MULTI-YEAR FINANCIAL FORECAST

Introduction

The Multi-Year Financial Forecast (MYFF) was presented to the Mayor and City Council and adopted on April 18, 2005. The Council approved the concept of using the planning tool to bring a long-range perspective to the City's budget process. At that time, however, the City Council did not adopt a particular set of assumptions or one scenario to use for future planning purposes. As such, the model continues to utilize many of the assumptions used in the original MYFF. Major policy assumptions incorporated here include:

- No additional or restored funding for any General Fund programs, beyond small increases for inflation, except for the provision of funds for new Public Safety facilities.
- Labor negotiations with District City Attorney Association (DCAA), Local 145, and the San Diego Police Officers Association (POA) this year will result in a freeze of salary and benefits in Fiscal Year 2007, consistent with contracts already in place for the Municipal Employees' Association (MEA) and AFSCME Local 127.
- The City will securitize revenue to create a lump sum payment into the pension system, consistent with city Manager Report 05-190 and our new labor contracts.
- Any excess funds in a given year will be directed to additional pension liability solutions.

These assumptions are very austere and do not reflect policy decisions that the new Mayor or the City Council may choose to implement in future years. The use of the MYFF as a tool to model the impact of these potential policy decisions will be critical during budget development process for Fiscal Year 2007 and beyond.

Framework of the Forecast

The MYFF consists of two primary documents: the MYFF Model, which provides the analytic tool for undertaking the forecast and its analysis, and a MYFF Report, designed to communicate the key assumptions and conclusions of the analysis. By providing a forecast of revenues and expenditures over a five-year period, and incorporating a variety of core assumptions, the MYFF will assist the City in annually assessing its ability to meet the following key goals:

- Provide important City services after adjusting for inflation;
- Modify and make necessary changes to the pension system structure, including reducing unfunded actuarial accrued liabilities (UAAL);
- Meet future commitments, including staffing new public safety facilities; adhering to contractual commitments; and funding certain Capital Improvement Program needs and mandated programs; and
- Achieve long-term goals relating to the City's overall financial health, including the maintenance of targeted levels of reserves and not exceeding specified debt service levels.

It will be clear upon reviewing the MYFF that the first goal - providing important City Services - will be extremely challenging, due to growing financial pressures. The MYFF forecasts that revenue enhancements and/or expenditure cuts are necessary to maintain a balanced budget and implement solutions to the current pension liability. Beyond maintaining key City services, the City has many unmet needs. While these potential expenditures are not currently incorporated within the MYFF, long-range planning will help the City assess its opportunities for funding at least some of these needs.

The primary focus of the MYFF is the City's General Fund. The General Fund is the City's main operating fund, used to pay for such basic municipal services as police, fire-rescue, refuse collection, recreation and parks and libraries. Most of the City's tax revenues are deposited into the General Fund, as well as revenues from licenses, permits and fines.

This initial version of the MYFF forecasts General Fund operations for five years, from Fiscal Year 2005-06 through Fiscal Year 2009-10. The revenue and expenditure portions of the MYFF have been developed independently, based on a variety of known and assumed factors that drive each revenue and expenditure line item. Since the City budgets a portion of its general-purpose revenues in various Special Revenue Funds to pay debt service on outstanding lease obligations and other targeted expenditures, the current MYFF is expanded beyond the General Fund to incorporate a few other general-purpose funds. These revenues include sales tax, Safety sales tax, Transient Occupancy Tax (TOT), and Franchise Fees. A portion of these revenues is deposited in the TOT, Environmental Growth, Police Decentralization and other special funds.

The MYFF includes an analysis of the City's General Fund-secured and general obligation debt, calculating key ratios used by the rating agencies and investment community to evaluate the City's creditworthiness. In comparing debt service to revenues and expenditures, the Special Funds outlined above are included with the General Fund to determine "General Purpose Revenues", which serves as the denominator of the ratios. The model also is designed to reflect the City Council's goal of achieving General Fund reserves equal to 5% of revenues by 2014. It is also assumed that the City will comply with its Library, Mission Bay and Parking Meter ordinances, beginning in Fiscal Year 2006-07. These funding requirements are waived for Fiscal Year 2005-06. The "bottom line" result is reported as a "Net Surplus/ (Shortfall)" (with negative results, representing operating deficits, presented in parentheses).

While the MYFF may "forecast" deficits under a number of scenarios, the City can be expected to address budget gaps as they occur as part of its annual budgeting process, eliminating any budget deficit through reduced expenditures or increased revenues. It is important to note that the MYFF model described and displayed on the following pages is just one of many scenarios that may be used to evaluate future financial and policy decisions. The assumptions made in this model are not intended to predict future events or supplant policy discussions. The MYFF is an important tool in achieving such budget balance. It will help the City to analyze the long-term impact of decisions made today, aid in minimizing decisions that will create long term financial pressures, and encourage decisions that restore long-term structural balance.

