THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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2013 Lease Revenue Bonds - $30 Million Capital Improvement Projects Financing: Background Information and Options for Consideration

OVERVIEW

This item was before the City Council for consideration on March 4, 2013 and was trailed to the March 11, 2013 Council agenda to allow for additional information to be provided. The original proposal, which was limited to a $25 million lease revenue bond, was first discussed by the Budget and Finance Committee on September 26, 2012; approved by the Committee on October 10, 2012; and subsequently approved by the City Council on October 22, 2012. This item has carried over from the previous Mayoral administration to the new administration; also, two new Council members have taken office since Council approved this item in October.

Some assumptions and components of the original proposal have changed since it was first approved including improved interest rates; the proposed bond amount increasing from $25 million to $30 million; and identification of an estimated $40 million General Fund budget deficit for FY 2014. During Council discussion of this item on March 4, 2013 Councilmember Kersey proposed that consideration be given to authorizing an additional $10 million for a total $40 million bond issuance. This report discusses the evolution of this item since it was first approved, including the original financial analysis, and presents three options for Council consideration.

FISCAL/POLICY DISCUSSION

New Debt Service Costs Were Offset by Savings from Public Liability Fund Contribution

A new $25 million lease revenue bond was first discussed by City management at the September 26, 2012 Budget and Finance Committee to fund six new priority capital projects to take advantage of low interest rates and low construction costs. Over the past year and a half, the Council has made significant headway toward addressing the City's infrastructure challenges by approving the City's first multi-year financing program for deferred capital; adopting Capital

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Improvement Program (CIP) streamlining reforms to help accelerate project construction; establishing a formal community input process for the CIP budget; and recommending to the Mayor in March of 2012 that the City's remaining $8.3 million mid-year surplus be dedicated to further increase cash funding of deferred capital projects in FY 2013—just to name a few. With no other major funding source in close sight, Council has strongly encouraged management to continue to be creative and identify opportunities to piece together deferred capital and new infrastructure funding where financially feasible. The $25 million bond proposal was one such item.

Also in September 2012, the City received $27 million from SDG&E from the 2007 Wildfire Settlement which the former Mayor placed in the Public Liability Fund in order to accelerate achieving the City's policy goal—50% of outstanding claims—by FY 2019. This action has the added benefit of reducing annual required General Fund contributions to the Fund, freeing up General Funds for other purposes.

For "due diligence", at the September 26, 2012 Budget and Finance Committee meeting, the IBA requested that management provide the Committee with a cost/benefit analysis for using the $27 million SDG&E settlement money to fund the proposed capital projects, rather than using lease revenue bonds, and the impact on the FY 2014-2018 Five-Year Outlook. On October 10, 2012 staff presented two scenarios:[1]

- Increasing the Public Liability Fund by $27 million and issuing lease revenue bonds to fund the projects; and
- Utilizing the $27 million to cash fund the projects.

Scenario 1- Increase the Public Liability Fund by $27 Million and Issue Bonds for Capital Projects

By increasing the Public Liability Fund by $27 million and issuing bonds for the projects, it was estimated in October 2012 that the City would pay $1.8 million in annual debt service costs but would be able to reduce the annual contribution to the Public Liability Fund from $6.1 to $1.6 million, saving $4.5 million annually from FY 2014 to FY 2019. (Without this infusion, a $6.1 million increase annually would be necessary to achieve the City's policy goals for the fund by FY 2019.) After accounting for $1.8 million in annual debt service, $2.7 million of net savings would be gained annually for the period FY 2014 to FY 2019 as shown below.

Increasing the Public Liability Fund by $27 Million and Issuing $25 Million in Bonds to Fund the Projects

Millions of Dollars

	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
Initial Contribution	6.1	6.1	6.1	6.1	6.1	6.1
Reduction	(1.6)	(1.6)	(1.6)	(1.6)	(1.6)	(1.6)
Projected Savings	4.5	4.5	4.5	4.5	4.5	4.5
Debt Service	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)
Net Savings	2.7	2.7	2.7	2.7	2.7	2.7

[1] A third scenario of splitting the $27 million between the Public Liability Fund and funding of capital projects was also presented but was considered not desirable as it did not accomplish the desired goals.

