



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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FY 2018 CIP Mid-Year Budget Monitoring Report: General Fund Commercial Paper Program

OVERVIEW

The Fiscal Year 2018 Capital Improvements Program (CIP) Mid-Year Budget Monitoring Report (CIP Mid-Year Report) includes a consolidated budget request for City Council approval to appropriate, de-appropriate, or reallocate project funding. It also includes updates on several major CIP fund sources; process improvements; and the anticipated commercial paper borrowing program to support capital improvement projects that rely on the General Fund. This is the fifth semi-annual CIP Budget Monitoring Report since the issuance of the first report in December 2015.

Our report supplements the CIP Mid-Year Report by 1) highlighting important characteristics of the developing commercial paper program to fund General Fund capital improvements; 2) providing additional information on cash management strategies that affect the timing of the commercial paper program; and 3) providing an idea of the types of projects that may be proposed for the commercial paper program.

The CIP Mid-Year Report includes various recommendations for the anticipated General Fund commercial paper program, including that no new projects will be considered for this funding. Instead, funding is intended to complete existing projects. Our Office notes that the City continues to be faced with growing capital needs that rely on the General Fund which must be addressed by funding new capital improvement projects in the future.

FISCAL/POLICY DISCUSSION

General Fund Commercial Paper Program Taking Form

The FY 2019 – 2023 Five-Year Financial Outlook (Outlook) includes approximately \$27.2 million of debt service to support a \$270 million borrowing plan for General Fund capital improvements over the Outlook period. This same total borrowing plan has been included in the past two Outlooks,

though it has not yet commenced due to several factors including, spending down existing unrestrictive resources within the CIP. The borrowing plan assumes \$75 million of commercial paper notes being issued in FY 2019 and \$97.5 million of bonds being issued in FY 2021 and again in FY 2023. The estimated \$75 million commercial paper program is anticipated to provide as-needed funding for existing projects through FY 2021.

The CIP Mid-Year Report includes recommendations that begin to give the General Fund commercial paper program a timeline and structure. The recommended schedule provides that:

- A commercial paper program, including a proposed list of projects for funding, be brought to Council for approval in the spring of FY 2018 to fund General Fund capital projects; and
- The first commercial paper debt be issued within six months of Council approval of the program (first half of FY 2019).

The programmatic recommendations provide that:

- Funding from commercial paper be limited to projects that are 1) already *active*, and 2) need additional funding to be *completed*; and
- Projects be prioritized on a cash flow basis— or those that are most in need of immediate funding.

According to staff, the general methodology used that subsequently drove the need for the anticipated \$75 million to be issued in commercial paper was first identifying active projects in the CIP associated with General Fund asset types. From this subset of projects, a review of existing funds and projected expenditures from FY 2018 to FY 2021 was conducted to identify projects that need additional funding in order to be completed. Staff has indicated that projects identified through this process will also be compared to the recent list of projects submitted by Council this past November through the online survey conducted by the Capital Improvements Program Review and Advisory Committee, as well as recent Council budget priority memoranda.

The recommended timeline includes a gap up to six months between the time Council approves the program and project list, and the time the debt is actually issued. The authority to issue commercial paper when needed will provide staff with budget authority necessary for the construction contract bid and award process and for contractor set up activities. Since commercial paper is just-in-time borrowing, the debt proceeds will be issued in time to pay expenses incurred during this period, as they become due.

The CIP Mid-Year Report, like previous publications, states that the timing of *issuing* commercial paper notes will depend on factors including: when projects are estimated to need funding to proceed, interest rates, and the rate of spending outstanding bond proceeds and unrestricted CIP fund sources. Unrestricted CIP fund sources are flexible and for general use. These include the Capital Outlay Fund and Infrastructure Fund which can be used for acquisition, financing, and construction costs for permanent public improvements. The least restrictive funding source is General Fund contributions to the CIP which can be used for any purpose. Monitoring the spending of outstanding bond proceeds and unrestrictive fund sources is important to identify the optimal time to issue commercial paper notes. Available cash should be low enough to avoid incurring unnecessary borrowing costs by issuing debt prematurely, while at the same time not impeding project

implementation by lack of liquidity in the CIP.

