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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**IBA Report Number:** 09-31

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# First Amendment to the Master Lease Agreement with IBM Credit LLC

## OVERVIEW

On May 21, 2007, the City Council authorized a Master Lease Agreement (Agreement) with IBM Credit LLC to finance \$29.5 million of the OneSD Project estimated at the time to cost \$36.5 million. The Agreement established a \$29.5 million line of credit for the project which is set to expire on June 30, 2009. The estimated cost of the OneSD Project is now expected to increase by \$10.5 million which will require authorization by ordinance of 1) an additional \$7.5 million of financing not to exceed \$37 million, 2) renegotiated financing terms beginning July 1, 2009 through June 30, 2010, and 3) extending the acquisition period for equipment, services and increased labor costs through June 30, 2010.

As the proposed changes to the Agreement's financing terms are significant (the effective interest rate will more than double), this report briefly comments on the increased financing costs, raises the question of whether alternative and less expensive financing might exist, and notes concerns related to the timing of related SDDPC Board actions.

## FISCAL/POLICY DISCUSSION

### Fiscal Impact of Proposed Change in Lending Terms

As noted in the staff report, the proposed amendment to the Agreement will increase the authorized financing from \$29.5 million to an amount not to exceed \$37 million and extend the term by one year through June 30, 2010. Although the proposed amendment to the Agreement gives the City an option to borrow with a 5-year or 7-year term, City

staff expects to continue to finance the OneSD project using a 7-year term. Based on rates for the week ending March 27, 2009, the proposed change in the financing terms would increase the borrowing rate from 2.30% to 5.17%.

The proposed change in the borrowing rate is significant over a 7 year term. Looking at the total borrowing cost of the anticipated draw down amounts in Table 1 (right hand column) on page 3 of the staff report shows that the additional interest expense for borrowing \$10.9 million (draws #8 through #13) after June 30, 2009 is roughly \$6 million more than the interest expense for borrowing an identical \$10.9 million (draws #5 through #7) in the months before June 30, 2009. When asked about the significant increase in financing terms, staff explained that they result from:

- 1) More restrictive loan underwriting practices tied to recent changes in the lending and banking industry that have more than offset lower interest rates in the capital markets;
- 2) Inability to attract other lenders to complete the financing for the OneSD project that has been largely financed by IBM Credit LLC to date; and
- 3) Very few lenders willing to finance information technology related costs that can be difficult to collateralize (labor and consultant costs cannot be secured like equipment and software).

#### Alternative Cash-Funding Possibilities

In addition to the financing previously secured through IBM Credit LLC, the OneSD project has been funded with net assets (equity) from the San Diego Data Processing Corporation (SDDPC) and the City's A-List project fund. Each of these sources contributed \$3.5 million towards the originally estimated cost of \$36.5 million. Of the additional \$10.5 million that the OneSD project is now projected to require, an additional \$3 million is to come from these sources (\$2 million in SDDPC equity and another \$1 million from the City's A-List project fund).

In reviewing the balance sheet for SDDPC for the month ending February 28, 2009, the IBA notes that the corporation has net equity of approximately \$13.4 million. We also wonder if there might be other funds or lower priority projects in the City's A-List project fund that could alternatively be used in lieu of additional and more expensive financing from IBM Credit LLC. If there are alternative funding options that could reduce the more expensive borrowing terms associated with the proposed amendment to the Agreement, the IBA believes those options should be evaluated.

#### SDDPC Board Actions

Actions taken by the SDDPC Board at its meeting of March 26, 2009 include the approval to execute a contract with SAP to purchase the Public Budget Formulation software and associated implementation services to support the OneSD Project. This action, at a cost in excess of \$2.2 million, is described in the staff report as one of the

items contributing to the increased cost and scope. In the SDDPC Board materials, the funding is said to be coming through the City’s financing contract with IBM.

However, the IBA notes that at the time of the SDDPC Board meeting, the Council had not yet reviewed the amendment to the financing agreement that authorizes the increase in borrowing to support the added scope contemplated by this SAP contract. The material provided to the SDDPC Board does not describe that funding as being subject to future Council action. The approval granted by SDDPC may have already obligated the City for additional work. If the Council were to not approve the requested amendment to the financing agreement, the City may find itself in a position where it has committed itself beyond its current resources.

## CONCLUSION

As the OneSD project is critically important to the City, it may be necessary to authorize the proposed amendment to the Agreement in order to secure needed financing. As noted in the staff report, the OneSD project will provide the City with a financial system that supports enhanced accountability, greater transparency, increased fiscal responsibility, and oversight.

The IBA recommends, however, that staff provide assurances to the City Council that less expensive and/or alternative funding sources are not available for the OneSD project before authorizing the proposed amendment to the Agreement with IBM Credit LLC. Additionally, we recommend that City management not submit requests to the SDDPC Board that would increase project costs before necessary City Council authorization has been obtained.

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