OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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

Part III. Mayor’s Corrective Actions

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Report Overview

The Mayor’s Five-Year 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 is not balanced with shortfalls existing for every year of the Financial Outlook. The Mayor has proposed corrective actions to partially address and mitigate the City’s significant financial shortfall.

This IBA report provides a review of the Mayor’s corrective actions to address the projected shortfalls over the next five years. This is part III of a series of IBA reports issued on the Mayor’s Financial Outlook. IBA Report 07-6 (part I) examined the General Fund revenues and expenditures, and IBA Report 07-12 (part II) examined the Mayor’s eight significant areas. The IBA presented parts I and II to the Budget and Finance Committee on January 31, 2007. The IBA will also be examining possible new and increased fees, which are not contemplated in the Financial Outlook.

The following chart represents the results of the Mayor's proposed corrective actions to address the City's financial shortfall.

General Fund Corrective Actions *(in millions)*						
	FY 2008	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012**	**Total**
Positions	$25.1	$32.3	$39.5	$39.5	$39.5	**$175.9**
Employee Furlough	$4.3	$4.3	$4.3	$4.3	$4.3	**$21.5**
Debt Financing	$3.8	$3.8	$3.8	$3.8	$3.8	**$19.0**
Property Base Improvement District	$6.0	$10.0	$10.0	$10.0	$10.0	**$46.0**
Budget Clean-Up	$8.3	$5.3	$5.3	$5.3	$5.3	**$29.5**
Leveraging City Assets	$15.3	$21.8	$21.8	$21.8	$21.8	**$ 102.5**
Managed Competition	tbd	tbd	tbd	tbd	tbd	**tbd**
Total Corrective Actions	**$62.8**	**$77.5**	**$84.7**	**$84.7**	**$84.7**	**$394.4**
Deficit	*($87.4)*	*($173.8)*	*($175.9)*	*($178.8)*	*($178.3)*	*($794.2)*
Net Deficit After Actions	($24.6)	($96.3)	($91.2)	($94.1)	($93.6)	($399.8)

Discussion of the Mayor's Corrective Actions

Positions
(Estimated Fiscal Year 2008 Savings - $25.1 million)

Position Elimination

The Mayor's Financial Outlook is proposing to eliminate 671 positions in Fiscal Year 2008 and a total of 971 positions over the five-year period. Of the 971 positions, 463 positions are projected to be eliminated from General Fund departments over the five-year period, with 313 General Fund positions eliminated in Fiscal Year 2008. This represents a reduction in General Fund staffing of 6.2% and a reduction of 8.5% in total City staffing. The reduction of General Fund positions will realize a savings of $25.1 million in Fiscal Year 2008. The projected savings include personnel expenses (salaries and fringe) associated with the position. Positions eliminated include a variety of positions such as Code Compliance Officers, various support staff, Analysts, Engineers, Fire Fighters, and Program Managers.

These reductions represent a combination of vacant, middle management/supervisory and Business Process Reengineering (BPR) and Streamlining. The Financial Outlook states: "*Services should not be affected since most of the positions have been vacant for more than a year.*" In past City practice, a hiring freeze was imposed on City departments to generate personnel savings throughout the fiscal year due to the City's fiscal challenges. The past practice may represent a percentage of the current vacancies. Citizens have an expectation for City services by departments notwithstanding vacancies. When vacancies are not filled, remaining department staff absorbs the duties in order to continue operations and maintain service levels. The department's inability to hire staff may lead to their inability to operate at full capacity and could affect service levels provided to citizens. Although BPR will streamline and provide a more efficient government, an 8.5% staffing reduction could have an impact on current service levels.

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 will remove staffing resources from several City departments for the Project Organization Team. As a result, these departments will be operating at reduced staffing for approximately two years putting an additional strain on affected departments, even though no positions are proposed for elimination at this time for this project.

BPR & Streamlining

The Mayor's Financial Outlook identifies the reduction of 125 positions per year for three years (a total of 375) as a result of Business Process Reengineering (BPR) and streamlining efforts currently in progress or planned. Of the 125 positions identified for reduction, it is estimated that 75 will come from the general fund (three year total of 225). The estimated general fund savings from these efforts is approximately $7.2 million. The projected savings includes both personnel (PE) and non-personnel expenses (NPE) associated with the position (i.e. supplies and IT costs). Although little detail is provided in the report, the IBA has a few general concerns associated with this solution.

