, and an ever increasing cost of health care. As a consequence, retiree medical costs represent a "non-discretionary" expense, which will grow faster and most probably much faster, than the current employee salary base in the City budget.

While this retiree medical cost is currently a relatively small budget item, it will most likely grow at an increasing rate, in essence for costs of prior years' employee service. It is conceivable this liability at today's present value could exceed $100 million. It is unclear how well the City policy makers appreciate this overall expense issue and how it will affect the City budget in the future.

C. FUNDING LEVEL

Yet Dick Vortmann wrote to Fred Pierce on Feb. 18, 2002, alerting him that "a funded ratio at 85.6 percent is getting close to the 82.3 percent trigger".

SDCERS is not in a fully funded position. It is currently funded at 97% (i.e. its current assets equaled 97% of the actuarially computed present value of the future Pension Plan liabilities). The absolute dollar amount of under funding hit a peak of $148 million in Fiscal Year 1999. Excellent Pension asset investment performance reduced that unfunded liability to $69 million in Fiscal Year 2000. However, investment performance in Fiscal Year 2001 was less than half of the excellent performance in Fiscal Year 2000. Investment performance in the first seven months of Fiscal Year 2002 is lower than in Fiscal Year 2001. It is expected that the forthcoming actuarial report will show an increase in the unfunded dollar amount.

San Diego City Employees' Retirement System Financial Information
For Fiscal Years 1996 – 2001
($ IN MILLIONS)

	2001	2000	1999	1998	1997	1996
Pension Fund Assets	$2,807	$2,999	$2,476	$2,272	$1,855	$1,604
City Pension Expense	$68	$61	$56	$51	$48	$44
Pension Plan & Health Benefits Paid	$155[1]	$112	$100	$85	$67	$62
Unfunded Actuarial Accrued Liability	Not available	$69	$148	$125	$117	$140
Retiree Health Benefits Expense	$7	$5	$5	$4	$5	$5

[1] includes $24 million Corbett pay out settlement.

Conclusions

1. The City is not paying out of its current year's budget the full cost being incurred by its current workforce for their future pension and retiree health benefits. As a result, a portion of the cost of today's City workforce will be paid by future year's taxpayers. As compared to an alternative, GAAP approved actuarial method, current annual expense has a shortfall of approximately $6-8 million. The cumulative short fall, for Fiscal Years 1997-2000, is $31 million.

2. The City is experiencing a dramatic, steady increase in non-discretionary pension expense. This is due to the large benefit increases granted to employees by the City. The chart on page 21 illustrates that annual pension expense in Fiscal Year 2001 was 14.1% of payroll compared to 8.8% in Fiscal Year 1992. Worse, this 14.1% is artificially low since (per #1 above) the City is not paying the full cost of the pension benefit being earned each year. The 14.1% will continue to grow by at least a half percentage point each year. The Committee is very concerned whether the City fully appreciates the impact these increasing expenses have, (and particularly any future improvements in pension benefits granted to employees will have) on future annual City budgets.

3. This City is potentially building up a sizeable non-discretionary liability for retiree health benefits, the magnitude of which is not well recognized in the City's budgetary process.

4. A point of possible concern is that after an unprecedented 9-year boom in the equity market when many pension plans became flush and actually over funded, allowing the sponsors to reduce annual cash contributions, the City still has an unfunded liability. This, taken together with the growing annual liability for the "retroactive" pension improvements is a cause for concern.

Recommendations

> <u>Recommendation 2</u>: *Change the City's funding strategy to one that results in the City fully funding, on a current basis, its future obligations earned today which includes the pension benefits as well as health benefits.*
>
> <u>Recommendation 3</u>: *Obtain a current and comprehensive analysis of projected pension expenses and revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances.*

In regards to the above recommendations, the City should determine, as a part of the comprehensive analysis, how many years in the future the City's pension contribution expense will increase by a half percentage point of the total payroll base if it stays with the current funding method or will a large increase be required.

The City should also be apprised of the current present value of the unfunded retiree health benefits. A simulation model should be run to determine whether/how soon the City might have to add a separate budget line to pay health benefit costs out of annual cash flow rather than out of the SDCERS Trust Fund as at present. Further, the Retirement Board/City should consider funding this liability each year on an actuarial basis as it is earned by the current employees rather than the present method of waiting until employees retire and then funding the actual cost. The Committee recognizes this is in competition with its recommendations to fund general deferred maintenance and increase reserves.

IV. GENERAL DEFERRED MAINTENANCE AND UNFUNDED PROCUREMENT

One of the foremost items affecting the fiscal health of the City is the condition of its infrastructure including physical deterioration and obsolescence.

