THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: July 29, 2021 **IBA Report Number:** 21-21

City Council Docket Date: August 2, 2021

Item Numbers: 603 and 605

Analysis of Request to Spend $293 Million for Capital Projects and Other Expenses

On August 2, 2021, Council will be considering an item authorizing up to $148.0 million in financing proceeds to fund equipment and one capital improvement project needed to implement three high-priority activities. **Since these capital expenses are planned to occur over the next four years, Council may wish to request periodic updates be provided on the status of each of these projects.**

On the same day, Council will also be considering the appropriation of $145.0 million to the Capital Improvements Program (CIP) budget for various high priority projects. This report provides background on the City's General Fund Commercial Paper Notes program and discusses the proposed CIP project allocations. We also offer that if Council wishes to fully fund design for the Skyline Hills Fire Station for an additional $200,000, it could reduce funding for Citywide streetlight installations in a like amount, leaving $800,000 proposed for streetlights in addition to the $2.2 million received in the FY 2022 Adopted Budget. At the end of this report, we expand on a discussion that came up following comments from our Office at the Budget and Government Efficiency Committee on July 21, 2021 suggesting it was unlikely that significant requests for additional debt, and associated new project allocations, will come to Council in the next three years given financial and project administration/execution capacity challenges.

Our Office is generally supportive of both items. In this report, we offer the following main takeaways that are explained further in this report:

1) The CIP item before Council requests the appropriation of the second round, or installment, of financing using commercial paper notes to support General Fund capital projects, as well as other available bond proceeds. The first installment was appropriated in 2018.
2) It will likely take about three to four years to expend the $145.0 million for CIP projects based on prior spending trends.
3) Actual expenditures may differ from the proposed list of project allocations as other urgent capital needs may arise in the future.
4) Although this is a significant investment in City General Fund infrastructure, the City still has a $3.02 billion capital infrastructure funding shortfall over the next five years.

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SUMMARY OF ITEMS BEFORE COUNCIL

On August 3, 2021, Council will be considering the appropriation of $145.0 million for various high priority capital improvement projects supported by commercial paper note and lease revenue bond proceeds. The proposed list of project allocations is discussed further in the sections below. On the same day, Council will be asked to consider the expenditure of up to $148.0 million of yet to be issued proceeds from lease revenue bonds and commercial paper notes for equipment such as public safety radios, fire engines, as well as items needed to implement SB 1383[1] such as vehicles, organics containers, and one capital improvement project – the Kearny Mesa Repair Facility. In summary, the Council is being asked to authorize the expenditure of $293 million ($145 million + $148 million) of debt proceeds for the projects identified in both action items.

We note that if the additional $148.0 million borrowing is approved, all expenditure authorizations will have been granted and staff would only need to return to Council for follow-up debt issuance related approvals for the $148.0 million or for any potential contract approvals. **As these capital expenses are planned to occur over the next four years, Council may wish to request periodic updates be provided on the status of each of these projects.** It should also be noted that the equipment purchases are not expected to delay or hinder the $145 million of capital project expenditures.

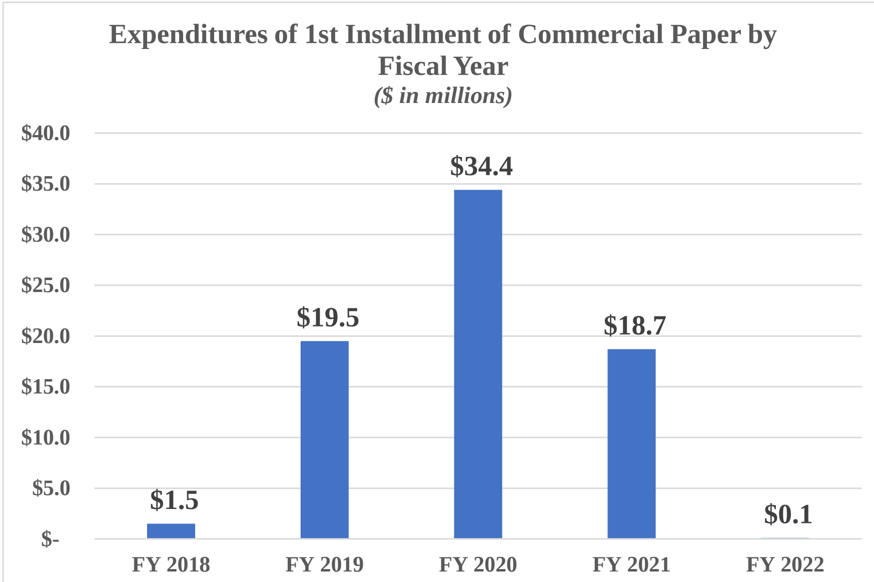
Approval of these two Council items authorizes $293 million of expenditures over approximately the next four years. Staff generally plans to finance most of the $293 million of identified projects by using, and then refreshing, its existing $88.5 million commercial paper line of credit. After first using approximately $56.5 million of available proceeds from the 2021 Lease Revenue Bonds, staff plans to borrow using commercial paper, when needed, for capital projects and equipment purchases until such time as they begin to approach the $88.5 million General Fund commercial paper authorization limit. At that point, they will return to Council with a request to issue long-term bonds to pay off outstanding commercial paper notes and refresh the $88.5 million authorization amount until they have financed the entire $293 million. Depending on market conditions and/or other emerging project needs, staff could alternatively decide to use long-term bonds sooner or in greater amounts to fund other yet to be identified projects. Staff will need to return to Council for any long-term bond authorization described above.