The IBA can not determine if the estimated savings amount per year is conservative or optimistic. The average savings per employee reduction is estimated to be $96,000. Based on the average personnel expense of FY 07 (approximately $99,600-general fund; $94,300-all funds) this projection seems justified. However, the report notes that NPE associated with the positions reduced is included in the annual savings projection. Upon further research, the IBA was able to determine the Financial Outlook assumes a 5% NPE reduction for departments that had completed a BPR as of 10/15/06 and a 2.5% reduction for all other BPRs that have not been completed. The reduction is based on a percentage of the department's entire NPE budget, which may be a high projection depending on the specific department's NPE budget (which includes contractual services, utilities, and other non-discretionary items).

The Mayor's Financial Outlook has not targeted specific positions associated with BPR, but developed an estimate based on management's experience with these efforts. However, the IBA would caution the use of funding from these eliminations/reductions until the specific positions have been identified. It is to be expected that a lengthy process will have to occur before any of these positions are actually eliminated/reduced, including Meet and Confer and a reduction-in-force process for impacted employees. Also, if a department is being considered for managed competition, the savings identified in the BPR may not be fully implemented until (a) the department is determined not to be a candidate for managed competition, (b) the department wins the managed competition bid, or (c) a private sector vendor successfully wins the managed competition bid. It is estimated that the first managed competition process will begin shortly with a Request for Proposal (RFP) being issued in the summer of 2007. This process could take approximately three to nine months and therefore any savings previously identified may not occur until 2008.

The IBA fully supports the Mayor's Business Process Reengineering and streamlining efforts, but cautions utilizing projected savings until more BPRs have been completed and actual savings have been achieved. Although BPRs may project significant savings, it may take some amount of time until these savings are fully achieved.

Employee Benefit Adjustment & Furlough
(Estimated Fiscal Year 2008 Savings - $4.3 million)

As with the other corrective actions, more information is needed regarding the nature of benefit adjustments that are proposed before a thorough analysis is possible. It is likely that each of the proposals will require bargaining with labor unions through the Meet & Confer process, so distribution of the details on these proposals must be within the parameters of applicable law. However, as stated in IBA Report 07-14 on Fiscal Year 2008 Budget Priorities, the probability of an outcome of a particular proposal should govern its budget treatment. Depending on the progress made through Meet & Confer and in accordance with the tenets of bargaining in good faith, these proposals may or may not be appropriate components of a balanced Fiscal Year 2008 Proposed Budget. Notwithstanding this cautious approach to inclusion in the budget, as discussed in previous reports, the IBA heartily supports bargaining with the labor unions to reform and modify the entire package of employee benefits. The IBA supports an employee benefits package that balances fiscal prudence with retention and recruitment considerations for the applicable job classifications.

The Financial Outlook also proposes to implement a mandatory furlough to be met and conferred upon with the labor unions. The IBA recommends that savings projections for furlough be provided when possible. These savings must be compared to savings already realized annually through the current voluntary furlough program. New savings will equate to the incremental difference between savings realized through the voluntary program and savings anticipated under the mandatory program. In other words, the savings will only be realized through employees required to take furlough that do not currently participate in the voluntary program. Based on payroll data for Fiscal Year 2007, it appears that 1,763 employees have taken over 100,000 hours under the voluntary furlough program, for a savings of approximately $2.5 million citywide. Clearly, there are thousands of employees that did not participate. However, furlough opportunities are likely to differ for certain classifications, including public safety and other critical functions. When available, and no later than in the Proposed Budget if used as a balancing measure, details on number of participants, length of mandatory furlough as well as additional voluntary furlough assumptions, and savings in General Fund and Non-General Funds should be provided. Based on the information available, however, the IBA is concerned that the Financial Outlook may assume a mandatory furlough for all five years of the projection period. We believe mandatory employee furlough should be a stop-gap measure in times of financial emergency, not a recurring, five-year solution to a structural budget deficit. If permanent reductions are required, the City should seek to permanently reduce its labor force and services rather than requiring employees to take a pay cut each year in order to help address the structural deficit.

Managed Competition

Although the Mayor’s Financial Outlook identifies managed competition as a solution for the City’s fiscal recovery, the report does not include any projected savings. The IBA concurs with this approach, as the City does not know what magnitude of savings will be achieved through this process. The IBA would like to note that costs savings is not the only component of managed competition. As stated in Section 117 of the City Charter, outsourcing will occur when "…City services can be provided more economically and efficiently by an independent contractor than by persons employed in the Classified Service while maintaining service quality and protecting the public interest." Therefore it is important to remember that the quality of services provided to the citizens shall not be sacrificed for cost savings.

Also, the report states that the first Request for Proposal (RFP) will be issued in the summer of 2007. It is not clear when the results of this first managed competition effort will be experienced. The IBA would like to obtain additional information, including the timeframe and process details associated with issuing the first RFP.