Physical assets require periodic major maintenance. Major maintenance items are capital in nature and would include replacing roofs, boilers, pipes, pumps, interior ceilings, re-paving streets, parking lots, etc. Major maintenance projects should be able to be scheduled out over a multi-year period. If the replacement and maintenance schedule of these major items are not met, then they become an item of deferred maintenance.

In theory, the backlog of deferred maintenance projects should be identifiable and the dollars quantifiable. Further, a plan should exist to "work off" any deferred maintenance backlog with the ultimate goal being to perform all major maintenance on schedu1e.

While a deferred maintenance backlog does not necessarily mean that assets are in a dangerous state of disrepair, the importance of performing major maintenance projects on schedule cannot be understated. As any property owner is aware, periodic maintenance significantly reduces overall maintenance costs since the very goal of scheduled maintenance is preventative.

This is also true of deferred unfunded procurement. Some assets, such as computer equipment, are subject to obsolescence or reach a point where maintenance is no longer cost effective such as in the case of vehicles.

The Committee focused on the non-Enterprise funds for deferred maintenance. The Enterprise Funds for Airports, Environmental Services and Golf Courses reported that they either do not have any significant deferred maintenance issues or have funding plans to deal with them. See Section V for a discussion of capital and future needs related to Water, Wastewater, Storm Water and the Multiple Species Conservation Program.

The Committee asked the City Manager's Office to estimate deferred maintenance and/or procurement needs in the areas of Streets, Alleys, Sidewalks, Street Light and Traffic Signals, Bridges, Buildings and Structures, Fleet, Coastal Infrastructure and Facilities, and Information Technology.

The Committee was advised that the Fiscal Year 2002 budget specifically identified $11.4 million as a budget increase for ongoing maintenance in the areas of streets, fleet replacement, and general infrastructure improvements.

The following information gives details behind the five major categories of deferred maintenance and unfunded procurement identified by the Committee:

- Streets, Alleys, Sidewalks, Street Lights and Traffic Signals, and Bridges
- Buildings and Structures
- Fleet
- Coastal Infrastructure and Facilities
- Information Technology

A. DEFERRED MAINTENANCE

1. Streets, Alleys, Sidewalks, Street Lights And Traffic Signals, And Bridges

A memorandum dated October 29, 2001 from the Street Division on the status of the deferred maintenance cites the dollar amount of the current backlog for streets, alleys, sidewalks, street lights, traffic signals and bridge repair as $163 million as shown below.

Streets	$139 million
Alleys	$ 10 million
Sidewalks	$ 8 million
Subtotal	$157 million
Street lights/signals	$ 5 million
Bridges	$ 1 million
Total Estimate	$163 million

A separate Manager's Report on the status of the City's streets and sidewalks was presented to a City Council Committee on April 25, 2001 and the report was updated in October. This report did not include information on street light/signals nor on bridges. According to the report, at the current rate of funding, the backlog of deferred maintenance on streets, alleys and sidewalks would be $245 million within five years. This increase of $88 million results both from an increase in the number of miles of pavement needing maintenance and from the fact that deferral of the $157 million is resulting in ever-increasing maintenance costs.

It is also important to note that only streets and alleys have had a comprehensive status assessment. Sidewalks, bridges, and street lights are only included in the backlog list if they are reported by citizens or noted by staff when in the area.

2. Buildings And Structures

A report is currently being prepared quantifying the backlog of deferred maintenance on buildings and structures. A very preliminary draft of this report indicates the amount is approximately $65 million. This is a reduction from the 1998 estimate of $93 million.

Because the report is not yet complete, it is not possible to determine the actual methodology used to make these calculations. Upon completion, the report should be thoroughly reviewed and compared to other available estimates. For example, the total costs included in the draft report for the

City Administration Building is less than $1 million. A recent estimate by Gruen Gruen + Associates, however, identifies the cost of asbestos removal, deferred maintenance and the Americans with Disabilities Act (ADA) requirement upgrades for the building at $6 million.

It is also not possible to determine which deficiencies are being included in the estimate. For example, it appears that asbestos abatement, ADA compliance measures, parking lots (except for the downtown parkade) are not yet included for any of the buildings. The draft report itself indicates that the amounts shown for police and fire buildings are not current.

The draft preliminary list does include deferred maintenance on libraries, but does not make clear the effects of related library expansions (some expansions may obviate the need for deferred maintenance).

The draft preliminary list does not lend itself to a calculation of an annual shortfall. This would require preparation of a prospective schedule of major repair and replacement needs.

