OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

REVIEW OF MAYOR'S FIVE-YEAR FINANCIAL OUTLOOK FISCAL YEARS 2008 – 2012

Part I. Baseline General Fund Revenues and Expenditures

Date Issued: January 12, 2007 **IBA Report Number: 07-6**

Report Overview

The Mayor's Five-Year Financial Outlook (Financial Outlook) for Fiscal Years 2008-2012 was presented at the November 29, 2006 Budget and Finance Committee meeting. This Financial Outlook represents a view of the City's long range fiscal condition and fiscal challenges for the next five years. The Financial Outlook identifies the Mayor's priorities that he hopes or plans to address during Fiscal Years 2008-2012.

This IBA report provides a review of the General Fund revenues and expenditures. This represents the first of a series of IBA reports that will address the areas of the Financial Outlook which will include: General Fund revenues and expenditures; the "eight significant areas," and possible solutions to balance the budget. Please see Attachment I for timeline. The IBA will also be examining possible new and increased fees which are not contemplated in the Financial Outlook.

Discussion of Major General Fund Revenue Outlook

Arguably the most important component of a multi-year forecast is the General Fund revenue projection. Just as in the annual budget process, General Fund revenues establish the foundation for the Financial Outlook. While many projected General Fund expenditures are subject to policy decisions, General Fund revenues are largely determined outside the decision-making process. Growth in General Fund revenue drives the bottom line throughout the forecast.

The Financial Outlook projects total General Fund revenue to increase from $1.031 billion in Fiscal Year 2007 to $1.184 billion in Fiscal Year 2012, an increase of nearly $153.0 million or 14.8 percent. On average, annual growth is projected at approximately 2.8 percent. In Fiscal Year 2007, four major revenue sources – property tax, sales tax, Transient Occupancy Tax, and franchise fees – comprise approximately 70 percent of all budgeted General Fund revenue. In the Financial Outlook, these four revenue sources account for over 85 percent of all revenue growth over the forecast period.

The General Fund revenue forecast is broken down into smaller components. Each of the four major revenues is projected individually, as are minor tax revenues such as property transfer tax and safety sales tax. Beyond that, most of the remaining General Fund revenues are examined by major category, such as Licenses & Permits, or Charges for Current Services. These categories group together similar revenue sources that are generally budgeted within individual departments. Given the sheer number of different revenue sources within these categories, and the relatively minor amount of revenue attributable to each one, it makes practical sense to look at the category as a whole.

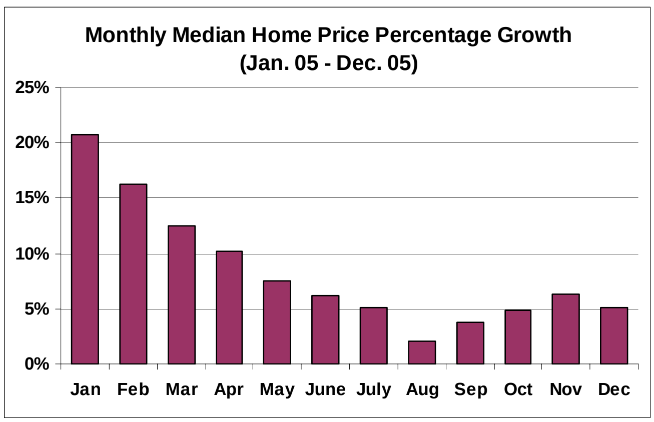
In this report, we review the assumptions and growth projections for each of the four major General Fund revenue sources, and take a brief look at some of the other revenue components. It is not our goal to “pick apart” the revenue projections or make alternative recommendations, but rather, to provide some perspective on the major revenues, including recent trends, historical growth, and future prospects. In addition, we discuss possible risks to the forecast, and highlight areas where more concentrated research may be appropriate.

Finally, it is important to note that perhaps more than any other aspect of the Financial Outlook, the General Fund revenue projections are highly dynamic, and will be subject to constant revision as new information becomes available. In this regard, the current General Fund revenue projections should be viewed as the first step in an evolving financial outlook.

Property Tax

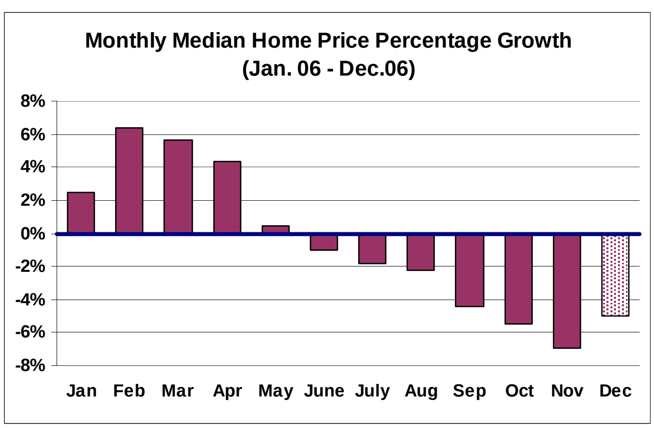
Property tax is the single largest source of General Fund revenue, accounting for nearly $344.2 million, or 33.7 percent, of total budgeted General Fund revenue in Fiscal Year 2007. In Fiscal Year 2005, the State of California enacted a Vehicle License Fee (VLF)-Property tax swap, which eliminated the VLF Backfill and replaced it dollar-for-dollar with property tax. In Fiscal Year 2007, the VLF swap accounted for nearly $89.7 million of the total property tax budget.

The Financial Outlook projects property tax revenue to grow 3.5 percent in Fiscal Year 2008, and 2 percent each year thereafter. These growth rate projections, down substantially from growth rates in recent years, reflect the sharp decline in the local housing market in calendar year 2006. After years of substantial growth in the residential real estate market, in which median prices consistently saw year-over-year gains of 20 percent or more on a monthly basis, the housing market began to slow in 2005. The chart below shows year-over-year growth by month in the median price for all homes in 2005.