Budget Clean-Up
(Estimated Fiscal Year 2008 Savings - $8.3 million)

The Budget Clean-Up corrective actions identified in the Mayor's Five-Year Financial Outlook is made up of three components: Allocation of General Fund Expenditures (commonly known as the General Government Services Billing, or GGSB), Release of Encumbered Funds, and Transfer of Inactive Fund Balances. The table below shows total General Fund resources that are anticipated to be freed-up by these corrective actions.

	FY 2008	5-Year Total
General Government Services Billing	$3.2 million	$24.4 million
Release of Encumbered Funds	$3.0 million	$3.0 million
Transfer of Inactive Fund Balances	$2.1 million	$2.1 million
TOTAL BUDGET CLEAN-UP	**$8.3 million**	**$29.5 million**

Each of these three budget clean-up components is discussed in greater detail below.

General Government Services Billing

The City uses General Government Services Billing (GGSB) to recover a proportionate share of the cost associated with General Fund departments that provide centralized support services, such as Auditor and Comptroller, City Attorney, and Financial Management. In the past, the costs for several departments, including the Mayor's Office, the City Council, and more recently the Office of the IBA and the Office of Ethics and Integrity, have been fully funded by the General Fund. Beginning in Fiscal Year 2008, the cost associated with these departments will be allocated citywide as part of the GGSB, thereby relieving the General Fund of a portion of those costs. The Five-Year Outlook identifies $3.2 million in savings for FY 2008, reflecting known costs allocations associated with the departments mentioned above. Savings in the amount of $5.3 million have been identified for FY 2009 – FY 2012, which reflects additional cost allocation based on anticipated restructuring in FY08. It should be noted that these costs will be picked up by other, Non-General Fund departments. Additional information is needed on the exact list of centralized departments and associated costs that will be allocated.

Release of Encumbered Funds
An encumbrance essentially refers to a portion of a department's budget that is earmarked and set aside for a particular purpose. Departments may encumber funds for a number of reasons; for instance, if a department enters into a contract for supplies or services, it will create an encumbrance to ensure that the funds are available when payment is due. Departments may set up numerous encumbrances each year, and many of these retain funding after the fiscal year ends. However, there is no formal process for reviewing and closing open encumbrances. As a result, many unnecessary or inactive encumbrances that were established throughout the years remain open, with the encumbered funds sitting idle.

In developing the corrective action for budget clean-up, all open encumbrances were identified and departments were asked to provide operational or legal justification for the ones that should remain open. An example of legal justification might be an unpaid contract, or expenditures that are required pursuant to Council resolution. Operational justification might include encumbrances for routine/ongoing purchase of supplies. All encumbrances for which sufficient justification was not provided will be closed. According to the Financial Outlook, closing the encumbrances for which the associated expenditures will not take place will free up $3.0 million, which can be allocated to reserves.

In the course of providing justification for open encumbrances, several departments indicated that further research was needed for many of the encumbrances. An expanded review period was granted, and departments will submit their final evaluation of all remaining encumbrances by February 20, 2007. This second review may result in the closure of additional encumbrances, thereby increasing available resources.

While we strongly support this budgetary clean-up measure, we believe that it is critical to establish a process and definitive policy by which encumbrances are reviewed at the end of each fiscal year. This will allow for a more comprehensive tracking of all open encumbrances, and prevent the buildup of unnecessary and inactive encumbrances that contain idle funding.

Transfer of Inactive Fund Balances
The Financial Outlook also identifies an additional $2.1 million in inactive fund balances that can be transferred to the General Fund. From time to time, various funds are established for specific purposes, many of which were funded by the General Fund. A list of funds identified as being obsolete or inactive was initially generated, and several of the funds that were funded by the General Fund were targeted for closure.

The majority of the estimated $2.1 million in inactive fund balances is due to the GASB 31 fund, which was created a number of years ago to hedge against unrealized losses in the City's investment portfolio. An unrealized loss refers to a situation when the market value of the City's investments is less than the book value, meaning that if the City sold all of its investments it would realize a loss. If the City does not sell its investments, the loss is not realized but still must be recorded in the financial statements as an unrealized loss. While this practice is purely a financial accounting requirement under GAAP, it does impact fund balances. In previous years, specific General Fund carryover targets were established prior to the end of the fiscal year. The GASB 31 fund was established in order to be able to meet these targets should the City have to record an unrealized loss.

While more information on the complete list of funds that make up the $2.1 million in inactive fund balance transfers is needed, the GASB 31 fund accounts for approximately $2.0 million. It should also be noted that staff is continuing to look at other funds and CIP projects to determine if there are additional inactive funds or projects that may be closed, which may result in even greater additional resources for the General Fund.