Cash Management Strategies

The City's CIP is a multi-billion-dollar program that includes over 1,300 active capital improvement projects (including sublet projects) which span multiple years to complete, and are supported by a variety of funding sources. Effectively managing the funds in such a large program is important in keeping projects moving forward and cash flow shortfalls from delaying implementation of priority projects.

In recent years, the City has focused on closely monitoring the funds and project delivery schedules within the CIP so that cash management strategies can be implemented. This monitoring results in identifying funds that are idle in a project that is either not moving forward¹ or not expected to spend its existing budget until a future fiscal year. These funds can then be reallocated to another project in need of funding so it can proceed.

In addition, prioritizing the expenditure of certain fund sources over others supports efficient use of CIP resources. Since each funding source used within the CIP has unique legal eligibility and time restrictions, these restrictions guide the prioritization of funds to be expended. The most restrictive fund sources are used first, and the least restrictive sources are used last, so that funding can be spread to as many projects as possible.

Lease revenue bonds issued by the City, referred to as deferred capital bonds (DC bonds), to finance General Fund capital improvement projects are generally the highest priority fund source to be spent in projects because they are time-sensitive due to IRS spending guidelines. Fund sources that are restricted to certain communities (e.g. development impact fees and facilities benefit assessments) or uses (e.g. TransNet and gas tax revenues²) are then prioritized. Funds that are unrestricted for general use (e.g. Capital Outlay, Infrastructure Fund, and General Fund) are typically the last to be spent because they can be used for many projects. These funds can also be reallocated to projects ready to proceed when no other sources are available.

Spending Down Existing Funds

One of the major factors driving the timing of commercial paper program is spending down available funds in the CIP. Staff has been able to increase expenditures in the CIP through cash management strategies such as: continuous monitoring of the CIP projects and available funds; identifying funds that can be more efficiently used for another project; and either administratively reallocating funds within the authority provided in the Appropriations Ordinance, or seeking Council approval as necessary. The CIP Mid-Year Report discusses the status of the following major fund sources: TransNet, gas tax revenues, DC bond proceeds, and unrestrictive fund sources (General Fund contributions to the CIP, Capital Outlay Fund, and Infrastructure Fund).

The previously large TransNet fund balance has been significantly reduced, resulting in the City being above the TransNet Independent Taxpayer Oversight Committee monitoring thresholds for

¹ Project delays can be caused by a variety of things such as litigation, construction moratoriums, or unforeseen site conditions or obstacles.

² Gas tax, Prop 42, and the Road Maintenance and Rehabilitation Account

expenditures. The CIP Mid-Year Report indicates that gas tax revenues are estimated to be fully expended by the end of the fiscal year.

Out of the \$120 million lease revenue bonds the City issued in 2015, the CIP Mid-Year Report cites that \$28.8 million has yet to be expended as of the end of October 2017. Based on the recent average monthly spending rate of these funds, the report indicates that the City is on target to exceed the IRS guidelines of spending about 85% (\$102 million) within three years of issuance. This reflects an average spending rate of \$5.8 million per month from April 2017 to October 2017. This is an increase from an average of \$4.1 million per month from October 2016 to April 2017.

The CIP Mid-Year Report cites the use of authority provided in the Appropriations Ordinance as a helpful tool for spending down DC bond proceeds. The authority allows revenue sources, including bond proceeds, to be reallocated between projects if it does not result in a budget increase to the associated projects. This allows staff to direct DC bond proceeds to projects that are progressing, in place of other fund sources that are not time sensitive, such as General Fund, Capital Outlay, and Infrastructure Fund. While this fund swap prioritizes DC bond proceeds for expenditure, it results in slower expenditure, and thereby preservation of, unrestricted fund sources.