Revenue Forecast

The Revenue Forecast combines an analysis of the general economic factors driving the City's revenue base, and the specific revenue sources available to the City. While San Diego's economy is increasingly diverse and vital, the City's revenue structure is relatively limited for a large city. The revenue structure reflects various historical decisions to limit exactions. For example, the City does not levy a utility user's tax or refuse collection fee, has low business taxes, and has kept local taxes such as real estate transfer taxes low, bucking the trend of other large cities in the State. Even the City's share of the 1% property tax is relatively low, as the low tax rates levied in the 1970's became permanently institutionalized in the State law implementing 1978's Proposition 13. The City's revenues are increasingly affected by decisions made by the State regarding the allocation of local revenue. Three of the City's largest historical General Fund revenues-property tax, sales tax, and motor vehicle license fees-are all subject to State legislative actions, and have been impacted by recent and past State budget decisions.

Economic Assumptions

This MYFF reflects assumptions about the future economic environment. These assumptions were developed after reviewing the projections of State and national economic forecasts, including the UCLA Anderson Business Forecast and DRI/Global Insight. Because of San Diego's well-diversified economy and strength in research driven technology industries, local economic growth is anticipated to continue to outpace the rest of the State and nation. Among California's most daunting challenges is the State budget, with a structural imbalance remaining from the State spending more than its income over several years. The imbalance is "funded" by State borrowing of $15 billion through the sale of bonds and from revenue taken from cities, counties and school districts across California. The MYFF assumes that the State will maintain local government revenues as agreed to as part of the 2004-05 State budget deliberations, that no new revenue shifts will be implemented in future years, and that certain diverted property taxes will be restored beginning in Fiscal Year 2007. The revenue forecast takes into consideration the following specific economic assumptions:

- Real Gross Domestic Product is expected to grow within a range from 3.1 to 3.6% over the forecast period.
- Interest rates are expected to steadily rise over the forecast period. The Federal funds rate has risen from 1.33% in 2004 and is anticipated to reach 5.1% by 2010. Mortgage rates are also expected to rise over the period, although not quite as dramatically as the Fed rate, from 5.9% in 2004, to 7.9% in 2010.
- Historically low national inflation rates should be steady at around 2.6%. Although remaining above national levels, local inflation is anticipated to moderate from 3.7% in 2004 to between 3.3 and 3.5% through 2010.
- The City's population growth levels is anticipated to moderate from the recent 1.8% gain in 2003 to just less than 1.0% annually over the forecast period. Total population is expected to grow from 1,294,000 residents in 2004 to 1,370,000 residents in 2010.
- County unemployment should remain below State and national unemployment rates, averaging between 4.4% and 4.7% over the forecast period. This set of economic assumptions produces overall revenue growth averaging about 4% a year over the forecast period.

General Fund Revenues

The following summarizes the City's major General Fund revenue sources as they are shown in the MYFF model and includes recently updated assumptions. In comparing year-to-year changes, it is important to note that General Fund revenues from many of these sources will reflect both economic activity and the allocation of these revenues between the General Fund and various special funds.

Property Tax

Property tax remains the single largest General Fund revenue. Because of the methodology by which property tax is allocated among overlapping taxing jurisdictions, the City of San Diego historically receives only about 17% of the 1% tax rate levied under Proposition 13. The basis for allocation under State law is the average tax rate levied by the taxing agency for the three years before Proposition 13 was adopted (referred to as "the AB 8 formula"). Because of its low tax rate at the time of the passage of Proposition 13, San Diego receives a relatively smaller allocation of the 1% than many other cities in the State. Property tax revenue has experienced strong growth over the past five fiscal years at 8.7% (6.7% for the past ten years), and this strong growth is projected to continue, in part due to a continuing strong real estate market. Property tax growth can be expected even if prices are stable, as accumulated appreciation is recognized when property is reassessed at the time of sale. If the real estate market cools off, however, the reduced number of transactions will translate into slower growth in the tax base and a concurrent reduction in Property Transfer Tax. Several features of the State budget affect the property tax forecast, as the State has taken advantage of its power under State law to reallocate this revenue to address a number of its own objectives.

In Fiscal Year 2005, the State of California enacted a complex shift, whereby revenue from state collected Motor Vehicle License Fees (VLF) was exchanged for property tax. This revenue shift resulted from the elimination of the State's VLF backfill, which was paid to local governments directly from the State's General Fund. In order to hold local governments harmless, the State shifted property tax revenue from the Educational Revenue Augmentation Fund ("ERAF", a mechanism used to fund local schools with property taxes in order to reduce state funding requirements) to local governments in proportion to each jurisdiction's VLF backfill loss. In Fiscal Year 2005, these actions resulted in approximately $71 million being shifted from VLF to property tax for the City of San Diego.

In addition, Fiscal Year 2005 marked the first year of a two-year agreement in which local governments agreed to contribute revenue to the State in exchange for the Governor's support of Proposition 1A, a State constitutional amendment designed to protect local government revenues, which passed in the November 2004 election. For the City of San Diego, this two-year contribution amounts to a reduction in property tax revenues of approximately $16.9 million in Fiscal Year 2005 and 2006. This revenue will be reduced from the property tax in lieu of VLF that is shifted from ERAF to local governments, as described above. The expiration of the agreement in Fiscal Year 2007 results in a substantial increase in projected revenue from Fiscal Year 2006, as the City will no longer make the $16.9 million contribution. As a result, property tax is forecasted to experience even higher growth in Fiscal Year 2007.

A third reallocation involving property tax is referred to as the "Triple Flip," and is discussed under sales tax, below.