Debt Refinancing
(Estimated Fiscal Year 2008 Savings - $3.8 million)

The Financial Outlook estimated $19 million in General Fund annual debt service savings for the PETCO Park bonds over the five year period. On January 16, 2007, the City Council introduced an ordinance to facilitate the refunding of the PETCO Park bonds. A second reading of this ordinance took place on January 30, 2007 and it is anticipated that the ordinance will become effective in the first week of March 2007. If so, the refunding bonds will be sold in early March 2007.

Debt Management Department staff, working with their financial consultants, has recently analyzed market conditions and now estimates that the bonds, if issued today, would be priced so as to result in $3.5 million annual savings though maturity in 2032. It is important to note that the refunding bonds cannot be sold until the ordinance becomes effective in early March 2007 and that changing financial market conditions could increase or decrease the current estimate of annual debt service savings. The current $3.5 million estimate equates to $17.5 million over five years, which is $1.5 million lower than the $19 million five-year debt service savings estimate in the Financial Outlook. As the final sale of the PETCO Park bonds is imminent, the IBA concurs with the Financial Outlook's reliance upon this revenue source and recommends that this element of the five-year plan be updated soon after the bonds have been priced.

Property Based Improvement District
(Estimated Fiscal Year 2008 Savings - $6 million)

The corrective actions outlined in the Financial Outlook assume the implementation of a Property Based Improvement District (PBID), whereby hotel and motel owners would assess a fee on themselves in order to obtain a secure source of funding for marketing and tourism promotion. The Lodging Industry Association (LIA) is proposing to levy a self-assessed fee of 2 percent of gross room rental revenues, just as the City levies the Transient Occupancy Tax. This new assessment would purportedly offset annual TOT funding that is currently allocated by the City for marketing and tourism promotion, which would then be available to be re-directed to the General Fund for other purposes. It is estimated that the establishment of the PBID would result in $46.0 million in additional revenue to the General Fund over the five-year period.

The Municipal Code currently requires that 4.0 cents of the 10.5-cent TOT be deposited in the Transient Occupancy Tax Fund, and be used for the purposes of promoting the City. One additional cent must be deposited in the TOT Fund, but can be used for any purpose. The remaining 5.5 cents of the City's TOT is allocated directly to the General Fund. The 5.0-cent allocation to the TOT Fund is the primary funding source for the Special Promotional Program

(Special Promo), which allocates funding for various marketing and promotional programs and activities such as the San Diego Convention and Visitors Bureau (ConVis), the Convention Center, arts and culture programs, and economic development.

Baseline expenditures in the Financial Outlook assume that Special Promo funding allocations will add up to the full 5.0-cent TOT allocation. In this manner, elimination of any current or future Special Promo allocations due to the creation of a PBID will result in corresponding savings that may be available for transfer to the General Fund. This is reflected in the table below.

	FY08	FY09	FY10	FY11	FY12
REVENUE					
5.0-cent TOT Allocation[1]	$75.8	$79.5	$83.5	$87.7	$92.1
TOTAL REVENUE	**$75.8**	**$79.5**	**$83.5**	**$87.7**	**$92.1**
EXPENSE					
Special Promo Allocations	$75.8	$79.5	$83.5	$87.7	$92.1
Eliminated Allocations[2]	($6.0)	($10.0)	($10.0)	($10.0)	($10.0)
TOTAL EXPENSE	**$69.8**	**$69.5**	**$73.5**	**$77.7**	**$82.1**
SAVINGS/TRANSFER TO GF	**$6.0**	**$10.0**	**$10.0**	**$10.0**	**$10.0**

1. Based on General Fund TOT projections in the 5-Year Outlook.

2. Represents elimination of current Special Promo allocations due to establishment of the PBID.

The Financial Outlook assumes that the establishment of the PBID could relieve the City of "supplying $10 million of organizational support" per year to entities such as ConVis, the San Diego Film Commission, the Holiday Bowl, and others. However, the Financial Outlook does not provide an itemized list of all Special Promo allocations that may be eliminated with the creation of the PBID. The LIA has previously indicated that the PBID may fund other entities currently receiving City support, such as the San Diego North Convention and Visitors Bureau, the San Diego International Sports Council, and the Hall of Champions. Since the current allocations to ConVis, the Film Commission and the Holiday Bowl total $9.9 million, if the PBID does provide funding for other organizations, as mentioned in the Outlook, savings available to the General Fund are likely to exceed the estimated $10 million.

