OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: November 30, 2006 **IBA Report Number:** 06-61

City Council Agenda Date: December 4, 2006

Item Number: 205 & 206

Item: San Diego Medical Service Enterprise LLC (SDMSE): Proposed Contract Amendments to the Third Amended and Restated Operating Agreement

OVERVIEW

There are two proposed contract amendments to the Third Amended and Restated Operating Agreement with SDMSE. The first amendment involves two proposed changes to the SDMSE profit distribution policy. This item was previously scheduled for the City Council dockets of September 25, 2006 and October 24, 2006, but subsequently withdrawn to allow staff to further clarify the requested action. The second amendment would extend the term of the SDMSE Limited Liability Company (LLC) by five years. This report attempts to clarify the requested actions and also presents recommendations that are related to those actions.

FISCAL/POLICY DISCUSSION

<u>Background</u>

SDMSE is a public/private partnership (formed as a LLC) between the City and Rural/Metro of San Diego (Rural Metro). The terms and conditions of the partnership are currently set forth in a Third Amendment and Restated Operating Agreement of SDMSE (Operating Agreement) which will expire on June 30, 2008. The City previously extended the original 1997 Operating Agreement in 2002 and 2005 and will need to re-bid the contract before it expires in June 2008.

SDMSE was created in1997 pursuant to a City request for proposal process for the provision of 911 paramedic and non-emergency medical transportation throughout San Diego County. In addition to providing emergency medical services (EMS) for the City, SDMSE conducts other business within the County of San Diego by providing both emergency and non-emergency medical transportation services.

Proposed Contract Amendment: Profit Distributions (Item #205)

The SDMSE Operating Agreement specifies that the profits and losses of the LLC shall be shared equally by its members (the City and Rural Metro), with stated limitations for any City losses. Given that the LLC, with City consent, is able to periodically adjust its average patient charges and perform profitable non-City services, their operational revenues have always exceeded operating expenses. Revenues in excess of operating expenses may either be retained by SDMSE as equity or equally distributed as profits to the LLC members in accordance with the Operating Agreement. The IBA received information indicating that the LLC had generated approximately $12.1 million in profits from inception through FY 05, with approximately $4.6 million of profit distributions to the City from inception through August 2005.

As a matter of practice, profit distributions have been governed by a profit distribution policy adopted by the LLC's Board of Managers. The current profit distribution policy has five conditions that must be satisfied prior to a distribution of profits. These conditions are listed in the Report to the City Council (No. 06-184). If the conditions are satisfied, the decision to distribute profits is then made by the Board of Managers in accordance with the Operating Agreement. The Operating Agreement specifies that the Board of Managers be comprised of three City staff and two Rural Metro staff.

There are two proposed changes related to the SDMSE profit distribution policy. The first involves replacing what is referred to as the 120% requirement (whereby SDMSE must have cash reserves that are 20% greater than projected operating expenses over a three month period) with a new requirement that profit distributions can be made so long as there is a $500,000 cash reserve. The current 120% requirement is specified within the Operating Agreement. The proposal effectively changes 120% requirement to a less restrictive requirement so that retained profits can be more easily shared with the LLC members.

The new requirement makes sense to the IBA provided that it is a prudent substitute requirement considering SDMSE's operating history and historical cash flow experience. We discussed the new $500,000 cash reserve requirement with the City Auditor (who processes Fire-Rescue bills to SDMSE, tracks City profit distributions and receives SDMSE's annual independent audit) and they have opined that a $500,000 reserve is adequate. As an additional check, the IBA tested the new requirement using SDMSE monthly cash flows from FY 04 through FY 06. We assumed that maximum profit distributions were made whenever the new requirement would have allowed for it (which we believe is a very conservative test as maximum distributions at every opportunity are unlikely) and found that the new requirement resulted in five relatively small negative month end cash balances. In every instance, these hypothetical negative month end cash balances were more than covered by revenues received in the following month.

The Report to the City Council states, "As a mature enterprise, SDMSE has very stable and predictable cash expenditures and collections." The CFO of SDMSE has informed the IBA that SDMSE has not drawn on its line of credit since February of 1999 and that they will continue to avoid utilization of the line of credit as a matter of operating policy (accessing the line of credit could result from aggressive profit taking thereby resulting in additional interest expense for the LLC). Given these representations, the City Auditor's opinion, the other profit distribution requirements and our own cash flow testing, the IBA recommends supporting the requested change to a $500,000 cash reserve requirement.