3. Fleet

A report dated November 28, 2000 prepared by DMG-Maximus, Inc. was provided to the City of San Diego. The report identified a $58 million deferred purchase (fleet replacement) backlog. According to the report, the backlog was increasing by $9 million per year. It is important to clarify that this level of deferred purchases does not mean the fleet is unsafe. It does mean that some vehicles are past their normal service life and that failure to make these purchases is unnecessarily costing the City extra money for maintenance.

Of the total, $16 million pertains to police vehicles. We are informed that the Police Department is working on, but has not completed, a plan to fund this backlog.

Of the total, $27 million pertains to fire vehicles. The Fire Department has a five-year plan beginning in Fiscal Year 2001. However, nothing was purchased in the first year (2001). Both Fiscal Years 2001 and 2002 purchases are to occur in Fiscal Year 2002 through lease purchases.

The remaining $15 million pertains to other vehicles maintained by the Equipment Division. The Manager has prepared a plan for Fiscal Years 2002-2011, which, if fully funded, would replace the vehicles as necessary.

4. Coastal Infrastructure And Facilities

We reviewed a report called the "Coastal Infrastructure and Facilities Needs List" dated June 11, 1999. The report indicated a total backlog of approximately $21 million.

Some of the items contained in the report appear to be strictly related to coastal erosion. Other items like the implementation of a master plan for Sunset Cliffs Park do not appear to be items of deferred maintenance. Still others appear to be duplicates of items found in the draft buildings/structures report.

Approximately $1.5 million is being annually allocated to this need. We were unable to determine from the report whether the annual allocation was resulting in an actual decrease to the backlog.

B. <u>UNFUNDED PROCUREMENT</u>

1. Information Technology

A strategic plan to determine the City's goals and objectives with respect to Information Technology (IT) went to the City Council on January 28, 2002. Based on the report, total estimated IT needs are estimated to be up to $170 million which includes an emergency communication system for an estimated cost of up to $50 million. The majority of the $170 million is not deferred maintenance but rather is identified needs resulting from a combination of improving technology and early anticipation of future needs over the next 2-5 years.

<u>Conclusion</u>

The Committee believes that the City's backlog of general deferred maintenance exceeds $300 million and the City has $170 million of Information Technology needs which is mainly for unfunded procurement.

> <u>Recommendation 4</u>*: The City Manager should establish a process so that all deferred maintenance and unfunded procurement information is developed, aggregated, consistent, complete, non-duplicative, rated for priority, and is available on call for budgetary decisions.*

> <u>Recommendation 5</u>*: The City Manager should prepare and present a public report during the annual budget hearings identifying the cumulative deferred maintenance backlog and unfunded procurement needs which includes asset descriptions, dollar requirements, and categorized by level of need with funding sources.*

The report should answer the following questions for each area of consideration:

1) If the entire backlog in this area could be funded today:
   a. What would that dollar amount be?
   b. How much money would need to be annually allocated to stay current on scheduled major maintenance if the backlog was eliminated?

2) Is there a current plan to "work off" the backlog? If so, what are the funding sources and timeframe?

> <u>Recommendation 6</u>*: The City's policy with respect to funding deferred maintenance and Information Technology procurement be revised to increase expenditures in these crucial areas. While the Committee notes some improvement in addressing deferred maintenance needs in some specific areas, other areas continue to deteriorate.*

V. WATER, WASTEWATER, STORM WATER AND MULTIPLE SPECIES CONSERVATION PROGRAM

The committee believes that an evaluation of the fiscal health of the City would not be complete without considering major fiscal areas the City will face in the near future.

The Committee focused on four major areas:

- *Water*
- *Wastewater*
- *Storm water*
- *Multiple Species Conservation Program (MSCP)*

A. <u>WATER</u>

1. Water Availability

The City of San Diego currently uses about 230,000 acre feet (AF) of water per year. Currently, the imported water is purchased at a cost of $439/AF for raw water and $521/AF for treated water.

The amount increased by $5/AF effective January 1, 2002 as a result of pass thru charges from the San Diego County Water Authority (CWA). Water supply varies in availability and price. Thus adequate storage capacity enables purchases during high availability periods when water is less costly.

On the average, the City purchases between 80-90% of its demand from the San Diego County Water Authority (imported water). The remaining 10-20% of the water is locally captured water, which is used to meet demands.

Demand growth is generally about 2% per year.