Currently, the property tax forecast assumes a 7.5% growth rate in Fiscal Year 2006, 6.5% growth in Fiscal Year 07, 6.0% growth in Fiscal Year 08, and 5.5% growth in Fiscal Year 09 and Fiscal Year 10. The forecast also takes into account the VLF-property tax swap implemented in Fiscal Year 05, as well as the negotiated $16.9 contribution to the State in Fiscal Year 07 (ERAFIII).

Sales Tax

A 7.75 cent sales tax is levied on each dollar of taxable sales within the City's boundaries. Of that amount, 0.50 cents is attributable to Proposition A TransNet, and the balance reflects the statewide levy. One-cent of the statewide levy historically has been allocated to the City under the State's Bradley-Burns law. About 67% of this amount has been allocated to the General Fund. In addition, a small additional amount of these funds are projected to be allocated toward the City's General Fund Unappropriated Reserve to maintain Council approved levels; these contributions are projected to represent less than 2% of sales tax revenues. The balance of sales tax revenues are allocated to the Transient Occupancy Tax Fund, the Street Division and the Police Decentralization Fund. A small fraction of sales tax revenues, representing a portion of the tax receipts generated from specific redevelopment projects areas, is allocated under development and owner participation agreements.

Sales tax revenue is highly sensitive to economic conditions, and reflects the factors that drive taxable sales, including the levels of unemployment, consumer confidence, per-capita income, and business investment. Growth in this revenue has averaged 4.0% over the past five years, and 6.5% over the past ten years. The sales tax projections also take into account the impact of the "Triple Flip," a complex revenue shift that resulted from the passage of Proposition 57 in the March 2004 elections. Proposition 57 authorized the State to issue up to $15 billion in Economic Recovery Bonds to pay off the accumulated deficit in the State's General Fund. To secure the bonds, the State has implemented a complex revenue shift known as the "Triple Flip," whereby local governments will shift ¼-cent of their one-cent Bradley-Burns Sales and Use Tax to the State in exchange for an equivalent amount of property tax, which will be shifted from the Educational Revenue Augmentation Fund. While the Triple Flip is intended to hold local government harmless, the intricate mechanics of this shift will result in minor fluctuations in sales tax revenue from year to year.

In all forecast years, the property tax reimbursement from the Triple Flip is included in the sales tax projection. This is done for two principal reasons. First, the year-over-year growth in the reimbursement amount will be equivalent to the growth in taxable sales, not the growth in assessed valuation. As such, it is considered a subset of sales tax for forecasting purposes, not a subset of property tax. Secondly, once the Economic Recovery Bonds are paid off, cities will no longer receive the property tax reimbursement, but will instead regain the ¼-cent sales tax that was diverted to the State by the Triple Flip. In these two ways, the property tax reimbursement from the Triple Flip is markedly different from the VLF-property tax swap, as described in the previous section. In the case of the latter, the VLF-property tax swap marks a permanent shift of revenues from VLF to property tax. Beginning in Fiscal Year 2006, this shift will no longer be considered a revenue swap, but rather a permanent increase in property tax revenue, with year over-year growth being based on the growth in assessed valuation.

The sales tax forecast assumes a 4.5% growth rate in Fiscal Year 2006, and a 4.0% growth rate in Fiscal Years 2007-2010. Sales tax revenue is allocated to various non-General Funds and to the General Fund. The non-General Fund allocations are projected separately from the sales tax. The sales tax forecast includes the property tax reimbursement from the Triple Flip.

Safety Sales Tax

Safety sales tax revenue is derived from Prop 172, the Local Public Safety Protection and Improvement Act of 1993, which was approved by California voters on November 2, 1993. Monies received as the City's allocation from the State for this half-cent sales tax must be utilized solely for public safety services. A portion of these revenues are allocated to the Fire and Lifeguard Facilities Fund to pay for lease payments and project and debt management costs related to the lease revenue bonds issued for the capital improvement of fire and lifeguard stations throughout the City and the acquisition of land for future construction of fire and/or lifeguard facilities. The Fire and Lifeguard Facilities Fund was established in June 2002. The balance of the Safety sales tax funds is used to augment existing General Fund expenditures for public safety purposes such as purchases of equipment, supplies, and to continue funding salary adjustments that have occurred since the inception of the Safety sales tax. The forecast for safety sales tax assumes a 5.0% growth rate, using the Fiscal Year 2006 Annual Budget as the base. This growth rate for safety sales tax is greater than that of regular sales due to a different method of allocation. Safety sales tax is first allocated to the Fire and Lifeguard Facilities Fund for debt services and the remainder is allocated to the General Fund.

Transient Occupancy Tax (TOT)

Commonly known as the hotel tax or room tax, San Diego's TOT is levied at ten and one-half cents per dollar of the daily room price. Currently, an equivalent of five cents of the TOT, approximately 48%, is allocated to Special Promotional Programs for the promotion of tourism and other purposes designated by City Council policy, and deposited in the Transient Occupancy Tax Fund. The remaining five and one-half cents, approximately 52%, is allocated directly to the General Fund for general government purposes. Growth in this revenue has averaged 3.1% over the past five years, and 7.5% over the past ten years. Two recent efforts to increase this tax have failed to win voter approval. The TOT forecast assumes 5.0% growth. In addition, the equivalent of 3.5 cents of TOT is allocated to the TOT fund from sales tax. These revenues in the Transient Occupancy Tax Fund are used for debt service payments and special promotional programs.