A second requested change related to the profit distribution policy would delegate the authority to declare a profit distribution from the Board of Managers (with a 3-2 City majority) to the officers of SDMSE (with a 2-1 Rural Metro majority). The revised Report to the City Council now recommends adding another requirement to the SDMSE profit distribution policy that would require unanimous support from the three SDMSE officers in order to make a profit distribution. The reason given for the requested change is that it would then be easier to expeditiously facilitate profit distribution decisions without the challenges of convening (or waiting for) a meeting of the Board of Managers. The IBA believes that this is a policy decision that should be guided by the City Council's comfort with the City's oversight of SDMSE operations.

Proposed Contract Amendment: Expiration Language (Item #206)

As noted above, the SDMSE Operating Agreement will terminate on or before June 30, 2008. Citing increased liability exposure for the City and the potential for lost business opportunities for the LLC, the Fire-Rescue Department is recommending a third extension of the Operating Agreement for an additional five years. The Report to the City Council mentions that the activities and operations of the SDMSE are subject to general, professional and contractual liability claims for up to four years from the time the liability accrues. If the Operating Agreement terminates, the City loses the liability protections accorded to a limited liability company. A five-year extension puts the City comfortably past the applicable four-year limitations period for claims. The Office of the City Attorney has confirmed for the IBA that there would be increased liability exposure for the City and that they support the five-year extension of the Operating Agreement as an effective means of mitigating it.

The IBA agrees that the City is a partner in the LLC and that we do not want to hinder their business opportunities (providing needed services within the County) for the remainder of the contract period. However, we are concerned that new business contracts extending beyond June 2008 could become problematic should the City ultimately select a new EMS service partner in the RFP process that may begin next fall. The Office of the City Attorney has assured us that the draft amended Operating Agreement will have adequate protections for the City. The draft amended Operating Agreement enables the City to withdraw from the LLC at its sole discretion. It would further compel Rural Metro to assume outstanding non-City service contracts and indemnify the City for all liabilities associated with those contracts. Given the increased liability considerations and the above mentioned assurances from the Office of the City Attorney, the IBA supports the recommend five-year extension of the Operating Agreement.

Related IBA Recommendations

In researching the proposed amendments to the SDMSE Operating agreement, the IBA made some noteworthy observations. Based on those observations, we have developed the following recommendations for City Council consideration:

1) Several of the existing profit distribution criteria are not in the current Operating Agreement. The 120% requirement is in the Operating Agreement, but it is unclear. If the City Council adopts the recommendations in the Report to the City Council, it would be the IBA's recommendation that all of the new profit distribution criteria replace the old in the amended Operating Agreement.

2) The City has a budgeted position for an EMS Program Manager that has been vacant since May 2006. The EMS Program Manager position is responsible for the City's oversight of all aspects of the SDMSE operation including: response times, customer complaints, financial oversight, contract compliance, evaluation of average patient charges, etc. The IBA believes that this critical oversight responsibility requires dedicated coverage, preferably independent of Fire-Rescue to maintain objectivity, and recommends that the Mayor consider filling this position.

3) The City receives half of all SDMSE distributed profits. The IBA has been informed that the City's share of the profits are dedicated to "EMS enhancements" (equipment, software, paramedic certification, dispatchers, etc.); however, there is currently no policy or codified language as to how those monies are to be expended. We have been told that EMS enhancement priority may have been referenced in the City's appropriation ordinance several years ago. The IBA recommends that a thoughtful policy for the expenditure of SDMSE profits be developed and returned to the Council for adoption. A Council Policy is necessary for expenditure direction and accountability.

CONCLUSION

The IBA recommends support for the two proposed contract amendments to the SDMSE Operating Agreement for the reasons specified within this report; however, we are not providing a policy recommendation on requested delegation of profit distribution authority from the Board of Managers. We encourage the City Council to consider the related IBA recommendations (above) that we developed in preparing this report.

[SIGNED]	**[SIGNED]**
Jeff Kawar	APPROVED: Andrea Tevlin
Fiscal & Policy Analyst	Independent Budget Analyst