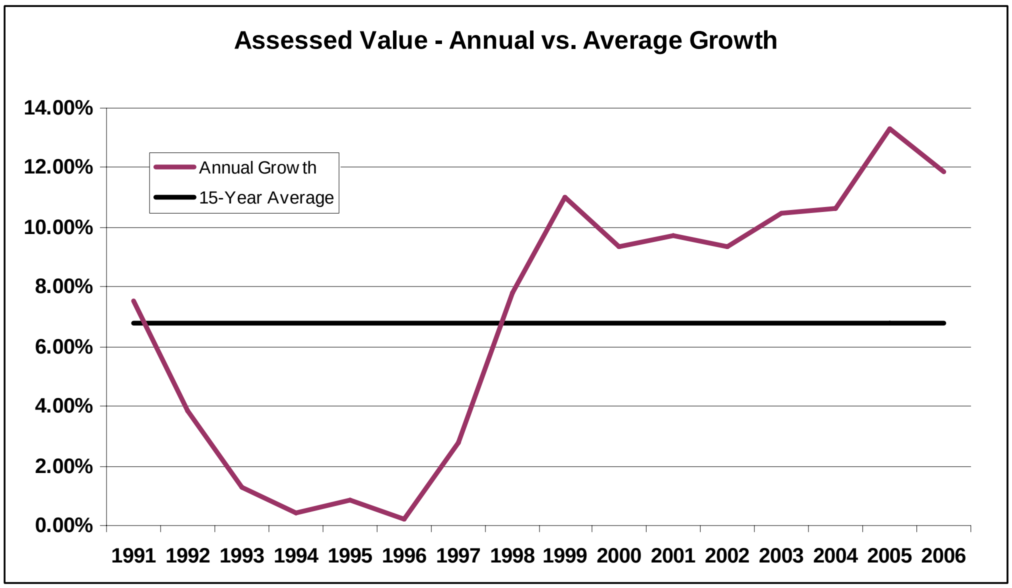
Source: DataQuick

The market activity in calendar year 2005 was the basis for property tax revenues in Fiscal Year 2007. The significant price gains in the early months were sufficient to keep growth in assessed valuation (AV) at a healthy 11.4 percent. Looking forward to Fiscal Year 2008, it is instructive to examine the market activity in calendar year 2006. As the chart below shows, median price growth declined markedly in 2006, even turning negative around the middle of the year.



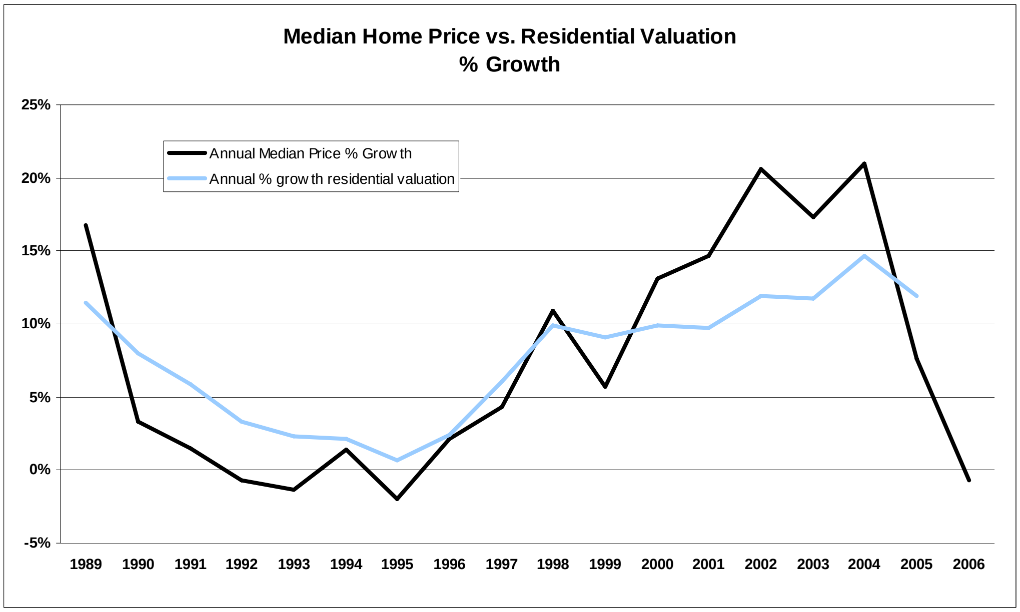
Source: DataQuick, IBA projections

In addition to the decline in prices, the number of home sales has been plummeting as well. November 2006 marked the 29th straight month with year-over-year declines in monthly sales. In short, there were fewer sales and each sale was fetching a lower price. While there is no question that this combination will lead to a reduction in AV growth, the real question is of magnitude. As shown in the chart below, growth in assessed valuation has been well above average over the past several years, and it is unclear just how large of an impact the decline in home prices and sales will have.



Source: County of San Diego, Inventory of Parcels and Valuations

One way to get a sense of the magnitude is to compare the annual median price growth to annual growth is residential valuation. Residential valuation accounts for approximately 72 percent of total assessed valuation. The chart below makes this comparison.



Source: DataQuick, County of San Diego, IBA projections

This chart shows that there is a high correlation between growth in median home prices and growth in residential valuation. The steep decline in median price growth in 2006 strongly suggests that residential valuation will decline sharply as well. We should not necessarily expect residential valuation growth to fall as far as the growth in median prices, however, since the chart also shows that residential valuation has less volatility. The decline in residential valuation may also be partially offset by growth in commercial valuation, which makes up approximately 18 percent of total assessed valuation. Over the past several years, annual growth in commercial valuation has increased steadily, from 7.3 percent in 2002 to 13.2 percent in 2005, and is likely to remain robust in near future. Further research on the economic fundamentals of commercial valuation would provide for a greater understanding of total assessed valuation growth, and may improve the accuracy of property tax projections.

