334
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THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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City Council Meeting Date: April 1, 2008

Item Number: 334

General Fund Deferred Maintenance Capital Improvement Projects Financing

OVERVIEW

The City Council is being asked to adopt an ordinance authorizing the issuance of Lease Revenue Bonds, Series 2008A (the "2008A Bonds") in a principal amount not to exceed $108 million. Proceeds from the issuance of 2008A Bonds would finance various General Fund deferred maintenance capital improvement projects and costs associated with issuing the bonds. This report briefly comments on the FY 08 budget plan to finance deferred maintenance projects, the prioritization criteria used to identify deferred maintenance projects, and items related to the proposed 2008A Bonds.

FISCAL/POLICY DISCUSSION

Budget Plan to Finance Needed Deferred Maintenance Projects

The FY 08 Budget estimated the City's deferred maintenance/capital needs, excluding those related to Water and Wastewater enterprises, to be at least $800 to $900 million. This estimate was derived from a 2006 City staff estimate. A detailed update on the actual magnitude of the deferred maintenance problem has yet to be developed. The FY 08 Budget allocated $38.3M to address facility repairs and improvements ($5.3M) and street and storm drain improvements ($33M). Of the $33M budgeted for street and storm drain improvements, 75% or $24.75M was to be financed with the remaining $8.25M to be cash funded.

The City's deferred maintenance/capital needs, excluding those related to water, wastewater and landfill enterprises, is estimated to be at least $800 to $900 million based on a 2006 City staff estimate. A detailed update on the actual magnitude of the deferred maintenance problem has yet to be developed.

Office of Independent Budget Analyst
202 C Street, MS 3A • San Diego, CA 92101
Tel (619) 236-6555 Fax (619) 236-6556

The Mayor's most recent Five-Year Financial Outlook ("Outlook") proposes to allocate $472.3M in bond financing and $308.7M in cash to finance deferred maintenance/capital needs through FY 13 ($80.8M of the cash would be used to pay debt service on the bonds). In FY 09, $77.5M in debt financing and $29.7M in cash, specified within the Outlook, is planned to fund deferred maintenance/capital projects.

Citing limited available cash and an inability to access the public debt market earlier in FY 08, the proposal before the City Council would consolidate planned debt financing for FY 08 ($24.75M) and FY 09 ($77.5M) for a total borrowing of approximately $102.6M, including certain costs associated with issuing debt. The ordinance before the City Council authorizes the sale of up to $108M in 2008A Bonds. Pursuant to City Charter Section 99, the proposed ordinance requires six votes of the City Council for adoption.

Identified Deferred Maintenance Projects

The FY 08 Budget planned to finance $24.75M for street and storm drain improvements in FY 08 and the Outlook committed to financing another $77.5M in FY 09 that would also address City facilities. Attachment A of the Report to the City Council #08-042 lists all of the deferred maintenance projects to be debt financed in FY 08 and FY 09. The IBA has been informed that most of these projects have yet to be bid and will not be completed until FY 10.

In reviewing the FY 08 Budget with respect to deferred maintenance financing, the IBA was unable to determine how specific deferred maintenance projects were identified, given the extensive project backlog and limited funding. The City Council subsequently supported an IBA recommendation, generated during a review of the City's new Debt Policy, that a Capital Improvement Project (CIP) prioritization policy be developed. A CIP prioritization policy has since been developed and presented to the Budget and Finance Committee twice for review. The CIP prioritization policy will be forwarded to the City Council for final consideration this summer; however, the policy was not ready for use in identifying deferred maintenance projects to be funded with the 2008A Bonds.

Lacking a CIP prioritization policy, the Deputy Chief of Public Works and the General Services Department Director explained their selection criteria to the IBA for the various categories of deferred maintenance projects listed below. We have listed the deferred maintenance projects from Attachment A and noted the utilized selection criteria:

STREET AND STORM DRAINS ($77.25M)

Project Category	Selection Criteria Utilized
Street Projects **$53.5 M**	Condition Assessments (every 2-3 years) Pavement Management System Maintenance History

Project Category	Selection Criteria Utilized
Sidewalk/Concrete Projects **$9.55M**	Maintenance Records Public Work Requests
Storm Drain Projects **$14.2M**	Known Problem Areas (i.e., flooding) Maintenance History Exceeded Life Expectancy Potential Liability for Property Damage
FACILITIES ($25M)	**(Emphasis on Public Safety Facilities)**
Roofing **$3.925M**	Phase I Condition Assessment of 31 facilities Maintenance History Customer Input/Feedback
Public Safety Facilities **$8.6M**	General Services worked jointly with E&CP to identify these as high priority projects. Phase I Condition Assessment of 31 facilities Maintenance History
Parking Lot Resurfacing (Overlay) **$4.53M**	Maintenance History Customer Input/Feedback Work with P&R to identify priority lots
HVAC Projects **$3.25M**	Maintenance History Exceeded Life Expectancy
Plumbing **$1.36M**	Maintenance History Exceeded Life Expectancy
Electrical Projects **$.95M**	Maintenance History Exceeded Life Expectancy
Elevator Modernization Projects **$1.385M**	Maintenance History Entrapments Service Contract Feedback
Windows /Doors **$1.0M**	Customer Input/Feedback

The Deputy Chief of Public Works has indicated that the intent will be to use the proceeds of the 2008A Bonds to complete those projects identified in Attachment A; however, there is no bond document requirement to construct these specific projects and management retains the ability to substitute other projects should circumstances dictate that a higher priority needs to be addressed. **The IBA recommends that the City Council be updated on a semi-annual basis on the status of funded projects and of any project substitutions.**

2008A Bonds

As discussed in the staff report, the Public Facilities Financing Authority of the City of San Diego ("Authority) would issue the proposed 2008A Bonds. The 2008A Bonds have a 10 year maturity and would be privately placed with Bank of America, N.A. The contemplated borrowing is a lease-purchase financing whereby a lease is created between the City and the Authority. The City leases five General Fund assets/facilities to the Authority for a nominal rent of $1 and the Authority subsequently leases back those same facilities to the City, at a rate sufficient to cover the debt service on the 2008A Bonds. The City has used asset transfers to facilitate previous General Fund lease financings (see Attachment 1 to the staff Report #08-041).

