

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: April 12, 2007

IBA Report Number: 07-42

City Council Docket Date: April 17, 2007

Item Number: 331

Subject: Lease-Purchase Agreement with IBM to Finance the Enterprise Resource Planning System Core Project (ERP)

OVERVIEW

On February 5, 2007, the City Council adopted Resolution R-302332 which approved, in concept, the ERP described in Report to the City Council No. 07-027 and requested that the Mayor's staff return to the City Council to approve a financing package for the ERP. In accordance with that direction, the Debt Management Department will request approval of an ordinance on April 17, 2007 authorizing the City to enter into a lease-purchase agreement with IBM Credit LLC (IBM), and a related reimbursement resolution, to facilitate implementation of the ERP. This report comments on updated ERP procurement and financing information provided within Report to the City Council No. 07-060.

FISCAL/POLICY DISCUSSION

ERP System

In keeping with the City's financial remediation objectives, the contemplated ERP is intended to replace the City's major financial software systems which are considered to be antiquated and inefficient. The ERP will be the largest financial information technology project ever undertaken by the City and is proposed to enhance financial management capabilities and improve overall City efficiency. As noted in Report to the City Council No. 07-060, the \$36.5 million estimate for ERP is roughly comprised of the following expenses:

- Hardware, Software & Peripheral Devices: \$ 4.5M to \$6M
- Systems Integrator Consultants & City Staff Time: \$ 26.5M to \$30.5M

Although the Report to the City Council indicates that hardware/software vendor selection will be finalized in the third week of April 2007, the Chief Information Officer (CIO) has informed the IBA that final vendor selection will be two to three weeks later. It should be noted that ERP's largest cost component is for System Integrator consultants. The RFP for System Integrator consultants will be issued after hardware/software vendor selection. System Integrator selection is anticipated to occur in June 2007. The Report to the City Council does not provide a breakdown or allocation of anticipated labor costs between the Systems Integrator, City staff that will be required from several departments and San Diego Data Processing Corporation (SDDPC).

Approximately \$29.5 million of the \$36.5 million total estimated cost for ERP is to be financed with the proposed lease-purchase agreement. The remaining \$7 million has been determined to be ineligible for lease-purchase financing and would be funded with cash from the General Fund and SDDPC. Report to the City Council No. 07-027 indicates that the City would contribute \$3.5 of the \$7 million from the A-List funds (#50066) that "were budgeted for the maintenance and enhancement of systems that will be replaced by the ERP system." SDDPC would contribute the other \$3.5 million from their reserve which the CIO has attributed to SDDPC expenditure savings and unanticipated customer revenues.

Requested City Council Actions

There will be two actions, or subitems, related to the request before the City Council on April 17, 2007. Subitem-A introduces an ordinance that will authorize the Mayor to execute a Master Lease Agreement with IBM for a period not to exceed seven years for the purpose of financing ERP through lease-purchase. The ordinance also authorizes and directs the Auditor and Comptroller to establish an ERP Fund (#50071) and to transfer up to \$3.5 million from the A-List Fund to the new ERP Fund. This \$3.5 million coupled with the \$3.5 million cash contribution from the San Diego Data Processing Corporation (SDDPC) will fund the ERP labor and non-personnel expenses that are not eligible for lease-purchase.

Subitem-B requests approval of a reimbursement resolution related to the proposed lease-purchase agreement with IBM. Similar to the reimbursement resolutions that the City has adopted to facilitate reimbursements for water and wastewater system expenditures, this resolution is necessary to comply with Federal Treasury regulations requiring the City to declare its intent to use funds borrowed through lease-purchase to reimburse already incurred ERP expenses within specified timeframes. This resolution would not be necessary were IBM to directly make payment to ERP vendors and consultants on behalf of the City; however, it is likely that the City will incur costs more frequently than IBM is willing to make payment and hence the reimbursement resolution becomes necessary.

IBA Questions/Concerns

Prior to the February 5th City Council meeting, the IBA issued Report 07-23 briefly discussing ERP and the request for conceptual approval of the ERP plan. In that report, the IBA expressed support for replacing the City's aging software and computer systems with ERP to increase overall City efficiency. The report further recommended that "periodic reports be provided to the City Council as major steps are taken or as milestones are achieved for the ERP project."