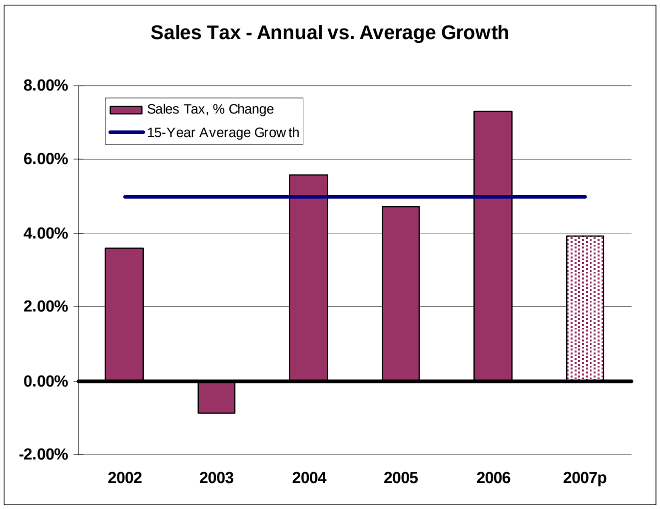
Recent trends in the residential real estate sector, as discussed above, support the sharp decline in property tax growth projected in the Financial Outlook. It is unclear how long the housing market will stay depressed, however, and the 2 percent projected growth in the outlying years may prove to be somewhat conservative if growth in housing prices begins to pick up. Overall, though, the forecast for property tax is reasonable.

Sales Tax

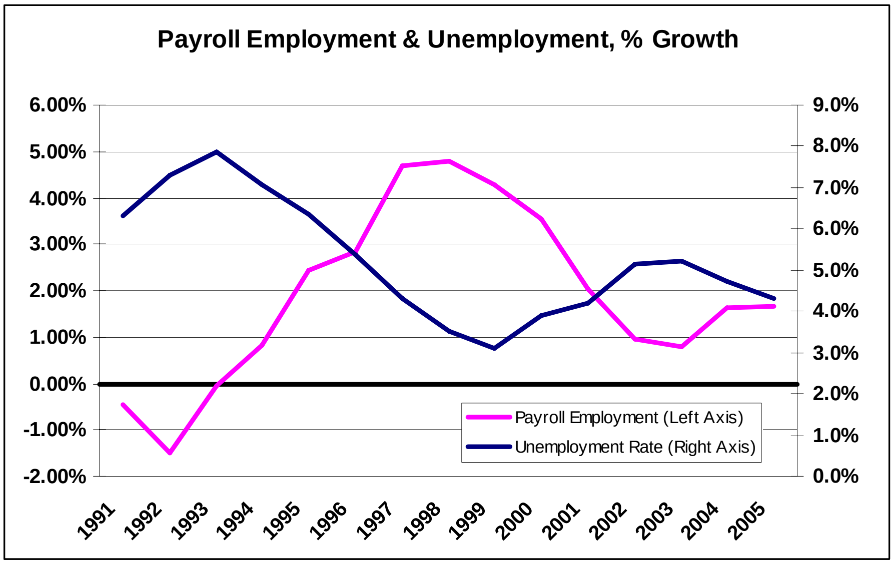
Sales tax is the second largest General Fund revenue source, budgeted in Fiscal Year 2007 at $234.9 million, or approximately 23 percent of total General Fund revenue. In previous years, sales tax revenue was allocated to various non-General Funds, such as Special Promotional Programs, Street Division, and Police Decentralization. The General Fund sales tax budget was the remainder of projected sales tax after all allocations. Budget restructuring in Fiscal Year 2007 changed this practice to the budgeting of all sales tax revenue in the General Fund. This improved practice will make it easier to track and compare sales tax revenue in the future.

The Financial Outlook projects sales tax growth to be 3 percent per year over the forecast period. While this forecast assumes sustained growth in local taxable sales, it conservatively reflects projected job losses in the financial and real estate sectors related to the declining housing market, as well as the possibility of lower consumer spending due to the “wealth effect.” As home prices have risen dramatically over the past several years, homeowners feel wealthier and subsequently spend more. As referenced in the Financial Outlook, the UCLA Anderson Forecast states that spending in San Diego County has been rising faster than incomes, largely due to the surge in home prices.

Over the past 15 years, average sales tax growth has been approximately 5 percent per year. The chart below shows how recent growth trends compare to the 15-year average.



Over the long-run, sales tax revenue is largely driven by income growth and the rate of saving. If the savings rate is constant, meaning that consumers always spent the same percentage of their discretionary income, then sales tax growth should closely follow income growth. Unfortunately, data on local income growth is rather limited. Other, more widely available data such as job growth or unemployment can be used as a proxy for income growth. The chart below shows payroll job growth in San Diego County plotted against the unemployment rate over the past 15 years.