Critical components in long-term water availability involve:

- Expanded storage capacity - which is considered to be very promising
- Continued public water conservation education
- Expanded use of reclaimed water
- Exploring alternate water sources
- Ability to meet increasingly stringent water quality standards

Overall, it appears that the City is prudently moving towards increasing water availability.

2. Infrastructure and Price

The Water System has great infrastructure needs for both growth and rehabilitation or replacement of older system components.

The current system has up to 150 miles of old small diameter (less than 12 inches) cast iron mains. The replacement level has been in the 10-mile-per-year range at a cost of approximately $l million per mile. At this rate, the system will always be behind the curve. Doubling the rate to 20 miles a year would be operationally prudent, but has not been contemplated in the current business model and rate structure.

The City currently has adequate local storage to meet its normal and emergency needs and requirements to at least the year 2030.

The City also has enough storage capacity, in its local reservoirs, to take advantage of imported water programs which offer discounted water for local storage during low demand periods of the year for use during the peak demand months, such as during the summer.

The City does require additional transmission facilities, such as pipelines and pump stations, to meet emergency needs and to operate more efficiently during normal operations. To this end, the City is participating with CWA in the Emergency Storage Project. Such project will allow the City to meet its emergency needs and improve normal operations for greater savings to the City.

The City is concerned with the increasing cost of water and therefore desires to explore and study new and alternative water supplies and sources for the region. Expanded storage capacity allows the City to maximize rainwater storage and water purchases at times when the cost is low.

Plans are in the works to finance the acquisition, growth, and replacement needs of the Water System with a combination of bond issues and rate increases. An annual 6% rate increase is projected for a five-year period beginning in 2002. Two bond sales are also anticipated over the next five years.

Conclusion

From a financial standpoint several areas warrant high-level ongoing attention:

1) *Expanding storage capacity to enable cheaper water purchases*

2) *Addressing the operational benefit for expanding old pipe and main replacements*

3) *Stimulating other revenue opportunities such as reclaimed water sales at strong margins*

4) *Conditioning constituents to continuous rate increases*

5) *Developing more finite CIP plans*

6) *Constant monitoring of Federal and State compliance issues*

Overall, the Committee found the main areas of concern to be water storage, price and infrastructure needs. Action plans and financing plans are in place to address these concerns. The Committee believes if the City follows through with these plans and constantly monitors compliance with mandatory requirements, the City's fiscal health will not be impacted.

B. WASTEWATER

The City's Wastewater System represents a challenge relative to the fiscal health of the City for the following reasons:

- A large portion of the collection system is past its economic useful life.
- The treatment system is operating under a 5-year waiver from Federal EPA requirements for secondary treatment. That waiver is currently up for renewal. If the renewal is not granted, the City faces a multi-billion dollar capital spending requirement.
- There is a possible need in the future to expand the Wastewater System as it relates to storm water run off. This could accelerate future capital expenditures.

1. The Collection System

The collection system includes about 3,000 miles of pipe of which almost 1,000 miles of said pipe is past its economic useful life of 50 years. Some of the pipe is over 100 years old. There is a high correlation between this older pipe and sewer spills. Additionally, there is higher operating cost for older pipes. Currently about 20 miles of this aged pipe is replaced per year. At this rate, it will take 50 years to complete the task. Further, it should be noted that the City pays fines for sewer spills - in the magnitude of $4.5 million in the past 18 months. This adds to the higher overall maintenance cost of this aged portion of the system. At the current rate of replacement, it can be expected that maintenance costs and sewer spills will continue to increase. This will in turn increase the level of monetary fines.

In recognition of the above situation, the Metropolitan Wastewater Department has proposed a major pipeline replacement, or repair where feasible, program costing $100 million per year for 10 years. This is a doubling of the previously planned expenditure rate.

Without this newly planned enhanced capital spending program, it is unlikely the sewer spills will be reduced. This new plan will necessitate an additional 2.5% rate increase on top of a planned 5% rate increase (for normal needs like inflation) which totals a 7.5% increase each year for Fiscal Years 2002 through 2005, followed by a 6.5% increase in Fiscal Year 2006 and a 5.0% increase each year for Fiscal Years 2007 through 2010.

2. Treatment and Disposal

The overall situation regarding the City treatment and disposal facilities can be labeled as quite good. The current system is in a “like new” physical condition and has adequate unused capacity to handle expected growth for at least 15 years.

However, there is one major caveat. The Treatment System is operating under a waiver from the Federal EPA Secondary Treatment requirements for the Point Loma Facility. This waiver had a 5-year life, expiring this year and was the result of extensive political debate and enabling legislation back in 1994.