Scenario 2 - $27 Million Cash Used for Capital Projects/No Lease Revenue Bonds Issued/No Infusion to Public Liability Fund

Since a bond would not be necessary, the City would not pay $1.8 million in annual debt service but would need to contribute the full $6.1 million in annual contributions to the Public Liability Fund. This scenario would not achieve any annual savings and would not accelerate contributions to the Public Liability Fund from FY 2014 to FY 2019.

Based on the projected savings available to offset the annual debt service for FY 2014 to FY 2019 as well as low interest rates on lease revenue bonds and lower construction costs, Management and the IBA recommended Budget and Finance Committee and City Council approval of Scenario 1 including a $25 million lease revenue bond and a $27 million infusion into the Public Liability Fund utilizing the SDG&E settlement money.

Since Council approval of the lease revenue bond in October, the City Attorney issued a memo opining that a yet-to-be-determined portion of the $27 million settlement money needed to be used to reimburse Public Utilities for its costs related to the 2007 Wildfires. Hence, only a portion would then be available for the Public Liability Fund (General Fund), which would reduce the liability savings as discussed in October and reflected in the Five-Year Financial Outlook. This matter will be further discussed during the FY 2014 budget process.

OTHER CHANGES SINCE OCTOBER 2012 COUNCIL APPROVAL

$40 Million Deficit Projected for FY 2014

In November 2012, the former Mayor issued a Five-Year Outlook for FY 2014-2018 which projected a $4.9 million surplus for FY 2014. In our review of the Outlook issued on November 19, 2012, our office projected a deficit ranging from $37-84.2 million, depending on the outcome of certain pending issues. The consensus figure at this time for the FY 2014 deficit is $40 million, attributable largely to increases in the City's pension payment and the State Department of Finance disallowing certain agreements between the City and former Redevelopment Agency for debt service and other payments. It should be noted that $4.5 million in savings from reduced contributions to the Public Liability Fund and $1.8 million in annual debt service for the planned $25 million bond have been taken into account in the $40 million projected deficit. Increasing debt service payments in excess of $1.8 million would increase the deficit projection.

Mayor Increases Council Action Item for Bond Issuance from $25 Million to $30 Million

Subsequent to the City Council providing their authorization to issue $25 million in lease revenue bonds, the Mayor requested Debt Management staff to increase the proposed issuance to $30 million to fund $5.0 million of General Fund Storm Water capital projects. This change was based on a unanimous recommendation of the City's Capital Improvement Program Review and Advisory Committee (CIPRAC) to increase the proposed borrowing to address certain high priority storm water capital projects in FY 2014.[2]

A companion report to the City Council describing these specific needs was provided as backup information by Transportation & Storm Water. Debt Management staff provided debt service

[2] The Storm Water Division identified $5 million in high priority projects to install Best Management Practices (BMP) water purification system that are needed to comply with current Municipal Storm Water Permit requirements.

projections using current market interest rates which show that increasing the bond proposal from $25 million to $30 million raises the annual debt service payments from $1.4 million to $1.7 million. Due to a reduction in market interest rates, it is worth noting that the amount of debt service estimated for a $25 million bond in October 2012 ($1.8 million) is now more than sufficient to pay estimated debt service on a $30 million bond ($1.7 million). In fact it provides $100,000 in savings for the FY 2014 projected deficit.