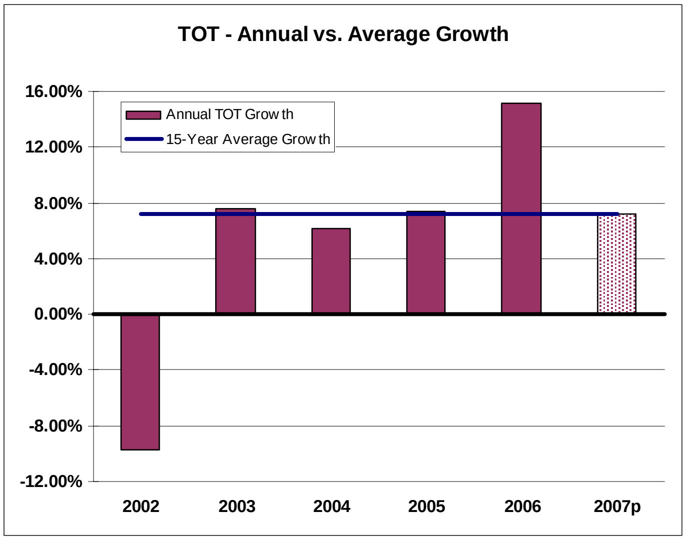
Source: California Economic Development Department

Looking forward, the biggest risk concerning sales tax revenue is the housing market, which may impact sales tax in three ways. First, sustained declines in the housing market may cause greater job losses in the financial and real estate sectors. Second, if home prices continue to fall, consumers may tighten their purse strings as they begin to feel less wealthy (the "wealth effect" reversed). Finally, a significant correction in the housing market could cause the economy to slip into a recession, which in turn could result in broader job losses across multiple sectors. The projections over the 5-year forecast period generally reflect a cautious outlook, though further declines in the housing market or a softening job market could push growth rates lower, particularly in the early part of the forecast. Sales tax trends and the related economic factors should be closely monitored to ensure that appropriate changes can be made to the projections if necessary.

Transient Occupancy Tax

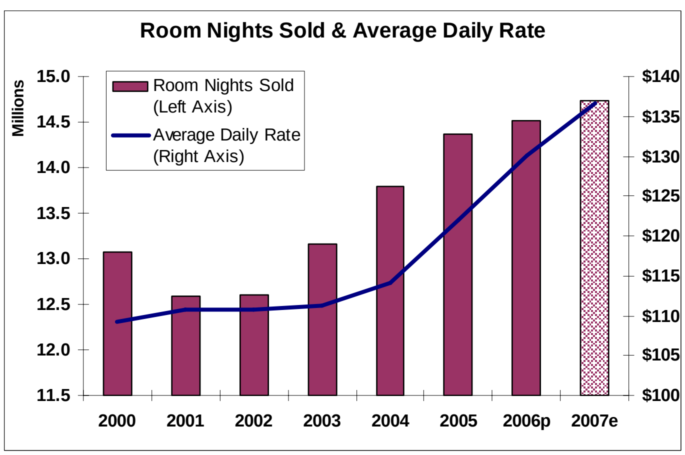
Transient Occupancy Tax (TOT) is the third-largest General Fund revenue source, and is derived from a 10.5-cent per dollar levy on the daily room rate charged by hotels and motels within the City of San Diego. Per Municipal Code requirements and Council Policy, 5.5 cents is allocated directly to the General Fund, and 5.0 cents is deposited in the Transient Occupancy Tax fund to support special promotional programs. In Fiscal Year 2007 citywide TOT was budgeted at $139.1 million, with $72.9 million budgeted in the General Fund, accounting for approximately 7.1 percent of the total General Fund revenue budget.

The Financial Outlook projects TOT revenue to grow by 6 percent in Fiscal Year 2008, and then 5 percent each year thereafter, reflecting a slight decline in San Diego's tourism industry. TOT revenue has experienced significant growth since the September 11, 2001 World Trade Center attacks. The chart below shows annual TOT growth over the past several years.



Over the past 15 years, TOT growth has averaged approximately 7.2 percent per year. This is reflected in the dark line on the chart above. As the chart shows, since 2002 TOT growth has been about average, with the exception of the 15 percent surge in Fiscal Year 2006.

On a citywide basis, TOT revenue is derived from total room revenue, which in turn is driven by factors such as number of visitors to the region, the number of nights stayed in hotels, and the price that is charged for each night's stay. These factors are captured in two variables, room nights sold, and average daily room rate (ADR). Room nights sold is a measure of industry demand, and reflects the total number of rooms that are sold over a given time period. ADR simply reflects the average rate that is charged for all rooms sold. The chart below shows the recent trends in both room nights sold and ADR.



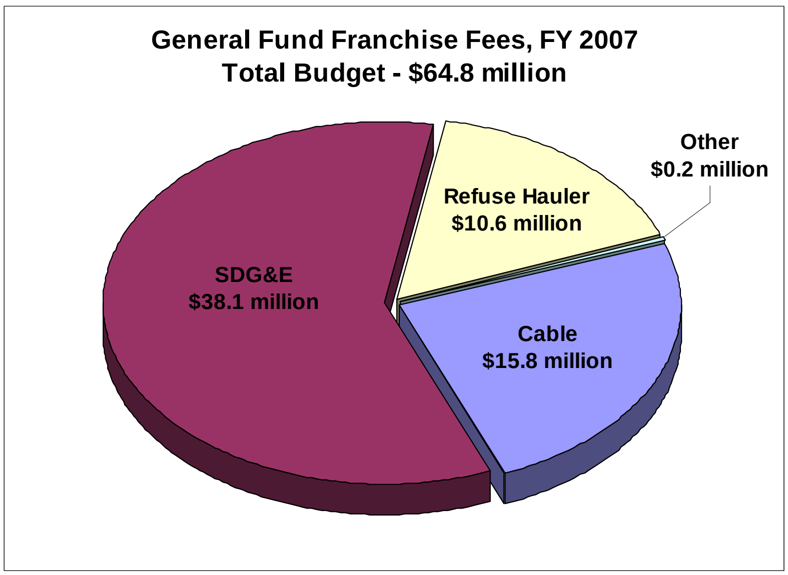
Source: San Diego Convention & Visitor's Bureau

The strong growth in both the number of room nights sold and the average daily room rate has driven the substantial gains in TOT over the past several years. It is reasonable to assume that the growth in these variables will moderate in the near future. Overall, the forecast in the Financial Outlook reasonably captures this gradual slowdown, although the starting point of 6 percent growth in Fiscal Year 2008 may be slightly conservative given the continued strength of the tourism industry.