The fiscal health of the City could be impacted if continued renewals of the waiver are not obtained. There is no plan to implement Secondary Treatment. Five years ago, it was estimated that the cost to do so would be about $3-5 billion. The City believes such requirements are not required and/or not beneficial in San Diego's specific circumstance.

The currently proposed wastewater rate increases assume a waiver renewal. If the Federal EPA denied the City’s application for a waiver, the City believes that EPA would grant an administrative extension to the existing waiver while the application for the renewal of the waiver is reviewed at an administrative hearing and, if necessary, in a court of law. If the waiver is not renewed, there would be an immediate need to have new facilities, which would likely be financed by long-term debt.

3. Storm Water Run Off

There is some minor cross impact between Storm Water drains and the Wastewater System. In certain sensitive areas like Mission Bay, and along the coast, a low flow diversion system has been installed to take the dry weather nuisance flow, which typically has high bacteria counts, and to divert it from the normal storm drainage (which runs directly to the bay/ocean) to the sewer system.

However, there is growing concern that no storm water run off should be allowed to enter the bay/ocean without first removing the contaminants with storm water Best Management Practices. This has the potential for being a very large and unplanned financial challenge for the City. It doesn’t make sense to send storm water to the wastewater treatment facility at Point Loma for treatment when storm water treatment can be located in the area of the storm flow. Storm flows are orders of magnitude greater than sewer flows. For example, the smallest storm drain is an

18-inch diameter pipe and the average sewer main is 8-inch pipe. In addition, the contaminants in storm water are not just bacteriological and would not be removed by conventional wastewater treatment methods. Stormwater treatment methods or storm water Best Management Practices include grass swales, wetlands, detention basins, wet ponds, and filters.

There is undoubtedly some meaningful synergy between the storm drains and the Wastewater System and the City should certainly attempt to capitalize on such as they address the Storm Water problem. However, it needs be recognized that any such use of the Wastewater System will undoubtedly accelerate costly capacity additions.

Conclusion

The City has a viable plan for its Wastewater System. The plan will adequately cope with the expected growth in population, while steadily reduce the number of spills. However it must be noted that the plan necessitates a 7.5% rate increase every year for the next 4 years. Additionally, the plan assumes continued "roll over" extensions of the 5-year waivers from the EPA on the treatment process.

Assuming the City maintains the waiver status, stays on track for an expanded replacement program, and achieves the support of the public for rate increases and bonds issues, the City's fiscal health will not be impacted.

C. STORM WATER

Any perspective on the City's storm drain system must start with the Federal Clean Water Act of 1972 and its amendments in 1987. The Act requires cities to get permits for what comes out of their storm drain systems with the stated goal: "To reduce pollution to the maximum extent possible".

The state issues the permits, with the first ones issued in 1990. The mechanism for issuing permits is through a State Regional Board. The permit was considered to be an "early permit" because it was issued prior to the adoption of the EPA Phase I (storm water) guidelines. Although the permit renewal cycle is 5 years, a new permit was not issued in 1995.

On February 21, 2001, the Regional Board significantly revised the Municipal Storm Water Permit with the adoption of Order No. 2001-01. It is an onerous permit with very stringent requirements and very little left to the discretion of the cities.

The Order stipulates that a jurisdictional Urban Runoff Management Program document be submitted to the Regional Board by February 21, 2002 which contains a written account of the overall program to be conducted during the five-year life of the Order. The draft Urban Runoff Management Plan was presented to the Mayor's Clean Water Task Force on December 6, 2001. The plan was approved by the City Council January 28, 2002.

The City began collecting a storm drain fee from water and sewer utility customers in 1990 for the purpose of reimbursing the General Fund for costs associated with storm drain maintenance. The Storm Drain Revenue Fund is used for the operations, maintenance, capital projects and management of the storm drain system. The fee has not been increased since it was set at $0.95 per month per residential customer by resolution No. R-27688 effective August 1, 1996. For Fiscal Year 2002, the Storm Drain Fund revenues are projected to be approximately $6 million per year.

Within the Fiscal Year 2002 budget, $14.6 million has been allocated for the City's Storm Water Program. The first step was to elevate the Storm Water Pollution Prevention Program to the division level within the newly formed General Services Department. With a budget of $3.1 million, the Storm Water Pollution Prevention Program is responsible for the oversight of the Urban Runoff Management Program and compliance with the Municipal Storm Water Permit. Using $10.2 million, the Transportation Department, Street Division is responsible for street sweeping and maintaining approximately 28,000 storm drain structures, pipes and channel. The remaining $1.3 million was added for construction inspection, watershed coordination, and long range planning.