Property Transfer Tax

Consistent with State law, the County charges $1.10 per $1,000 of sale price when any real property is transferred. The City of San Diego charges $0.55 per $1,000, which is credited against the County's charge, so that the City and the County both receive $0.55 per $1,000. This revenue source has outperformed inflation in the past (averaging 18.9% in annual growth for the past five years, and 19.0% in annual growth over the past ten years), particularly soaring with the recent real estate boom. The Fiscal Year 2005 Annual Budget originally projected a 6% growth in property transfer tax revenue; it now appears it will be closer to 21%. The MYFF projects a 10% growth in Fiscal Year 2006. Given the potential volatility of this revenue, a more modest 8% growth rate is projected thereafter. It is interesting to note that this revenue has been growing much faster than property tax itself. One of the reasons for this is that growth in assessed values (which derives in large measure from the transfer of property) only results in growth in General Fund property tax when it occurs outside of a redevelopment project area. Similar growth within the project areas has resulted in tremendous growth in tax increment, which is outside the scope of this study. The General Fund receives property transfer taxes for all sales that occur within a redevelopment project area. As mentioned above, a significant slowing of real estate sales will cause this revenue source to slow as well.

Licenses and Permits

The Licenses and Permits category reflects revenue generated to recover costs associated with performing regulatory functions. Major budgeted revenues in this category include general business license taxes, rental unit taxes, parking meter collections, and the refuse collection business license tax. A few updated revenue forecasts are summarized as follows:

- Business license taxes are grown at a 0% growth rate, using the Fiscal Year 2006 Annual Budget as the base. This growth rate is based on historical trend.
- Parking meter revenue is projected to grow by 5% per year, using the Fiscal Year 2006 Annual Budget as the base. This growth rate is based on historical trend.
- Other Licenses and Permits include revenues from permit fees. The year-to-year growth on these revenues changes based on the level of activity, as well as fee increases. The forecast does not assume any fee increases, but instead assumes a 1% annual increase in activity, using the Fiscal Year 2006 estimate as the base.

Fines, Forfeitures, and Penalties

Fines, Forfeitures, and Penalties include revenue generated from monetary sanctions associated with the violation of a law or regulation such as California Vehicle Code violations, City parking and ordinance violations, and litigation awards. Parking violations represent about half of this revenue. The California Vehicle Code Violations forecast assumes a 1.5% growth, using the Fiscal Year 2006 estimate as a base. This growth rate is based on historical trend. Forecast for the City Parking Violations assumes a 2% growth rate, using the Fiscal Year 2006 Annual Budget as a base. This growth rate is based on historical trend and does not assume any increases to parking citation fines. Finally, the forecast regarding other miscellaneous fines and penalties assumes a 5% growth rate, using the Fiscal Year 2006 estimate as the base.

Revenue from Money and Property

This category includes revenue from franchises to use the City's rights-of-way; rents and concessions from Mission Bay and other City properties; and interest earnings. Franchise fees are set through franchise agreements that are negotiated with individual utility companies. San Diego Gas & Electric (SDG&E), the single largest generator of franchise fee revenue, is charged 3% of gross sales from gas and electricity within the City. Three-fourths of total SDG&E franchise revenue is allocated to the General Fund, while one-fourth is required by the City Charter to be allocated to the Environmental Growth Fund. Franchise revenue from SDG&E remains unstable. Late in calendar year 2000, an unusual spike in natural gas prices sent utility bills soaring, increasing franchise fee revenue by nearly 45%. However, the unusually high natural gas prices did not last, and in Fiscal Year 2003, SDG&E franchise fee revenue fell almost 33%. SDG&E franchise fee revenues were up another 21% in Fiscal Year 2004. Over the past five years, the average growth in this revenue source has been almost 10% a year. The City has set a conservative estimate, forecasting 11.8% growth for Fiscal Year 2006, and 7.0% thereafter as part of the MYFF.

The Rents and Concessions category includes General Fund revenue generated from Mission Bay Park (the largest component), Balboa Park, Torrey Pines Golf Course and lease agreements on City Pueblo lands. The Mission Bay Ordinance requires that one-half of all revenue from Mission Bay rents and concessions in excess of $20 million be allocated to the Mission Bay Improvement Fund and the Regional Park Improvement Fund. This requirement was waived in Fiscal Year 2005 and Fiscal Year 2006, with compliance restored beginning in Fiscal Year 2007. Updated forecasts are summarized below:

Interest Earnings - Forecast is based on an estimate of the average earnings on the investment pool as provided by the Investments Division of the City Treasurer's Office. These earning rates are applied to the estimated investment pool, which is assumed to grow at the same rate as General Fund revenue. The General Fund's share of the total investment pool is assumed to be 13% based on historical trend.

Franchise Fees - The forecast is the sum of individual forecasts for each of the City's franchises. Franchise revenue from SDG&E is projected to grow by 8% per year, using the Fiscal Year 2006 Annual Budget as a base. Franchise revenue from Cox Cable and Time-Warner Cable is projected to grow at 6% per year. All other franchises are projected to grow approximately 5% per year.

Mission Bay Rents & Concessions - Forecast assumes a 5% growth in Mission Bay Lease revenue, using the Fiscal Year 2006 Annual Budget as a base. The projection does not assume a waiver of the Mission Bay Ordinance.