$145 MILLION FOR CIP PROJECTS IS LIKELY TO TAKE SEVERAL YEARS TO EXPEND

The City began using commercial paper note proceeds to fund General Fund capital projects with Council appropriations in May 2018 for $80.5 million and August 2018 for another $8.0 million for a total of $88.5 million. After accounting for the costs of issuance, $87.9 million in proceeds became available for General Fund capital improvement projects. The City issued its first tranche of commercial paper notes in November 2018. As shown in the bar graph below, the City is in its third year of spending down the first installment of commercial paper of $87.9 million. As of July

[1] Senate Bill 1383 was signed into law in 2016 establishing methane emissions reduction targets. The bill establishes targets of a 50% reduction in the level of statewide disposal of organic waste from 2020, with a 75% reduction by 2025.

26, 2021, a total of $74.2 million has been spent, an additional $8.5 million is encumbered, and $5.2 million is remaining to be spent.



Because spending down the first installment of commercial paper notes is taking a little over three years, our Office anticipates the expenditure of $145.0 million will take at least three years or longer. Therefore, it is unlikely that another list of project allocations of this magnitude will come forward to Council for approval before the second installment of $145.0 million has been substantially spent, which could be roughly three to four years.

ACTUAL PROJECT EXPENDITURES COULD CHANGE DEPENDING ON FUTURE NEEDS

Although Council approved a list of project allocations supported by the $88.5 million in May and August of 2018, other unforeseen capital needs have arisen since then, the most significant of which is the surge of storm water emergencies. During FY 2019 and FY 2020, staff came forward with multiple items to Council requesting that some projects be defunded to pay for storm water emergency projects with the commitment that funds would be replenished to defunded projects with the next round of commercial paper notes. Because the actual expenditures of the first installment of $88.5 million differed from the project list originally approved by Council, actual expenditures of the $145.0 million could differ from the project list before Council on August 2. If changes are needed, staff will come forward with subsequent items seeking Council approval.

SIGNIFICANT CAPITAL PROJECT NEEDS REMAIN

Overall, our Office is supportive of the proposed project allocations presented by staff as it restores funding that had been previously diverted and funds other critical City capital needs such as stormwater, street resurfacing, and City facilities. However, it is important to note that the most recent Capital Infrastructure Planning Outlook covering FY 2022 – FY 2026 identified a $3.02 billion funding gap between the anticipated capital needs and projected funding available over the next five years, even after accounting for the proposed $145.0 million for projects. Therefore, although this is a significant investment in the City’s General Fund infrastructure, there are significant capital infrastructure needs remaining. This includes other high priority capital initiatives for Council, such as the implementation of recommendations made in the Citygate report. The Citygate report, among other things, includes recommendations to add fire stations in certain areas to address response time gaps throughout the City. The Fairmount Fire Station is the greatest of these needs.

Working with staff, our Office tracked the status of replenishing CIP project budgets that were defunded to support previous storm water emergencies. Many defunded projects had funds replenished through other previous actions, including the approval of the FY 2022 Adopted Budget, and no longer need funding returned to them. However, not all projects have had their funding replenished as reflected in staff's PowerPoint presentation. Below we summarize the projects that did not make it in the proposed list of allocations and include the amounts borrowed, amounts needed, and impacts to these projects. Ash Street Signal Modifications was excluded since it is currently delayed for reasons other than funding.