Councilmember Kersey Proposes to Increase the Bond Amount from $30 Million to $40 Million

Recognizing that the $80 Million Deferred Capital Bond (DC3) planned for issuance in FY 2013 is likely to be delayed to FY 2014, at the Council meeting on March 4, 2013, Councilmember Kersey requested Council to consider increasing the current bond by about $10 million to a total of $40 million. Councilmember Kersey proposed this additional amount be dedicated to underfunded, high priority projects already identified through City prioritization processes that are ready for implementation. For example, he suggested a portion of the funds be added to existing contracts for resurfacing asphalt and concrete streets. He also recommended using bond proceeds to fund several projects that were identified by staff as needing funding to be completed. These projects are in priority order on the "Cascade" list of underfunded projects in the FY 2013 budget (Volume III, page 17, table 19).[3]

Since several Council Members had additional questions regarding the specifics of proposed projects during the meeting, the item was trailed for further discussion on Monday, March 11, 2013. Approving this additional amount would increase annual debt service requirements by about $600,000 from $1.7 million to $2.3 million.

OPTIONS FOR COUNCIL CONSIDERATION

Council has the following options:

Option 1 – Authorize issuance of lease revenue bonds with net proceeds of $25 million as originally approved by City Council in October 2012. Based on updated annual debt service estimates developed by Debt Management using recent market interest rates, the annual debt service payments are estimated at $1.4 million. This option would fund six high priority capital projects but would not fund $5.0 million in critical storm water projects recommended by CIPRAC and the Mayor. These Storm Water projects may have to be funded in FY 2014 through the General Fund due to Municipal Storm Water Permit requirements.

Impact to Five-Year Outlook – $400,000 in savings since annual debt service payments of $1.8 million have been included in the Outlook based on market interest rates for a $25 million bond in October 2012.

Option 2 – Authorize issuance of lease revenue bonds with net proceeds of $30 million as recommended by the Mayor. Annual debt service costs are estimated at $1.7 million. This would fund the original six capital projects as well as provide $5.0 million in funding for storm water

[3] As approved by Council in the FY 2013 Appropriations Ordinance, staff is authorized to transfer remaining funds from closed out projects to the projects on the "Cascade" list without returning to Council for approval.

projects and have the additional benefit of relieving the General Fund of this $5.0 million burden.

Impact to Five-Year Outlook – $100,000 in savings since annual debt service payments of $1.8 million have been included in the Outlook based on market interest rates for a $25 million bond in October 2012.

Option 3 – Authorize issuance of lease revenue bonds with net proceeds of $40 million as proposed by Councilmember Kersey on March 4, 2012. This would increase annual debt service costs by about $600,000 for a total of $2.3 million. This would include the original six recommended projects; $5.0 million in high priority storm water projects as recommended by CIPRAC and the Mayor; and would provide $10 million for high priority, underfunded projects that are ready to go and have been previously identified through City prioritization processes.

Impact to Five-Year Outlook – $500,000 increase in the projected deficit, since annual debt service payments of $1.8 million have been included in the Outlook based on market interest rates for a $25 million bond in October 2012.

CONCLUSION/RECOMMENDATION

The IBA supports Options 2 and 3 to authorize the issuance of lease revenue bonds with net proceeds of $30-40 million. Infrastructure funding is a top priority for the City Council and the community. For a relatively marginal debt service increase of $600,000 annually, the City can construct an additional $10 million of critical projects. With deferred capital of $900 million for streets, buildings, and storm drains, the City has an obligation to continue to chip away at its infrastructure needs. In addition, this is an opportunity to take advantage of low current interest rates. This coupled with low construction costs makes this an opportune time to finance priority infrastructure needs, especially since the third deferred capital bond issuance initially planned for FY 2013 may be delayed to FY 2014.

We are also recommending that Council dedicate the majority of the additional $10 million for street resurfacing, given that the deferred capital backlog for streets is $478 million; the Street Division can identify priority streets using its Pavement Management System; and this bond funding can easily be added to existing resurfacing contracts, spent expeditiously, and result in improvements across the City. As the City implements asset management and develops a Multi-Year Capital Improvements Plan, it will have a sound and transparent process for identifying priority capital projects and can strive to develop a financing strategy for more comprehensively addressing Citywide needs.

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