Other Rents & Concession - The forecast projects a 0% growth rate, due to the lack of an apparent historical trend.

Revenue from Other Agencies

Historically, the largest revenue in this category was the Vehicle License Fee (VLF), which was levied by the State at 2% of depreciated vehicle value, and in lieu of local property taxes on vehicles. Since 1999, the State has been reducing these fees and backfilling the lost revenues to the cities and counties out of its General Fund. With the Fiscal Year 2004-05 State budget, the VLF has been permanently set at 0.65% of depreciated vehicle value, and backfill revenues have been replaced with an equal amount of property taxes shifted from schools and community colleges. Accordingly, this revenue has been reduced significantly beginning with the Fiscal Year 2005 Budget. Separately, the City was scheduled to receive approximately $21.6 million in deferred VLF revenues from the State. The City has sold this receivable to a statewide financing pool, and is applying the proceeds to decrease outstanding debt. This category also accounts for most of the revenues from the tobacco settlement and State grants. Grant receipts are forecasted to be reduced from $9.2 million in Fiscal Year 2005 to $2.1 million in Fiscal Year 2007, given the uncertainty in the State's financial condition.

Vehicle License Fees - The forecast assumes a 5% growth rate, using the Fiscal Year 2006 Annual Budget as a base. The forecast reflects the VLF-property tax swap that was implemented in Fiscal Year 05.

State Grants and Allocations - The forecast assumes a 0% growth rate, using the Fiscal Year 2006 estimate as a base. Booking fee reimbursements by the State are assumed to be eliminated beginning in Fiscal Year 2007.

Carryover/Tobacco Revenue - Tobacco revenue is typically budgeted as carryover in the fiscal year following that in which it is received. The Carryover/Tobacco Revenue projection is based on the estimated Tobacco Settlement Revenue that the City expects to receive in the prior fiscal year, less the tobacco allocation to the Library Financing Plan. The projection for Fiscal Year 2006 includes an additional carryover increment.

Other Revenue from Other Agencies - The forecast assumes a 0% growth rate, based on the lack of apparent historical trend.

Charges for Current Services

This category includes revenue generated by General Fund departments from services provided to other City funds, including the water and wastewater funds. In addition, a number of departmental charges for public services are included in this category, most significantly by the Fire-Rescue and Police departments. The forecast for current services charges assumes a 2% growth rate, reflecting projected growth in activity. Much of the historical growth in this revenue category is based upon increases to fees and charges. The forecast does not assume any increases to these fees and charges.

Transfers from Other Funds

The City regularly transfers funds from various special revenue funds to the General Fund for various purposes. The largest source of such transfers is the residual available in the Transient Occupancy Tax (TOT) Fund after other allocations. The TOT fund is funded with TOT and sales tax revenue. Various allocations are made from the fund for debt service payments on capital improvements, and for special promotional activities. After all allocations are made, the balance is transferred back to the General Fund. In Fiscal Year 2006, allocations to most community and promotional groups has been reduced by 10% from Fiscal Year 05 levels. A 3% growth rate is then assumed for these allocations in Fiscal Year 07-10. Debt service allocations for all years are based on current cash-flow estimates. TOT fund revenue is based on the TOT and sales tax revenue projections. Also included in this category are a variety of onetime revenues.

New Revenues - One Time

Impacts of several new revenues are described under the discussion of the "Expenditure Forecast," below. The revenue category of new one-time revenues has been used to capture expenditure reductions in various special funds, and the transfer of the resulting savings to the General Fund. These additional transfers reflect certain assumptions made in the MYFF, specifically, the one-year delay of staffing for new facilities and waiver of the Library and Mission Bay ordinances further described below. For Fiscal Year 2007, the line item for "Future

Miscellaneous Revenues" accounts for yet-to-be identified one-time revenues. San Diego, like other big cities, can expect a certain amount of one-time revenues in any given fiscal year. Based on historical receipts, an average of $11 million a year in unidentified one-time revenues is used as a conservative estimate. In most fiscal years, one-time revenues are used to balance the budget. No specific one-time revenues have been assumed in the 5-Year revenue forecast. Other transfers are typically determined concurrent with the annual budget process. As a result, a 0% growth rate is assumed for these transfers.

New On-Going Revenues Included in MYFF

The MYFF identifies one new recurring revenue, which is itself generated by the application of a one-time revenue. The MYFF assumes annual savings of $6.6 million in General Fund debt service due to the redemption of Open Space General Obligation Bonds. The early redemption of these bonds is funded from the $20.4 million the City received from the sale of its VLF receivable in February 2005 (see Revenue from Other Agencies, above), together with $4.4 million available in the Environmental Growth Fund. This new revenue is partly offset by the elimination of one revenue source, the City's Right-of-Way Fee. The City transferred about $2.3 million from its water and sewer enterprises as fees for the use of public rights-of-way. These transfers were eliminated in Fiscal Year 2006.