Franchise Fees

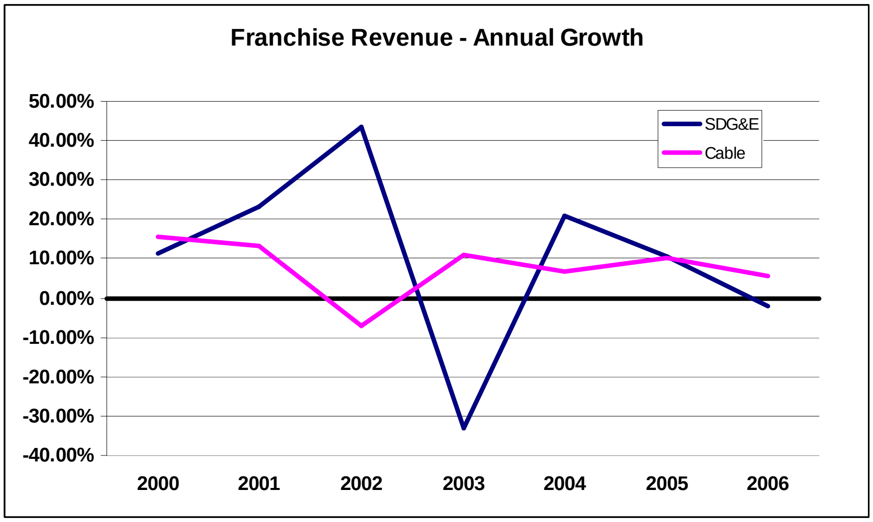
Franchise fees are paid to the City of San Diego by private utility companies for use of the City's rights-of-way, and are usually charged as a percentage of gross sales. Rates are set through Franchise Agreements that are negotiated with individual utility companies. The City has several franchise agreements, the largest being with San Diego Gas & Electric (SDG&E), Cox Communications and Time-Warner Cable. In addition, the City collects a refuse hauler franchise fee from private refuse haulers.

As a revenue source, franchise fees refers to the sum of the revenue derived from the City's various franchise agreements. The pie chart below shows the Fiscal Year 2007 General Fund budget for each component of the total franchise fees budget.



The Financial Outlook assumes 7.5 percent growth per year in franchise revenue from SDG&E and the two cable companies. The assumptions behind this projection are unclear, as little detail is provided in the Financial Outlook. Franchise fees are generally the most difficult major General Fund revenue source to project. Since the rates charged to SDG&E and the cable companies are levied as a percentage of gross revenue, projecting franchise revenue essentially amounts to projecting gross revenues for the various utilities. However, the general relationship between franchise revenue and the underlying economic factors is not well known, and projections rely heavily on growth rates trends. This is an area where more concentrated research may yield significant benefits in terms of developing more accurate forecasts and understanding the relationship between utility revenue and the underlying economic factors.

The chart below shows the annual growth in General Fund franchise revenue from SDG&E and the cable companies over the last several years.



As the chart indicates, annual growth has been somewhat sporadic over the last few years. Given this volatility, the 7.5 percent growth projection may prove to be a little aggressive, but as previously mentioned, additional research is needed before any further conclusions are drawn.

One of the risks to the forecast has to do with the passage of Assembly Bill 2987 in September 2006. AB 2987 creates a new statewide franchise for cable and video service providers, issued by the California Public Utilities Commission. According to the terms of this Bill, cable companies that have existing franchise agreements with local government, such as Cox Communications and Time-Warner, will have the opportunity to “opt out” of their franchise agreements 10 days after a competitor announces that they have received a franchise to deploy service in the cable company's service territory. The cable company can then apply for a state franchise to provide service in the same service territory under the new AB 2987 franchising rules. While the Bill allows local governments to receive franchise fees from State franchise agreements in exchange for the use of local rights-of-way, this essentially amount to a State subvention and is not protected by Proposition 1A. We recommend that this issue be closely monitored in order to determine any potential impacts to the City’s cable franchise revenue.

Other Revenue Sources/Categories

Aside from the four major revenues discussed above, the General Fund revenue projections in the Financial Outlook include projections of minor revenue sources such as property transfer tax, safety sales tax, vehicle license fees; as well as general revenue categories such as Licenses & Permits, Fines, Forfeitures and Penalties, Revenue from Money & Property, Revenue from Other Agencies, Charges for Current Services and Transfers from Other Funds. Since revenue from all of these other sources accounts for less than 30 percent of total General Fund revenue, we only wish to comment briefly on a few salient points:

- Property transfer tax is projected to decrease 5 percent per year in each of the first three years, and then remain constant thereafter. Property transfer tax revenues increased dramatically with the housing boom several years ago, but declined rapidly in Fiscal Year 2006 and Fiscal Year 2007 as the number of home sales has plummeted. This trend is likely to continue through Fiscal Year 2008. However, if home sales begin to rebound, the projected 5 percent declines in Fiscal Year 2009 and Fiscal Year 2010 could prove to be too conservative.

- Business license taxes and parking meter revenue are both included in the Licenses & Permits revenue category, although they are projected independently. Both are projected to increase 2 percent per year, while the remaining portion of the Licenses & Permits category is projected to grow at 1 percent per year.

- Revenue from Mission Bay rents and leases is projected to increase 5 percent per year, and is included in the Revenue from Money & Property category. Franchise fee revenues, discussed earlier, are also included in this category. Aside from Mission Bay rents and franchise fees, no other growth rate is applied to the revenue category.