There are no federal funds currently available to help comply and no known legislative efforts to bring realism into the picture.

All 20 entities in the San Diego area are in the same boat in terms of scrambling to comply and are of a similar mind that some of the Regional Board mandates may well not even contribute to helping solve storm water drainage problems. But the mandates still exist.

Finally and paradoxically, the City is in the unenviable position as being the "last stop" as drain water from other jurisdictions "dumps" into the San Diego system enroute to the ocean. Thus, while the majority of the "problem" is generated elsewhere, San Diego has the biggest “fix-it” problem. No accurate data exists at this time, but the judgement is that "the vast majority of the storm drain flow in San Diego originates outside of San Diego".

The above powerfully suggests that the real and best approach to compliance with the Regional Board requirements need be done at a regional level. (Los Angeles and Orange County use the mechanism of Flood Control Districts to address their regional needs.)

In regards to the general deferred maintenance of storm drains, a memorandum to Assistant City Manager, P. Lamont Ewell, dated October 12, 2001, states a backlog need totaling $143 million. Of the total, $70 million is identified as needs related to 380 projects through the City for upgrade and repair to the older parts of the storm drain system and $35 million is to replace 33 miles of corrugated metal pipe.

To address the fiscal health of the City relative to this storm drain issue, the following points are relevant.

1. Even if State mandates were relaxed, there is a significant upward cost to the City. For planning purposes, almost $40 million per year above current revenue.

   Note: To get the City to "break even" would require the City to increase the storm drain fee from $0.95 per month to over $7.00 per month (with equivalent increases in industrial and multi-unit fees). This is both politically horrendous and improbable, although the Council should consider some fee increase after the comprehensive plan has been developed and "sized".

2. Today's storm drain system was designed to rapidly carry flow to the ocean and be self-cleaning in the process. Tomorrow's design – based on the State's mandates - probably should be set up to take large flows of storm water to valleys or meadows to let a settling process address much of the contaminant problem.

3. More sophisticated monitoring processes are needed to gain important insight into the pollution generation problem.

4. The City must take a leadership role in the regional approach to compliance.

5. The 20 partners need to set up an effective, on-going dialog with the Regional Board so that those requirements addressed are critical to problem-solution and that others are mollified or modified.

6. Extensive public education is needed to gain the public's assistance in addressing the pollution generation problem and costs for remedial actions.

7. Proactive and vigorous efforts must be undertaken to attempt to get State and Federal assistance in addressing the problems posed by their mandates- as well as uniformity of their mandates throughout the State.

Conclusion

The Committee recognizes that this new mandate presents a clear and present concern to the fiscal health of the City. If the new requirements were to be covered by increased fees, current fees would have to be increased by about 700%. If such fee increase is politically infeasible, then up to $40 million per year must come out of other General Fund moneys. In addition the City has an estimated $143 million in general deferred maintenance for storm drains that needs to be addressed.

D. MULTIPLE SPECIES CONSERVATION PROGRAM

The Multiple Species Conservation Program (MSCP) is a comprehensive regional plan, which will permanently preserve a network of habitat and open space in order to protect San Diego's unique environment and enhance the regions' quality of life. The plan is designed to preserve native vegetation and meet the habitat needs of multiple species rather than focusing preservation efforts on one species at a time. The MSCP provides the future infrastructure for open space while accommodating future growth and development.

The financial impact of the MSCP is estimated to be between $334-$411 million (1996 dollars) over the next 30 years. This includes land acquisition, management and monitoring. The "payors" include the City, the County, the State, Federal Wildlife groups and the private sector.

It is unclear who is responsible for what costs in this effort. It should be noted that in the past fiscal year, grants from the California Department of Fish and Game, the California Coastal Conservancy, the State Wildlife Conservation Board, U.S. Fish and Wildlife Service and the California Transportation Commission were involved in the effort. Collectively, City land acquisitions of $19 million, State acquisitions of $17 million and Federal acquisitions of $2 million have occurred since 1994.

Thus, 50% of the total land acquisition cost was by the City, 45% by State, and 5% by Federal. Of the City amount, $9 million was non-mitigation funding and $10 million was through mitigating funding. Ultimately the City is proposing to acquire an additional 3,643 acres of land at an estimated cost of $75 million to achieve Mayor Murphy's goal Number 10, "Complete MSCP Open Space Acquisitions." Annual recurring cost of land management and biological monitoring is expected to cost $1.2 million at the completion of the land acquisition.