Other General Purpose Revenues

For a variety of historical reasons, the City maintains several other funds that should be considered in any analysis of general City resources: the Transient Occupancy Tax Fund, the Police Decentralization Fund, the Environmental Growth Fund, and the Fire and Lifeguard Facilities Fund. While these funds are accounted for as "Special Revenue Funds" (funds created to account for revenues that are dedicated to specific purposes), they are primarily funded with General Fund revenue. They are also the funds responsible for paying all of the City's current General Fund debt service. These funds have been incorporated within the MYFF as part of the City's general-purpose revenue base, particularly when calculating budget-based debt ratios. When calculating total general-purpose revenues, the MYFF nets out the amount transferred from these funds to the General Fund; this net amount of revenues is added to General Fund revenues to determine total general-purpose revenues.

Transient Occupancy Tax (TOT) Fund

This fund receives a portion of the City's TOT (5 cents of the 10.5 cents, with the balance going directly to the General Fund), and an allocation from sales tax equivalent to 3.5 cents of the 10.5 cent TOT. The TOT Fund finances the Special Promotional Programs Budget, including transfers to several other special revenue funds used to pay debt service, such as the Convention Center, Balboa Park and Mission Bay improvements, PETCO Park, Trolley Expansion, and other miscellaneous lease revenue financings. A portion of this Fund is transferred back to the General Fund; the amount of this transfer increased in Fiscal Year 2005 as a result of budgetary reductions to benefiting organizations.

Environmental Growth Fund

This fund receives 25% of the franchise fee paid by San Diego Gas & Electric, as required by the City Charter. Two-thirds of this amount has been used to pay debt service on the City's Open Space Facilities general obligation bonds, in lieu of the City levying additional property taxes for that purpose, as is more typical of general obligation bonds. The remaining one-third is used for the purpose of preserving and enhancing the environment, including open space and regional park maintenance and to provide matching funds for acquiring open space grants in cooperation with other private or governmental entities.

Police Decentralization Fund

A portion of the City's share of the 1% sales tax revenue is allocated to this fund to pay debt service on Series 1994 Police CIP Refunding Lease Revenue Bonds and to pay for jail services in accordance with a contract between the City and the County of San Diego. While the outstanding debt on the lease revenue bonds will be retired in Fiscal Year 2006, the Police Decentralization Fund will continue to receive a sales tax allocation in order to fund the ongoing jail-related services.

Fire and Lifeguard Facilities Fund

A portion of the City's Safety sales tax revenues, funded out of a statewide voter-approved halfcent sales tax, is allocated to this fund to pay debt service on lease revenue bonds issued to finance Fire and Lifeguard facilities. The balance of the tax is allocated directly to public safety services within the General Fund.

Expenditure Forecast

The primary costs to any city are its employees, who are responsible for delivering police, fire rescue and other municipal services. Budgeted salaries and wages represent 52% of San Diego's Fiscal Year 2006 General Fund budget. Total compensation, including retirement and other benefits, represent 79.6% of Fiscal Year 2006 General Fund budgeted expenditures.

The MYFF is built upon the Fiscal Year 2006 budget and expectations for future fiscal years. With current information available, now the MYFF reflects Fiscal Year 2006 Annual Budget figures and forecasts for five subsequent years. The MYFF assumes that any operating savings as a result of labor concessions would be applied towards addressing the unfunded liabilities of the retirement system in order to restore long-term stability.

Salaries

The basic forecast of personnel costs is based on the Fiscal Year 2006 General Fund budget and the continuation of already approved positions. An annual salary adjustment is added to account for the step increases provided to employees over time and the effect of turnover. In the initial years, the adjustment represents savings, reflecting turnover and subsequent new hiring at lower steps, combined with the fact that a large percentage of employees are now at the top salary step (Step E). Recently updated expenditure assumptions are listed below:

Negotiated Salary Adjustments - Fiscal Year 2006 is based on Annual Budget. Negotiated salary adjustments of 0%, 4.0%, 2.0% and 2.0% are projected for Fiscal Years 2007, 2008, 2009, and 2010, respectively.

Average Salary Adjustments

Fiscal Year 2007 – assumes savings due to large populations already at "E" step and likely increased terminations, new hires and movement. Also includes adjustment for continuation of Fiscal Year 2006 Departmental Expenditure Reductions.

Fiscal Year 2008 – assumes savings due to increased movement and new hires.

Fiscal Year 2009 – assumes increased expense due primarily to decreased movement and step increases during the build-up cycle of the job class populations.

Fiscal Year 2010 – assumes increased expense due primarily to decreased movement and step increases during the build-up cycle of the job class populations.

Pension System Contributions

This represents one of the fastest growing expenditure areas. Rapid growth in the UAAL within San Diego City Employees' Retirement System (SDCERS) requires that the amount of resources allocated to amortize the UAAL also grow significantly. This growth in UAAL represents a combination of investment losses, increased benefits, past deferral of funding, and changes in actuarial assumptions. The forecast assumes that the City will make its full payment obligations consistent with the provision of the Gleason Settlement and Proposition G, as described below. The MYFF does not incorporate any savings from the issuance of pension obligation bonds. Several of the key factors driving the City's contribution to its retirement system and its impact on the MYFF are described below.

Gleason Settlement

Commencing in July 1996, the City was making annual contributions to SDCERS in accordance with a funding method that permitted contributions to be made by specified rates that were below the actuarially required rates of contribution. In response to litigation alleging that the City violated the City Charter and the Municipal Code by failing to contribute to SDCERS at rates determined by the SDCERS actuary, the City entered into the "Gleason Settlement" in July 2004. The settlement provides that the City will contribute a fixed amount of $130 million for Citywide contributions in Fiscal Year 2005. Commencing with the June 30, 2004 Annual Actuarial Valuation, the UAAL amortization period will be reset to a new 30-year fixed amortization period; for Fiscal Years 2006, 2007 and 2008, the City's contribution will be based on the actuarially determined funding level with the new 30-year fixed amortization period commencing with Fiscal Year 2005.