- Revenue from the employee pick-up savings is included in the Revenue from Other Agencies category.

Overall, the General Fund revenue projections provide a reasonable foundation for the Financial Outlook. The assumptions employed are reasonable, and the growth projections are generally consistent with the expected outlook. There remain several areas in which more concentrated research may enhance the accuracy of the revenue projections, and provide greater understanding of the relationship between revenue sources and the underlying economic factors. Finally, it is worth reiterating that General Fund revenue projections are highly dynamic, and should be updated frequently as part of an ongoing and evolving financial outlook.

Discussion of Mayor's General Fund Expenditure Outlook

Total City spending will grow at an average annual rate of 4.3 percent under the Financial Outlook for Fiscal Years 2008-2012. The largest expenditure increase is 9.7 percent in Fiscal Year 2009 with an average annual expenditure growth rate of 2.5 percent for Fiscal Years 2010-2012. The total General Fund expenditures are estimated to rise from $1.15 billion in 2008 to $1.36 billion in 2012.

This increase in spending is primarily driven by increases in the City's labor costs, as well as pension payments to SDCERS, retiree health care, reserves, deferred maintenance/capital infrastructure and storm water runoff compliance, ADA improvements, Workers' Compensation Fund and the Public Liability Fund.

Spending is expected to grow substantially in a few discreet portions of the budget that are largely outside the City's near-term control. These categories continue to drive the City's spending upwards at a rate that exceeds revenue growth. For example, pension payments to SDCERS per the Financial Outlook are expected to rise from $154.4 million in 2008 to $168.7 million in 2012. Likewise, the growth in retiree health care Other Post-Employment Benefits (OPEB) spending is projected to increase from $33.4 million in 2008 to $58.6 million in 2012.

The Financial Outlook is not balanced. Shortfalls exist for every year of the Financial Outlook. The Mayor has proposed financial solutions to partially address and mitigate the City's significant financial shortfall. Even with the proposed solutions, the City faces a shortfall in all five years. As stated earlier, the IBA will be reviewing the proposed solutions along with other recommendations to address the shortfall.

Salaries

Salaries represent approximately 73 percent of the General Fund budget. The primary reason for the slight expenditure growth is lack of provisions for future raises. Contracts with labor unions will begin to expire at the end of this fiscal year. According to the Financial Outlook, no City employees will be granted any raises after Fiscal Year 2008. This includes the following bargaining units: Municipal Employees' Association, Local 127; Local 145; Police Officer Association; Deputy City Attorney Association; and all Unclassified/Unrepresented employees. The only two bargaining units scheduled to receive salary increases are the Municipal Employees' Association and Local 127, with both receiving 4 percent increases in Fiscal Year 2008.

Recently, the independent and comprehensive pay and benefits comparison survey for the San Diego Police Department (SDPD) officers was released that showed SDPD officers at the bottom for take home pay in comparison with other jurisdictions. The Mayor has stated that officers should be compensated fairly and has committed to correct the total take home pay deficiencies and resume a competitive pay level for the SDPD officers in order to avoid further loss of officers and to recruit new, qualified officers. No provisions are included in the Financial Outlook for the proposed negotiation. A pay and benefits comparison similar to the Police study is underway for San Diego Fire-Rescue Firefighters. The results of this study and future negotiations could potentially impact salary assumptions as well.

It is estimated that each one percentage point increase above current negotiated terms for City employees will cost the city the following:

Bargaining Unit	Estimated Cost to City
Municipal Employees Association	$2.4 million
Local 127	$868k
Local 145	$655k
Police Officer Association	$1.3 million
Deputy City Attorney Association	$135k
Unclassified/Unrepresented	$566k
Total	**$6 million**

estimated cost to City for 1% point increase

Flexible benefits

According to the Financial Outlook, employees will go without any cost of living adjustments or flexible benefit increases over the next four to five years depending upon bargaining unit. The Financial Outlook includes an increase of $500 in flexible benefits for Municipal Employees' Association employees only in Fiscal Year 2008. This will cause City employees to absorb health insurance cost increases, which is the highest cost component of the flexible benefits. According to the Employer Health Benefits 2006 Annual Survey released by the Kaiser Family Foundation and the Health Research and Educational Trust, premiums for employer-sponsored health coverage rose an average of 7.7 percent in 2006. Although the increase is less than the 9.2 percent recorded in 2005, continuing rising health care costs will further impact employees' take home pay. Premiums have increased 87 percent since 2000. It is our understanding that the Mayor is actively pursuing reform in health care to offer better rates and assist employees to maximize flexible benefit dollars, as well as to assist with recruitment and retention. We wholeheartedly support this action and have made such recommendations in the past.

Vacancy factor

A vacancy factor is intended to reflect normal attrition in an organization. This adjustment is made to department budgets to account for vacant and/or under filled positions, salary step savings, and recruitment time. The average vacancy factor applied to the General Fund is projected to be adjusted downward to 3.5 percent, 3.0 percent, 2.5 percent, 2.4 percent, and 2.3 percent for Fiscal Years 2008-2012, respectively. The average vacancy factor used for the Fiscal Year 2007 Budget was 5.3 percent. See Attachment II for Fiscal Year 2007 General Fund vacancy factor by department. Given Business Process Reengineering adjustments and reduced staffing levels resulting from the Mayor's proposed solutions, the revised vacancy factor appears more reasonable and realistic.

Pension Payments and Other Post Employment Benefits

The Financial Outlook is more comprehensive in addressing various components of post-employment benefits than recent budgets. The Financial Outlook does assume full payment of the ARC to SDCERS as well as correcting funding practices codified in the Waterfall, such as Corbett, 13th Check and past funding diversions for retiree health payments. This gives a more complete picture of the City's true liabilities. Further review of this issue will be discussed by the IBA in a future report.