The IBA inquired as to how the identified General Fund assets/facilities were selected for this financing. We were informed that the Debt Management Department worked with the Real Estate Assets Department to select approximately $111M of General Fund assets from a total suitable asset pool of approximately $350M in order to facilitate the lease purchase transaction with the borrower. The five selected General Fund assets are Police Headquarters, Rose Canyon Operations Station, Mission Valley Library, Malcolm X Library and Scripps Ranch Library. Each of the five assets was recently appraised and does not carry other encumbrances.

Interest only payments of approximately $3.5 million will be made on the 2008A Bonds for the first two years on a semi-annual basis. These interest payments will be made by the General Fund. The interest expense was incorporated into the Mayor's Outlook and will be included in the FY 09 budget.

The 2008A Bonds have been structured with two-tiered pricing that establishes a fixed rate for the first two years (estimated to be approximately 3.46%) and, if necessary, resets the fixed rate for years 3 through 10 at 2.25% above a specified Bank of America cost of funds rate. If the fixed rate for years 3 through 10 were to have been reset earlier this month, it would have been approximately 4.45%. The current financing plan calls for refunding the 2008A Bonds with a 30-year public offering at the end of the initial two-year term. If the long-term refunding plan is executed as planned, pricing terms for years 3 through 10 will be inconsequential.

In keeping with the plan to refund at the end of the second year, the 2008A Bonds are callable two years after the anticipated bond closing in June 2008. As structured, the 2008A Bonds cannot be called before June 2010. **If, however, long-term rates in the public markets were to go lower during the two year period, the IBA recommends that the Debt Management Department monitor the feasibility of an advance refunding.**

An advance refunding could allow the City to take advantage of lower long-term fixed interest rates in the near future without an earlier call feature on the 2008A Bonds. The City may be able to reenter the public markets as soon as this summer. Long-term interest rates are relatively low and may trend lower. If so, an advance refunding could enable the City to lock-in low, long-term fixed rates and potentially significant interest savings in the event that interest rates were forecasted to rise as we approach June 2010.

CONCLUSION

Given an urgent need for the City to begin addressing the significant backlog of deferred maintenance projects, the IBA recommends support of the proposed 2008A Bonds. We remain concerned, however, that without a detailed, quantified and prioritized inventory of current deferred maintenance needs, it is difficult to understand what progress is being made in reducing the citywide problem. It also makes it challenging to effectively plan to address the highest priority projects. We further note the related importance of 1) funding routine maintenance for all public infrastructure and 2) the impact that rising construction and materials costs could have on the total cost of addressing citywide deferred maintenance.

The proposed 2008A Bonds are effectively a two-year financing with a firm obligation to refund or re-price the debt in June of 2010. Because of the uncertainty of interest rate levels two years from now and the City's inability to call the bonds before that time, there is some interest rate risk associated with the subsequent re-pricing (fixed long-term interest rates could be better or worse than current rates). The IBA recommends that the Debt Management Department monitor long-term fixed interest rates and evaluate the feasibility of an advance refunding, to potentially achieve long-term interest savings, if interest rates move significantly lower in the near term or if future rates are forecasted to rise.

Additionally, the IBA recommends that the City Council be updated on a semi-annual basis regarding the construction status of the identified facilities. This will ensure that the City Council is periodically apprised of any project substitutions and how bonds proceeds are being expended.

The Office of the City Attorney will issue a useful due diligence and disclosure obligation memorandum related to the 2008A Bonds on March 28, 2008. In addition to

> *The due diligence and disclosure obligation memorandum issued by the Office of the City Attorney briefly describes the bond financing documents and provides useful questions and answers for the City Council to consider. The IBA encourages the City Council to ask any questions they might have directly to members of the City's financing team including the City's financial advisor, bond counsel and even the purchaser of the 2008A Bonds (Bank of America).*

providing guidance to the City Council regarding due diligence obligations under federal securities laws, the memorandum briefly describes the bond financing documents and provides useful questions and answers for the City Council to consider. A certification by the Disclosure Practices Working Group has also been attached indicating that financial information disclosed in the 2008A Bonds has been reviewed to ensure accuracy.

The IBA has been informed that representatives of the entire financing team will be present for the City Council meeting on April 1, 2008. The IBA encourages the City Council to ask any questions they might have directly to members of the City's financing team including the City's financial advisor, bond counsel and even the purchaser of the 2008A Bonds (Bank of America). The availability of financing consultants to the City Council at or before City Council meetings where approval is sought for debt is a recommendation within the comprehensive financial training program adopted by the City Council on December 6, 2006.

Jeff Kawar
Fiscal & Policy Analyst

APPROVED: Andrea Tevlin
Independent Budget Analyst