As mentioned above, the CIP Mid-Year Report states that the timing of issuing commercial paper notes will depend on several factors, including the rate of spending unrestricted CIP fund sources. Table 1 reflects the amounts that have not been spent in these fund sources. The CIP Mid-Year Report indicates that these funds, in addition to DC bond proceeds, can be used to provide cash funding before beginning a General Fund commercial paper borrowing program.

Table 1: Unexpended Funds of Unrestricted Sources, as of 10/31/17 (\$ in millions)

General Fund Contributions to CIP	Capital Outlay	Infrastructure Fund	Total Balance
\$48.6	\$31.5	\$16.6	\$96.7

¹ Amounts include encumbered funds. Encumbered amounts include: \$12.5 million in General Fund; \$4.8 million in Capital Outlay; and \$2.6 million in Infrastructure Fund.

In the amounts reflected above, only \$5.1 million in Capital Outlay funds is uncommitted fund balance. The rest are either encumbered funds that are obligated for a specific activity, or unencumbered funds budgeted for specific projects. The ability to spend these funds largely depends upon project delivery schedules or the extent to which these funds can be reallocated to other projects that are ready to move forward but lack necessary funding.

Timing of General Fund Commercial Paper Program

Because it is most advantageous for the City to borrow using commercial paper when the proceeds are actually needed to pay project expenses, estimating when this need is expected to materialize is important. Though the CIP Mid-Year Report shows significant unexpended funds in General Fund, Capital Outlay, and Infrastructure Fund, enough funding needs to be available so that project delivery is not slowed down due to lack of liquidity. The exact level of available funding necessary is difficult to identify since project schedules often change which affects anticipated funding needs. However, an indication that it is time to issue commercial paper notes is that without an infusion of additional funding into the CIP, projects would be delayed.

As mentioned above, unrestrictive fund sources can be reallocated to other priority projects so that they can proceed. An example of this was an item approved by Council on November 14, 2017 which transferred \$282,000 in General Fund from the Market Street-Euclid to Pitta Improvements (S16022) for the construction of Hayes Avenue Storm Drain (S11002). The staff report indicated that S16002 does not need this funding in the current fiscal year but funding will be provided to this project when it is needed in the future. If funding is not provided in the future, the project will be delayed. As more adjustments like these are made where projects temporarily let go of funds that are not currently needed, unrestrictive fund sources within the CIP will be reduced. It will likely become more difficult to reallocate funds in this way as liquidity in the CIP is reduced and fewer projects have available funds to lend to other projects. Commercial paper is intended to keep enough unrestrictive fund sources in the CIP so that cash management strategies, such as fund reallocations, can continue to keep projects moving.

Anticipated Types of Projects to be Supported by Commercial Paper

The CIP Mid-Year Report includes requests totaling \$1.3 million to transfer General Fund and Capital Outlay funds from various projects³ to backfill funds that were used for emergency drainage repair. The report indicates that the projects from which funds were transferred will be made whole in the commercial paper request. In addition to these projects, many other underfunded projects exist in the CIP that have insufficient funds for project completion. These projects could potentially qualify for commercial paper based on the recommended criteria. The unfunded project needs list published in the FY 2018 Adopted Budget provides a list of these types of projects.

The unfunded needs as of the publication of the adopted budget totals \$1.76 billion for the five year period the budget reflects (FY 2018 through FY 2022), which is based on the FY 2018 – 2022 Five – Year Capital Infrastructure Planning Outlook (Capital Outlook).⁴ However, as indicated in the CIP Mid-Year Report, the recommended General Fund commercial paper program is intended to provide funding in order to *complete* projects. Therefore, projects that need funding between FY 2018 and FY 2021 in order to be completed could potentially qualify for commercial paper funding. Although, as noted earlier, it is important to address new priority projects as well if deemed necessary to maintain City services.