Project	Amount Borrowed	Amount Needed as of 6/24/2021	Impact
Fire Air Ops / S18007	$ 7,000,000	$ 19,000,000	Will not be able to proceed with awarding a design-build contract.
Balboa Park Comfort Stations / B20117	3,000,000	3,000,000	Will not be able to begin design and hire a consultant. Additional funds will be needed for construction.
Olive Grove Community Park ADA Improvements / S15028	$ 1,050,000	$ 3,000,000	Will not be able to go out to bid for construction.

Fire Station No. 51 – Skyline Hills

The item before Council includes $250,000 for Fire Station No. 51 – Skyline Hills (S20015) which fully replenishes the funds that were borrowed to support storm water emergency projects. However, Engineering and Capital Projects (E&CP) staff indicate that this amount will only fund 60% of design but an additional $200,000 is needed to fully fund design. **If Council wishes to fully fund the design phase for the Skyline Hills Fire Station, it will require a reduction of $200,000 of another project on the proposed list.** One suggestion for Council is to reduce the proposed allocation of $1.0 million for Installation of City Owned Street Lights (AIH00001) to $800,000 since the funding will go towards the initiation of new, currently unidentified projects. We also note that the FY 2022 Adopted Budget includes a total of $2.2 million for new streetlights.

It is important to note that once design is complete, the project will need an estimated $13.0 million for construction and a future funding source has not been identified. Without plan to fund construction, the project could stall. If a funding source is eventually identified, staff may need to go back and update design depending on how long the project is stalled.

Ocean Beach and San Carlos Libraries

The proposal also includes allocations for the Ocean Beach Branch Library (S20015) to complete design and San Carlos Branch Library (S00800) to update bridging documents, each for $470,000. We note that an estimated $5.0 million is needed to construct the Ocean Beach library expansion and $24.0 million needed for a design-build contract for the San Carlos library. No future funding source has been identified for these projects. Like the Skyline Hills Fire Station, without a plan to fund construction, the project may stall and by the time funding is identified, staff may need to redo previously completed work.

Update on Kearny Mesa Repair Facility

In April 2017, the City entered into a 10-year lease of the facility which is intended to serve as a new maintenance and repair facility for heavy-duty fire apparatus. The need for additional space to maintain the City's Fire and Refuse fleet was initially identified in 2016 but it has become even more necessary in order to implement SB 1383 as it will free up space at the Miramar Facility to allow for additional refuse/recycling packers. At the time City Council approved the lease, staff estimated the cost of improvements to be $6.5 million. Subsequent estimates went as high as $17.0 million, resulting in significant delays as the preliminary design plans for the site were re-evaluated, the initial $6.5 million of construction funding was diverted to the General Fund, and the lease was extended up to 30 years. The cost estimate for the project was refined in 2020 and has been updated since then. The item requesting approval of $148.0 million in debt proceeds to support capital equipment includes $15.4 million to fully fund improvements to the Kearny Mesa Repair Facility. Currently Transportation staff are working out of the facility and will be relocated to a place not yet identified prior to the start of construction. Once the construction agreement with the facility owner has been executed, construction is expected to take 12-16 months. According to the Fleet Operations Department, the construction agreement is estimated to take two to three months to finalize once funding is approved.

FOLLOW-UP ON DISCUSSION AT BUDGET AND GOVERNMENT EFFICIENCY (B&GE) MEETING

In comments made at the B&GE meeting on July 21st, our Office noted that the proposed expenditure of an additional $148 million of borrowed funds, coupled with the $145 million of 2021 Lease Revenue Bonds issued in April 2021, likely represents most if not all of General Fund borrowing over the next three or four years. This statement was primarily based on the City's recent pace of spending borrowed proceeds (from commercial paper and long-term bonds) for capital projects. We also considered the City Debt Policy's 25% goal/ratio for long-term fixed costs as a percentage of total General fund revenue.

Our Office commented on the probability that there would be limited additional General Fund borrowing over the next three to four years to highlight the capital project challenges the City faces and set realistic expectations with respect to financing new priority projects in the near term. It will also be challenging to finance/complete existing Councilmember priority projects that have already received initial funding. The following sections discuss the City's revenue and project capacity limitations.