Another baseline assumption is full payment of current retiree health costs on a pay-as-you-go basis. The Financial Outlook further assumes increased funding to a Retiree Health Trust Fund, which will also be discussed by the IBA in a future report.

The Financial Outlook also assumes continuation of current levels of the City "Pick-Up" and the "Employee Pick-up Savings" that is currently being set aside to leverage a reduction in the UAAL. Both of these assumptions warrant further scrutiny. The City's current fiscal position and political climate make it unlikely that an increased employer pick-up could be approved. However, the compensation studies that the Mayor has undertaken should be the key guide to ensure the City's competitive position. The Compensation and Benefits Study for Police classifications shows that the offset for Police is significantly lower than the majority of our peer jurisdictions. The studies for other classifications may show the same or different results for the City's competitive position amongst comparable employers. Should it be warranted, in the context of a competitive total compensation and benefits package, an increase to the pick-up for Police and/or other employee units would create a further deficit in outlying years in this Financial Outlook. The City may have to weigh fiscal demands against competitive pressures and the ability to retain and recruit qualified personnel in the future.

The Employee Pick-Up Savings is assumed to continue at current levels, even though the Financial Outlook does not explicitly project compliance with the labor contracts that require a $600 million infusion into the Retirement System by June 30, 2008. The Financial Outlook does not discuss an infusion of funds, nor does it include debt service for any new leveraged financing to achieve this goal. As we stated in IBA Report 06-51, we believe there are outstanding questions about the results of the City's non-compliance with these contracts. If the City does not infuse additional funds into the System, it is not a given that the Pick-Up Savings will continue at the current level. Therefore, the IBA believes that this Financial Outlook contains an inherent contradiction that should be corrected. If the City does not expect to fulfill the contract obligations, the Mayor's office must investigate the financial repercussions and include those in the Financial Outlook assumptions for this line item. If the City does plan to fulfill the obligations of the contracts, the continuation of this level of Pick-Up Savings is acceptable, but supplementary information should be published to describe plans for fulfillment and any financial impact to the Financial Outlook.

Other "Committed" Expenditures

The Financial Outlook indicates that all committed expenditures are included. Committed expenditures are defined as follows:

- Contractual services obligations;
- New facilities and related operations and maintenance costs for those facilities previously approved by Council;
- City Council-mandated expenditures such as the Library Ordinance;
- Lease payment obligations for Police helicopters and Fire ladder trucks;
- Inflationary increases to certain line items including utilities, fuel, supplies and services.

The following chart displays all of the new facilities and their associated operating and maintenance costs that are included in the Financial Outlook:

New Facilities for Fiscal Years 2008 - 2012	
Fire	
Fire Station 47 – Pacific Highland Ranch($1.8 mil) *Fire Station 49 – Otay Mesa Area($2 mil)*	*Fire Station 48 – Black Mountain Ranch($2 mil)*
Police	
Northwestern Area Station($9 mil)	
Library	
Logan Heights Branch Library($957k)	
Park and Recreation ***($6.6 million)***	
**Black Mtn. Neighborhood Park* **Black Mtn. Neighborhood Park – North* **Carroll Neighborhood Park* **Del Mar Mesa Neighborhood Park* **Gonzales Canyon Neighborhood Park* **Home Avenue Neighborhood Park* **Penasquitos Towne Centre Linear Neighborhood Park* **Rancho Encantada Neighborhood Park* **Torrey Del Mar Neighborhood Park* **Torrey Highlands Neighborhood Park* **Carmel Valley South Community Park* **Central Avenue Mini Park* **Fire Station #2 Mini Park* **North Park Mini Park* **West Lewis and Falcon Streets - Mini Park* **West Maple Canyon Mini Park* **Carson Elementary School Joint Use* **Fay Elementary School Joint Use* **Flo Jo School Joint Use* **Kennedy/Porter School Joint Use* **La Mirada Elementary School Joint Use* **Mead/Chollas Elementary School Joint Use* **Normal Heights Elementary School Joint Use* **Rodriguez Elementary School Joint Use* **Scripps Ranch Middle School Joint Use* **Rancho Encantada Interpretive Center*	**Carroll Neighborhood Park Comfort Station* **Cherokee Pt. Park Comfort Station* **North Chollas Community Park Comfort Station* **House of Pacific Relations* **House of Spain* **Marston House Improvements* **Mira Mesa Field House* **The Ficus Garden* **Carmel Valley Skate park* **Tierrasanta Skate Park* **39th Street Park (Phase II)* **Carroll Neighborhood Park Swimming Pool* **Encanto Swimming Pool* **Carmel Valley South Recreation Center* **Camino Ruiz* **Park De La Cruz (Phase II) Park Expansion* **Teralta Park Comfort Station & Bike Pedestrian Corridor* **Fire Station #45 Park Area* **252 Corridor Park* **Ocean View Hills Community Park Pacific Breezes* **Ballfields* **Fox Canyon (Phase II) – Creek and Park Improvements* **OVRP - Athletic Complex*

While the Financial Outlook includes costs for the facilities listed above, other facilities such as 19 of the 22 fire stations, identified by San Diego Fire-Rescue, to bring response times up to national standards, have not been included. Additionally, other desirable facilities in the areas of Police, Park and Recreation, Libraries and Streets, are not contemplated over the next five-years. Due to the City's financial position, these capital needs, which have been put off for several years, will likely remain deferred over the next five-year horizon.

City-Council Mandated Expenditures

The City-Council mandated items in the Financial Outlook include the Living Wage Ordinance, enacted in 2006, the Library Ordinance enacted in 2002, and the Mission Bay Ordinance enacted in 2004.