It is important to note that project schedules and funding needs included on the unfunded list have likely changed since the publication of the FY 2018 Adopted Budget. Therefore, updated information is necessary to accurately identify which projects would qualify for commercial paper funding, given the recommended criteria. In addition, an item being heard by Council on Wednesday, December 13 requests approval to provide \$13.7 million from bond restructuring proceeds to the Fire-Rescue Air Operations Facility project. This project is on the unfunded list and therefore the project's amount of unidentified funding would be significantly reduced if the item is approved.

³ Projects include: City Facilities Improvements (ABT00001); Fire Station Skyline Hills (S14017); Fairmount Avenue Fire Station (formerly Home Avenue Fire Station) (S14018); and Skyline Hills Community Park ADA Improvements (S15038)

⁴ Of the total unfunded needs, \$514.1 million is associated with Phase III of the Convention Center expansion.

Among the largest needs on this unfunded list are the annual allocations for Drainage Projects,⁵ City Facilities Improvements,⁶ and Watershed.⁷ The unfunded needs for these projects total \$461.1 million. This estimate already accounts for \$143.7 million assumed to be supported with a future financing plan, which is consistent with assumptions made in the Capital Outlook. There also appears to be additional standalone projects on this list that could potentially be eligible as they are active projects and have insufficient funds for project completion. These projects span the Parks, Library, Fire-Rescue, and Transportation and Storm Water asset management departments. Given the level of unfunded needs identified on this list, it is important that the anticipated \$75 million in commercial paper proceeds be strategically invested in CIP projects.

CONCLUSION

The purpose of this report is to provide additional information on the characteristics of the anticipated commercial paper program as recommended in the CIP Mid-Year Report, and provide an idea of the types of projects that may come before Council in the spring.

The CIP Mid-Year Report recommends that no new projects will be considered for this issuance of commercial paper funding. Our Office recognizes that the unfunded project list included in the FY 2018 Adopted CIP Budget reflects the CIP's significant existing General Fund project needs which far exceed the anticipated \$75 million General Fund commercial paper program. Staff has indicated that projects they have identified will also be compared to the recent list of priority projects submitted by Council this past November as well as recent budget priority memoranda. It should be noted that, as discussed in our Office's review of the Outlook, one of the ongoing challenges that the City faces is growing capital needs that rely on the General Fund, as evidenced by completion of recent condition assessments and responses from the community on capital needs. These needs must be addressed by supporting new capital improvement projects in the future. Restricting commercial paper to existing projects only is a sound guideline but should not eliminate consideration of important new projects.

Our Office agrees that it is fiscally prudent to spend down existing DC bond proceeds and unrestrictive fund sources prior to issuing more debt. We note that identifying the timing of commercial paper debt issuance has been difficult because the factors upon which it is dependent often change. However, at this time, staff expects that the General Fund commercial paper program will be presented to Council for approval in spring of FY 2018.

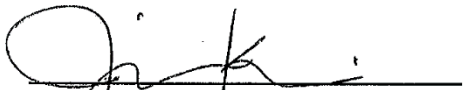
Council may wish to consider the following in anticipation of the request for approval of the General Fund commercial paper program and proposed project list this spring:


- Request a full list of projects that could be eligible for commercial paper based on the recommended criteria to assist Council's review of the proposed project list for the \$75 million issuance. This may highlight projects that were recommended over others.
- A broader plan be developed to more comprehensively address the City's existing deferred and future capital needs.

⁵ The Drainage Projects annual allocation (ACA00001) reconstructs and replaces failed storm drain structures.

⁶ The City Facilities Improvement annual allocation (ABT00001) provides capital improvements to all City facilities, such as roof and heating.

⁷ The Watershed CIP annual allocation (ACC00001) delivers projects that address storm drain discharge water quality standards by removing pollutants from storm water before it enters the City's waterways or to reuse the storm water to keep it from entering the waterways.


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