Proposition G

Proposition G, a Charter amendment approved by San Diego voters on November 2, 2004, requires that the amortization period for UAAL be shortened to no longer than 15 years beginning with Fiscal Year 2009. Shortening the amortization period from 26 years (the remaining term under the 30-year amortization established by the Gleason Settlement) to 15 years will have the effect of increasing the annual cost to amortize the liability. The forecast projects General Fund contributions to the retirement system growing from an estimated $160 million in Fiscal Year 2008 to estimated $204 million in Fiscal Year 2009 and estimated $223 million in Fiscal Year 2010, largely as a result of the accelerated amortization. The MYFF assumes the more conservative application of the proposition, defining the amortization period as a fixed 15-year term (with the remaining term declining each year), as opposed to a rolling 15-year term, which results in a modest increase in funding requirements.

Pension Obligation Bonds (POBs)

As one of the strategies for addressing SDCERS' high outstanding UAAL, the Pension Reform Committee recommended an infusion of up to $600 million in assets into the pension system over Fiscal Years 2005-2007. The specific recommendation was to fund no less than $200 million during Fiscal Year 2005 through the issuance of POBs. Subsequent funding phases, bringing the total to $600 million, were recommended through the issuance of additional POBs or some form of real estate secured transactions.

By means of a private placement or a public offering, a $200-600 million multi-phase issuance of POBs as one of the strategies for addressing the outstanding UAAL is currently being studied. While the City cannot proceed with a public offering of POBs in advance of the release of the Fiscal Year 2003 and Fiscal Year 2004 financial statements, preliminary discussions with underwriters active in the POB market indicate that the City could issue POBs on a private placement basis in the meantime.

The MYFF does not currently reflect the use of POBs. To the extent a portion of the outstanding UAAL is funded with POBs, the debt service on the bonds would replace a portion of the City's total retirement contribution attributable to the amortization of the UAAL. The City would only issue such POBs if it projected that total expenditures for retirement funding would be reduced. In general, POBs are expected to reduce the present value cost of funding the system due to the fact the interest rate on the bonds would be lower than the actuarial interest rate used to determine the amortization of the UAAL through annual payments. The latter rate is based on expected returns on SDCERS' investment portfolio.

MYFF Assumptions for Retirement System Contributions

The MYFF incorporates the provisions of the Gleason settlement and, beginning with Fiscal Year 2009, Proposition G amortization changes. In order to provide annual City contribution projections based on updated information, Towers Perrin, the City's actuary, implemented modifications to the June 30, 2004 valuation and made additional assumptions such as recognizing deferred investment gains, additional liabilities due to the Corbett Settlement and purchase of service credits.

The actual rates in the future will vary among the various retirement groups, such as Safety Employees and General Employees, which are not proportionately distributed between the General Fund and other funds. The following table summarizes the projected employer contribution rates for retirement. These rates assume a $100 million infusion to the Retirement System on June 30, 2006 by means of revenue securitization as reflected in the MYFF model. Fiscal Year 2009 spike is due to the Gleason Settlement having been fulfilled, and the amortization changing from 30 to 15 years per approval of Proposition G.

Pension Contribution Rate
City's Projections(1)

Fiscal Year	Contribution Rate
2006	26.86%
2007	28.88%
2008	28.04%
2009	35.29%
2010	37.29%

(1) 30-year fixed amortization for FY 05-08, 15 year *fixed/ declining* thereafter.

Retiree Health Benefits

The Municipal Code currently provides that in years when SDCERS earnings exceeded its actuarial target, that a portion of the City's employer contributions be deposited into a retiree's health care trust. Retiree health care benefits have historically been paid from the trust until funds were exhausted; subsequently, the City would pay directly from any source available. While this long-term practice was determined legal and was a common governmental practice, the Pension Reform Committee and the City Manager recommended that the practice cease. Starting Fiscal Year 2005, retiree health care benefits are funded in a manner that does not reduce the assets of SDCERS. The total retiree health cost for Fiscal Year 2005 was budgeted at $14.8 million. Of that amount, $7.9 million was paid from the retiree health care trust fund and the balance of $6.9 million was paid from City funds. The total retiree health cost for Fiscal Year 2006 is currently estimated at approximately $16.5 million on a cash basis. This entire amount will be funded on a cash basis by the City, with the General Fund departments contributing $10.4 million and the Non-General Fund departments contributing $6.1 million. Retiree health costs are assumed to be paid by the City on a cash basis throughout the forecast period. Retiree Health-Fiscal Year 2006 is based on Annual Budget which assumes a 10.6% increase from the projected Fiscal Year 2005 amount. Fiscal Year 2007 to 2010 assume an annual 12% increase.

Retirement Offset
This line item of expenditure in the MYFF Model represents a portion of the employees' contribution that the City has agreed to pay under current labor agreements. All subsequent fiscal years assume no change to the Offset Rate applied to the current year's salaries except for Fiscal Year 08 where City-paid employee contribution will be reduced by an additional 1% for all Municipal Employees' Association employees.