Conclusion

The Committee recognizes that the MSCP future cost to the City is uncertain. Therefore it is difficult to make a conclusion other than it appears that there could be a continued upward pressure of millions of dollars per year on City finances. A strong effort to secure grants for this purpose is needed to minimize the cost to the City.

VI. REVENUES AND EXPENDITURES

A. REVENUES

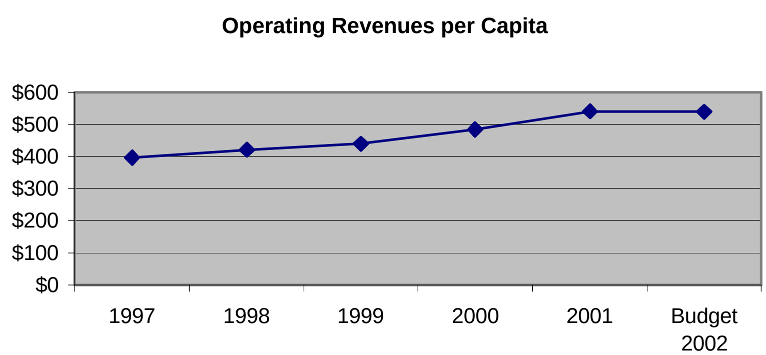
The Committee reviewed the City's General fund revenues with the objectives to:

- Identify total yearly operating revenues
- Compare to prior years and future projections, and
- Compare operating revenues per capita to other large cities.

Between Fiscal Years 1997 to 2001 total general fund revenues, on a financial reporting basis, have increased by 38% - from $514 million to $710 million. And is budgeted, as adjusted, on a financial reporting basis, for Fiscal Year 2002 to be $710 million. See summary below:

Revenues:	1997	1998	1999	2000	2001	Budget 2002
Operating Revenues	$474,310,000	$515,241,000	$551,003,000	$618,580,000	$675,100,000	$665,115,000
Other Financing Sources	$40,005,000	$45,676,000	$31,057,000	$32,952,000	$34,874,000	$45,248,000
Total Revenues	$514,315,000	$560,917,000	$582,060,000	$651,532,000	$709,974,000	$710,363,000

We examined revenues per capita, which shows changes in revenues relative to changes in population size. As population increases, it is expected that revenues and the need for services would increase proportionately. Our analysis revealed that operating revenues per capita has been increasing over the Fiscal Years:



As compared to other cities, San Diego's Operating Revenues per Capita is lower per Moody's Fiscal Year 1999 information. See Attachment 6. As discussed throughout this report, recommendations include increasing general reserves, increasing pension funding, and increasing expenditures for deferred maintenance. In order to address these concerns the City needs to identify alternate sources of revenues and develop and implement a plan to obtain the additional revenues. For example, ten other cities in California currently collect revenues from Utility User Tax, Residential Trash Collection Fees, and Water/Sewer Utility Right-of-Way/Franchise Fee. The City of San Diego does not currently collect revenues in these areas.

B. EXPENDITURES

The Committee found that between the Fiscal Years 1997 and 2001 total General Fund expenses increased 34% from $521 million to $700 million, averaging 7.7% growth per year. Budgeted increases through the Fiscal Year 2002 will bring expenses to $745 million. The 5-year increase per annum averages 7.4%. City expenses per capita are lower than other large cities in California and the Nation. See Attachment 7.

In recent years much effort is reported on improved efficiency of operations through the Zero-Based Management Review (ZBMR) and Organizational Effectiveness programs. It is noteworthy that the City reports its service levels have generally improved during these efficiency efforts. Personnel expenses account for about 75% of the General Fund costs. Current projections forecast reductions in the rate of growth of revenues in the near term.

Recommendations:

Recommendation 7: Expand the current revenue sources and seek additional sources of revenue.

Recommendation 8: Seek ways to reduce expenditures either through improved operational efficiencies or elimination of specific services in deference to higher priority needs.

VII. PRINCIPLES OF BUDGETING AND FINANCE

The City of San Diego is guided by six principles in the development of its current $2.5 billion budget. Consistent with the Mayor's direction, the Committee reviewed these principles to determine:

- *Whether they adequately addressed the needs of City taxpayers?*
- *Whether they were honored?*
- *Whether amendment is recommended?*

A. ANALYSIS OF THE CITY'S SIX EXISTING PRINCIPLES OF BUDGETING

1. ***Ongoing expenditures should be supported by ongoing revenues***.

The Committee strongly supports this principle, and urges its more constant adherence. In the most recent fiscal year, the use of one-time revenues was restricted to an immaterial amount that was matched by one-time expenses.