The ***Living Wage Ordinance*** requires covered employers and their subcontractors to pay their employees a wage that will enable a full-time worker to meet basic needs and avoid economic hardship. The current Living Wage rate is $10 per hour plus an additional health benefit rate of $2 per hour. The General Fund's share of the City's total contracts is 15 percent. The Financial Outlook includes funding for the Living Wage Ordinance. The additional General Fund costs are $489k, $506k, $523k, $540k, and $559k for Fiscal Years 2008-2012, respectively.

The ***Library Ordinance*** was established to provide increased funding for the Library System to adequately fund the library by requiring six percent of the General Fund budget allocated to the Library Department. The Financial Outlook assumes a waiver of the Library Ordinance in all years. Compliance with the Ordinance would have resulted in an additional $25 million being provided to the Library Department, based on a projected General Fund budget of $1.07 billion for Fiscal Year 2008, and comparable amounts in future years. A waiver of the Library Ordinance will be proposed again in Fiscal Year 2008 as it has for the past four fiscal years. The IBA recommends that the Mayor and City Council revisit the concept of the Library Ordinance with respect to the City's overall financial needs and budget principles.

The ***Mission Bay Ordinance*** requires lease revenues collected within Mission Bay in excess of $20 million to be used to fund the Mission Bay Improvement Fund and the Regional Park Fund. Each fund gets 25% of the excess dollars, not to exceed $2,500,000 each in a fiscal year. The money in the funds can only be used for permanent capital improvements or deferred maintenance within the parks. The Financial Outlook assumes compliance with the Mission Bay Ordinance throughout the five-year period.

Kroll Remediation

$20.2 million for Kroll remediation has been included in the Financial Outlook for the General Fund. The cost to implement the Kroll remediation is estimated at $45 million, which will be allocated between the General Fund and other City funds. The Cost Allocation Policy adopted on March 20, 2006 establishes guidelines for allocating costs to various funds, programs, grants, contracts and agreements. This policy recommends an allocation of 71 percent of all city-wide expenses to the General Fund and an allocation of 29 percent to other City funds based on Full-Time Equivalent (FTE) staffing.

The cost allocation applied to the Kroll remediation in the Financial Outlook is consistent with the Cost Allocation Policy except for the Enterprise Resource Planning (ERP) system that will replace the major software systems currently in use by the City's Department of Finance and Business Support Services with a new financial reporting system. The methodology used for the ERP system is based on a rough estimate of projected costs derived from prior acquisition costs for the City's older informational technology systems such as AMRIS and OPIS.

Eight Significant Areas

Funding for the Mayor's eight significant areas are included in the Financial Outlook, and will be discussed further in a subsequent IBA report. The eight significant areas are as follows:

- Additional funding for the City's Pension Plan
- Additional funding of the City's General Fund reserves
- Additional funding for deferred maintenance and capital improvement needs
- Additional funding of the City's Post Employment Medical Program
- Additional funding of the City's new obligations under Storm Water Runoff Permits
- Additional funding of the City's ADA obligations
- Additional funding of the City's Workers' Compensation Fund
- Additional funding of the City's Public Liability Fund

What is not included in the Financial Outlook?

Understanding **what is not** included in the Financial Outlook is as important as understanding **what is**. The community needs to be aware that, for the Financial Outlook period of Fiscal Years 2008-2012, the underlying message with respect to the provision of critical and/or highly desirable community services, programs and facilities is a bleak one. The Financial Outlook is the most comprehensive, forward-look at the City's financial condition and significant challenges in recent history. However, there is no discussion or analysis of existing service levels, highly desirable or critical service levels, or the potential impact of the Financial Outlook on services to the community over the five-year period. The Financial Outlook explicitly acknowledges no improvement in service levels.

Several significant funding needs of potential interest to the Council and community, not included in the Financial Outlook, are:

- Restoration of Library, Pool, and Recreation Center Hours
- Restoration of Park Maintenance Levels
- Application of the Library Ordinance
- Stormwater Infrastructure Operations and Maintenance Needs
- Police Officer Recruitment and Retention Issues to Address Compensation Study
- Replacement of Police Equipment and Facilities per the Police Five-Year Plan
- Funding of Fire-Rescue Stations and Equipment per the Comprehensive Public Safety Needs Assessment
- Implementation of 15-Year Amortization Period for Pension Liability

The revenue growth assumed in the Financial Outlook is totally consumed by eight expenditure requirements necessary to fulfill legal obligations or restore fiscal integrity, as a result of these obligations being ignored by previous administrations. Per the Financial Outlook, the community should expect no enhancement of City services in the near term, and, based on the data presented and the Mayor's rejection of tax or fee increases, it is our expectation that citizens are likely to see deterioration in services over the Financial Outlook period as a solution to closing the funding shortfalls of $24.6 million in Fiscal Year 2008 and $96.3 million in Fiscal Year 2009.

Conclusion

The Financial Outlook includes reasonable projections for General Fund revenues and many General Fund expenditure requirements. Based on our analysis, we believe the following are areas of exposure in the baseline assumptions for this Financial Outlook:

- Salary increases in Fiscal Year 2008 for select bargaining units only is a very precarious assumption. Based on the results of the upcoming Meet and Confer, the deficit in each year could expand considerably.
- The Employee Pick-Up Savings should not be assumed to remain at the current levels unless the Financial Outlook includes a plan to meet the retirement system cash infusion requirements of the current labor contracts.
- The Five-Year Financial Outlook should identify service levels associated with projected department budgets. The impact on existing service levels, of any reductions that are proposed to address funding short falls in Fiscal Year 2008 and beyond, should also be clearly identified.

[SIGNED]	**[SIGNED]**
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Penni Takade Deputy Director	APPROVED: Andrea Tevlin Independent Budget Analyst

Attachments