Capacity Considerations: 1) Revenue and 2) Project Administration/Execution

Revenue is an important consideration in the decision to borrow additional funds for capital projects. The sufficiency of revenue for additional debt is often evaluated as the percentage of General fund revenues (which largely equates to expenditures) dedicated to total debt-related costs and more broadly to other significant long-term fixed costs like pension and retire health care (OPEB). Section 4.2 of the City's Debt Policy identifies two ratios that can assist in assessing the impact of these long-term fixed cost obligations. The first is referred to as the **Debt Ratio** which includes all General Fund supported debt obligations (annual payments for bonds, commercial paper, and capital leases) as a percentage total revenue – the City strives to keep this ratio below 10%. The second can be referred to as the **Debt Ratio + Pension/OPEB** and includes annual payments for the City's pension and retiree health care – as a goal, the City strives to keep this ratio below 25%.

The City's Debt Management Department briefly discussed these ratios in their presentation to the Council regarding the Biennial Update of the City Debt Policy in June 2021. They also projected these ratios over the period of the last Five-Year Financial Outlook. Our Office asked the Debt Management Department to update the projected ratios to include approximately $8.5 million of additional annual debt service associated with the proposed $148.0 million borrowing. The adjusted ratios are show in the following table:

Debt Policy Identified Debt Ratios ***Projected Over the Most Recent Five-Year Financial Outlook Period - FY 2022 - 2026***						
Metric	***Debt Policy Goal***	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**
Debt Ratio [1]	***< 10%***	5.1%	5.7%	6.2%	6.0%	6.2%
Debt Ratio + Pension/OPEB	***< 25%***	25.5%	26.0%	27.2%	26.4%	26.1%

(1) Reflects total annual General Fund supported debt obligations as a percentage of available revenues; includes the impact associated with the proposed $148 million borrowing.

Source: Debt Management Department

As shown in the above table, the projected Debt Ratio remains significantly below the 10% threshold suggesting additional borrowing is reasonable and within the Debt Policy's 10% goal. Using this ratio, the City has a reasonable/modest amount of outstanding debt. However, when the City's annual pension and OPEB obligations (which have significantly escalated in recent years) are included, we are projecting to exceed the Debt Policy's 25% goal. **It is important to note that exceeding the 25% goal does not preclude the City from borrowing additional funds, but it should be considered as the City's annual long-term fixed costs are growing as a percentage of the City budget thereby limiting the City's ability to address other public service needs going forward.**

Project Administration/Execution capacity is an equally important consideration in deciding whether the City should borrow to fund new capital projects or complete existing projects. It makes little sense to borrow funds to initiate a new capital project unless there is a comprehensive multi-year plan to complete the project. Conversely, it does not make sense to allocate limited staff and consultant resources to begin projects (preliminary engineering, design) that will ultimately languish without continued financing and a solid project management plan.

The City CIP budget has grown significantly in recent years in large part due to the Pure Water Project. At the same time the CIP budget has grown to record levels, the City's Engineering & Capital Projects Department (E&CP) has identified several factors limiting the City's capacity to deliver projects. These factors include a shortage of qualified consultants, contractors, and skilled staff (the Capital Outlook reported an internal vacancy rate of approximately 20%). It should be noted that the FY 2022 Budget included salary increases for engineers to address the vacancy rate and $250,000 for E&CP to hire a consultant to review department operations to develop a plan for greater operational efficiency to meet the demands of a growing CIP budget.

CONCLUSION

Our Office is generally supportive of the two debt-related items before Council on August 2, 2021 which will authorize the expenditure of $293 million in financing proceeds in support of needed General Fund infrastructure and equipment. With regard to the $148.0 million of high-priority capital projects, we recommend that Council request periodic updates be provided on the status of each of these projects.

As Council considers the proposed CIP project allocations, it is important to keep in mind the $3.02 billion capital infrastructure funding gap over the next five years presented in the Capital Outlook, which was derived after including $145.0 million of the $293.0 million in expenditures being proposed. Such an enormous General Fund infrastructure gap challenges the City to find sources of revenue and project implementation strategies to begin to address numerous other high-priority General Fund projects like the critical fire stations identified in the Citygate report. This report discusses financial and project administration/execution capacity challenges that need to be considered in thinking about how to reduce the gap. Regarding project administration/execution capacity, recent salary increases for engineers and a pending consultant contract to increase E&CP operational efficiency are positive developments.

Our Office expects expenditure of the $145.0 million for CIP projects will take approximately three to four years, in line with previous spending trends. Therefore, it is unlikely that significant requests for additional debt and associated new project allocations will come to Council for approval within this time frame. Finally, it also reasonable for Council to expect that staff will come back at a later date to request changes to the proposed allocations based on updated CIP needs.

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