2. ***The General Fund should maintain a 3% reserve of General Fund revenue***.

As of June 30, 2001, the City's unallocated General Fund Reserve was $19.5 million, which is 2.7% of Fiscal year 2002 budgeted General Fund revenues of $727 million. While this is a significant increase over previously budgeted reserves, it is not consistent with the existing principle.

As discussed in Section I, the Committee recommends that this principle be changed to reflect a requirement of 7-10% in total General Reserves (the current principle reflects only the General Fund's portion of total General Reserves).

3. ***Capital Projects should identify all future cost considerations and financial impacts***.

The Committee supports this principle, and finds that the current 12 year capital budget does generally identify some, but not all, ongoing costs.

The Committee recommends that <u>all</u> costs be better-approximated in future capital budgets, so that significant staffing, maintenance, and operations costs can be anticipated. This recommendation would well serve the long term strategic planning recommended above, and result in better informed decisions about how scarce resources are allocated in both the short and long term.

4. ***<u>Include direct and indirect costs for each Enterprise Fund</u>***.

The Committee supports continued adherence to this principle. While public policy considerations may require individual adjustments in actual practice, the broad principle of identifying all costs associated with enterprise activities remains sound.

The Committee notes that until recently, a right of way fee assessed against the Water and Sewer Funds, in effect, transferred monies from the enterprise funds to the General Fund. A previous Mayor and Council voted to phase out this fee over six years. The last year it is charged is Fiscal Year 2002.

The Committee believes two important questions bear on whether the right of way fee is consistent with the principle of capturing all direct and indirect costs:

(a) Is the purpose of the fee to recover costs associated with water and sewer line construction impacts to streets, sidewalks and other public property?

(b) Is the purpose of the fee to also recover the value of public right of way in which water and sewer lines are placed, and is such recovery a valid "cost" to assess water and sewer rate payers? The Committee recommends that the Mayor and Council direct the City Manager to review and formulate recommendations on this matter.

5. ***<u>Activities Supported by User Fees Should Be Fully Cost Recoverable</u>***.

In evaluating this principle, the Committee distinguished between Enterprise Fund activities, where the principle is largely adhered to, and General Fund activities, where there are exceptions. The Committee believes that the General Fund exceptions often come with good cause (e.g. access to public swimming pools for low income individuals). As such activities represent only 2% of General Fund revenues, significant research was not conducted.

The Committee recommends that the City continue to respect the broad intent of this principle, particularly with regard to Enterprise Funds, but consider amendment as it relates to General Fund activities. Such amendment could specify that full cost recovery may not always be in the public interest, but could still require identification of a specific replacement revenue source where the principal is set-aside.

6. ***<u>Discretionary General Fund revenues should not be earmarked</u>***.

The Committee strongly supports this principle, and was troubled to note its violation, even for such a worthy cause as public libraries. The Library Council Policy requires the City Manager to include funding for library operations, maintenance and supplies in an amount that increases one-half percent each year until it reaches 6% of General Fund spending in Fiscal Year 2005. The Committee believes that a long-term strategic plan is the best way to memorialize long term commitments to important public priorities, while adherence to this principle provides the flexibility necessary to manage a large and fast changing City.

Conclusions and Recommendations

> *Recommendation 9: The City should follow its existing six budget principles and add two additional budget principles*:

> > ***Proposed Principle #7**: Budget development should be guided by a long term, or strategic budget plan proposed by the Manager and adopted by the Council.*

Addressing large capital project needs and long-term population growth require the City to have a multiple year approach to providing and funding municipal services. Development of a strategic plan for the City of San Diego would help citizens and their elected representatives better understand the public policy choices and investments required to maintain our quality of life, and offers an assurance that important long-term priorities are not lost among urgent year to year decision making. Further, strategic plans offer all parties an important opportunity to debate what San Diego should look like in future years. For purposes of better framing important public policy decisions, identifying long term City service and revenue needs, assuring attention to long term priorities, and accomplishing the highest and best uses of City tax dollars, the Committee calls on the City Manager to prepare, and the Mayor and Council to adopt, a San Diego Fiscal Strategic Plan.

> > ***Proposed Principle #8**: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.*

Sound financial and organizational management techniques dictate that once adopted, budgets should be changed only when urgently needed. When urgent circumstances, such as natural disasters or unforeseen economic slumps occur, it is imperative that specific funding be identified to accompany new priorities. Without such clarity, the legal obligation to provide a balanced budget cannot be honored, nor can spending priorities be recalibrated in the public setting taxpayers deserve. The Committee also notes that frequently changing priorities can increase the cost of City administration.