UAAL Dedicated Funds (Pension Liability)
After good faith bargaining, the City entered into three year agreements with the San Diego Municipal Employees' Association (MEA) and the AFSCME Local 127. The agreement with MEA resulted in reductions in City-paid (Retirement Offset) employee contribution of 3% for Fiscal Years 2006 - 08 and an additional 1% in Fiscal Year 08. Local 127 elected a 1.9% salary reduction in lieu of additional employee pension contribution and a flexible benefit increase for Fiscal Years 2006 - 08. One year agreements with the San Diego City Fighters Local 145 resulted in reductions in City-paid employee contribution of 3% for Fiscal Year 2006. Also, for Unrepresented employees a 3% reduction in City-paid employee contribution resulted for Fiscal Year 2006. The City was unable to reach agreement with the San Diego Police Officers Association (POA) and imposed its last, best and final offer for a one year term. This resulted in a 3.2% reduction in City-paid employee contribution for POA. Per labor union agreements, the funds from the net offset or salary reduction shall be applied to the Retirement System to increase its funding ratio.

On September 12, 2005, the City Council directed the City Manager to proceed with the further evaluation of pension solutions as presented in a City Manager's Report. The recommendations included quarterly status reports detailing leveraging of approximately $17-$18 million in City revenues generated from employee pick up savings during Fiscal Year 2006 via a revenue securitization option as part of a package to achieve a 80-85% funded ratio by Fiscal Year 2008.

Use of Any General Fund Savings
As discussed above, the General Fund could produce an operating savings in some years as a result of labor concessions. The MYFF assumes that any such savings would be used towards further reducing the retirement system's UAAL.

Fringe Benefits
This line item refers to costs associated with various employee-related costs, other than the Flexible Benefits Program. The primary components of this line item are workers compensation, Medicare, unemployment insurance, risk management, and compensated time off. Subsequent fiscal years projections are based on Fiscal Year 2006 fringe rate. This rate is adjusted annually for inflation at 3.00%, 3.09%, 3.18%, and 3.28% for Fiscal Year 2007, Fiscal Year 2008, Fiscal Year 2009 and Fiscal Year 2010, respectively.

Flexible Benefits
This category includes the City's cafeteria benefits plan, of which the highest cost component is health insurance. The forecast assumes that expenditures in this area will be frozen for Fiscal Year 2007. This does not reflect an expectation that costs for these benefits will not rise, but that any such costs will be absorbed by employees in the form of higher employee contributions or

reduced benefits. Flex benefits figures include 0.0% growth in Fiscal Year 2007 and a $500 increase in flexible benefits for Fiscal Year 2008; 8.78% annual growth thereafter.

Future Commitments Related to New Facilities

The MYFF incorporates the cost impacts associated with the staffing of new public safety facilities, and, in some instances, increases resulting from state or federal mandates. A major budgetary challenge facing the City in recent years has been the long-term costs of staffing and maintaining public facilities constructed by non-City funds. Since these new facilities and their related operational costs are phased in over a period of time, their future fiscal impacts, including the capacity of forecasted revenues to support the increased costs, are highlighted. In order to achieve budget balance, the MYFF assumes that in Fiscal Year 2006 funding for all new facilities except fire-rescue facilities will be absorbed by existing departmental operating budgets. Beginning in Fiscal Year 2007, the costs of only new public safety facilities are included as new General Fund expenditures. The funding of other new facilities such as recreation and parks and libraries will need to be identified for future years.

Supplies, Services, Information Technology, Energy/Utilities and Equipment Outlay

These line items capture most of the City's non-personnel expenses supported by the General Fund. The MYFF assumes that these expenditures will generally grow by inflation. Recently updated expenditure assumptions are summarized below:

Supplies and Services – Fiscal Year 2006 is based on Annual Budget. Fiscal Years 2007-2010 include addition of committed departmental expenditures and a 2.0% annual increase of non-department specific Committed Expenditures; Fiscal Year 2007 includes a $5,000,000 reduction from Fiscal Year 2006 base expenditures.

Information Technology, Energy/ Utilities, and Equipment Outlay - Fiscal Year 2006 is based on Annual Budget. Fiscal Years 2007–2010 non-department specific Committed Expenditures are projected to increase 3.0% annually.

Going Forward

The Multi-Year Financial Forecast is a tool to help produce a comprehensive, long-range analysis of its General Fund revenues and expenditures. It is only a first step in what should be a regular exercise. The model can be used to help analyze major decisions as they are being considered, and should be updated to assist with the City's annual budget process.

This long-term forecast has revealed serious structural challenges to the City. As alternative approaches to the City's challenges are identified, they should be incorporated into subsequent versions of the MYFF Model in order to forecast their long-term impact.

This project is intended to be an ongoing planning tool that will be utilized in each year's budget process. There will be a number of opportunities to improve this planning tool as future generations of the MYFF are developed. As the Mayor and City Council, management and City staff uses the MYFF, they will evolve it to better meet their needs, giving further input and direction as to what assumptions and alternatives should be explored. Alternative scenarios will be developed to further explore the various opportunities available to the City to meet the needs of its citizenry within available resources. Tools such as this are truly valuable only if they are maintained and evolved to meet the particular needs of decision makers over time.