While ERP systems hold tremendous potential for streamlining labor intensive processes, managing financial information, and using business process best practices, they also have been known to experience significant cost overruns and difficult/lengthy implementation periods. Some of the circumstances that can contribute to ERPs not being implemented within budget or on schedule include, but are not limited to:

- Insufficient staff resources to fully support the project
- Lack of budget control
- Contractor's lack of experience in implementing the latest ERP version
- Weak implementation system controls
- Existing infrastructure and resistance to change

The ERP financing plan before the City Council on April 17, 2007 appears to be the last required City Council action related to the procurement and implementation of the ERP. The CIO has acknowledged that the current ERP cost estimate of \$36.5 million is a rough order of magnitude estimate at this time because equipment, vendors and consultants have yet to be identified. Additionally, the IBA believes that City departments may be challenged to find sufficient experienced staff capacity to support ERP implementation and also perform core departmental responsibilities.

Given the potential magnitude of expenditures for ERP, the importance of this system to the City over the next 15 years, and the potential impact on key departmental staff, the IBA recommends that a process requirement be established for regularly apprizing the City Council and the public of significant and evolving ERP matters (implementation milestones, schedule changes, budget information, staffing considerations, challenges, opportunities, new system features, etc.). The IBA believes that it is not the City Council's intent to micro-manage ERP procurement and implementation, but rather to be appropriately informed of relevant information related to a multi-year implementation plan for such an important City system.

The IBA understands that the CIO will accompany Debt Management Department staff in making the presentation to the City Council on April 17th. Responses to the following questions may be presented or could be subsequently raised for discussion by members of the City Council:

- 1) **Project budget certainty** – What is the current level of certainty about the estimated project budget? How might cost overruns be handled? Does the IBM lease-purchase agreement allow for increases to borrowed amounts for costs which are eligible for financing? What controls are in place to ensure complete project planning, and cost containment?
- 2) **Time sensitivity** – If necessary, could the financing proposal be postponed until more specific information is available regarding hardware/software and the Systems Integrator? Will more information about the project budget be available within a relatively short period of time to allow for a more precise estimate of the project amount to be financed?
- 3) **Breakdown of costs** – What is the estimated breakdown of staff costs between SDDPC, City staff, and System Integrator? Why are some labor costs eligible for financing while others need to be cash funded? Have some of the pre-implementation costs already been incurred? If so, how much, and how was it funded?
- 4) **Cash funding** – Is current cash funding of \$7 million available now from SDDPC reserves and A-List project fund? If so, would it make sense to use this cash for the referenced \$5 million software purchase in FY 2007, and then reimburse it with later financing as would be permitted by the reimbursement resolution to reduce financing costs? Does the borrowing need to occur now if there is cash on hand?
- 5) **Assigned staff** – How many staff members will be reassigned to the ERP project and from which departments? Will there be an impact to existing department assignments/tasks? Will these staff costs be funded from ERP fund?
- 6) **Cost Allocation** - How were the breakdown of cost percentages determined between General Fund and non-General Fund departments on page 4 of the Report to the City Council?

Proposal from the Office of the City Attorney

At this morning's City Council staff briefing, the Office of the City Attorney indicated that while their office is supportive of the lease purchase agreement, they were also concerned that the City Council may not have had an opportunity to be sufficiently briefed on ERP procurement, costs associated therewith and implementation considerations prior to making a financial commitment to the project. The City Attorney indicated that they would prepare an amendment to the ordinance for City Council consideration that would condition any draw on the IBM credit facility upon the Council

receiving an update on ERP vendor selection procurement. The ERP information update would provide pertinent information to the City Council regarding the selected equipment vendor, the process for selection, hardware/software and system integrator and critical success variables. With that information known, the information update would also provide a revised total budget estimate and timeline for implementation. Once that condition was satisfied, the Mayor or his designee would be permitted to proceed to make draws on the IBM credit facility to pay the costs of the project.

CONCLUSION

The IBA reiterates its support for replacing the City’s aging software and computer systems with ERP to increase overall City efficiency. We also support the recommended use of lease-purchase financing; however, current cost estimates are rough and related questions have yet to be answered. Given the long-term importance of ERP to the City, the potential for cost overruns/delays, and other possible staffing/service impacts, the IBA recommends that the City Council be regularly apprized of all significant developments related to the procurement and implementation of ERP.

The Office of the City Attorney appears to share this concern and has developed the above referenced ordinance language to address it. There are certainly other approaches to reasonably provide pertinent information to the City Council, and the public, without delaying the implementation of ERP. The IBA recommends that the City Council adopt a version of the proposed ordinance that ensures they will be regularly apprized, and that many of the questions raised in this report will begin to be discussed at the City Council meeting on April 17th.

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