It is important to note that the contemplated PBID does not have a mechanism to ensure continued funding for those tourism-promoting organizations that have been longstanding recipients of City TOT funding. If the PBID is formed and the City redirects TOT funds to the General Fund, the decision of whether to continue funding these organizations, and at what funding level, will be entirely at the discretion of the benefiting hotel/motel business owners. If the tourism-promoting organizations subsequently do not receive funding from the envisioned PBID, these same organizations may return to the City for funding which, if granted, would diminish the revenue gain to the General Fund.

If it is the City's desire to maintain funding for these organizations, it may be possible for the City to facilitate discussion now between PBID proponents and the tourism-promoting organizations to result in organizational funding commitments and associated service commitments within the required PBID management plan which is intended to describe all elements of the proposed PBID. If so, these commitments could subsequently be reflected in the City's contract with the PBID. The IBA recommends that this possibility be discussed as soon as possible with PBID proponents, City funded tourism-promoting organizations and the City Attorney's Office. The IBA further recommends that the City Attorney's Office thoroughly review the proposed PBID for compliance with all applicable laws and/or potential challenges.

Several important PBID formation steps remain to be taken and the outcome of these formation steps is tied to the preferences of those hotel/motel business owners who stand to be assessed. The following three formation milestones must be achieved before assessments can begin to be levied and funds collected in August or September 2007:

1) City Council adoption of an enabling ordinance. The enabling ordinance is anticipated to be introduced in late February 2007 and become effective in late April 2007.

2) City Council adoption of a Resolution of Intention to form the PBID after receipt of a petition signed by hotel/motel business owners representing a majority of the total proposed assessment. The resolution would establish a date and time at City Council (at least 45 days thereafter) for a public hearing and a ballot protest procedure (which allows for tabulation of returned business owner ballots).

3) City Council conducts the required public hearing and ballot protest process (anticipated to take place in July 2007). If a majority of those hotel/motel business owners returning ballots favor PBID formation (where each ballot is weighted by its share of the total proposed assessment), then the City Council can adopt a resolution to establish the PBID and initiate the process for collecting assessments.

While the creation of a PBID may relieve some of the City's current funding obligations, there are still many unknowns that will need to be addressed before it is put into practice. Additionally, consideration of the establishment of a PBID should include a discussion of the potential impacts to the City's ability to increase the TOT rate in line with comparable jurisdictions.

Leveraging City Assets
(Estimated Fiscal Year 2008 Savings - $15.3 million)

The Financial Outlook includes leveraging City assets as a solution to minimize the General Fund's annual shortfall. Leveraging City assets includes the sale and/or lease of City-owned land. Estimated Fiscal Year 2008 revenue in the Financial Outlook from leveraging City assets is $15.3 million.

As indicated in the Financial Outlook, Charter § 77 entitled "Capital Outlay Fund" states "Into this fund each year there shall be placed all moneys derives from taxation required or needed for capital outlay expenditures and <u>all proceeds received from the sale of city-owned real property</u>." Because of this, all funds received from the sale of City property are to be deposited in the Capital Outlay fund and expended on capital projects.

The inclusion of projected land sale revenue in the General Fund presumes that corresponding eligible capital expenditures are also included in the General Fund budget, possibly in the form of costs related to ADA or deferred maintenance projects. While the Financial Outlook describes both the sale and lease of City properties, no detail is provided to indicate how much of the annual revenues would come from each option.

As described in the recent Report to the Committee on Land Use and Housing, the City is unique among municipalities in the size and diversity of the real estate portfolio that it owns and manages. The City's assets include 120,000 acres, 3,400 properties, and 680 ground leases.

The Real Estate Assets Department (READ) is currently reviewing the City's property inventory to determine which properties are no longer needed for public use and can be declared surplus, and then sold. Sale of surplus land could benefit the City by providing revenue to the capital improvement fund, relieve the City of potential liabilities and maintenance costs, return the properties to the tax rolls, and stimulate the economy by providing opportunities for private sector development.

At present, sixty properties have been noticed on the City's website as potential candidates for sale. Statutory requirements include a sixty-day period which includes notification to other governmental agencies that may have an interest in the properties for a variety of reasons, before the properties can be declared surplus. Sales of some parcels could be made to other governmental agencies before the properties are declared surplus. All sales of City land require City Council action.

The Financial Outlook includes revenues to the City's General Fund of approximately $20 million annually from leveraging City assets. Given the number, sizes and potential values of the City's real estate holdings, it is possible that these estimated amounts could be realized on an annual basis with a thorough review of all properties and concerted marketing efforts.

As described earlier in this report, in terms of budget and budget estimates, the probability of an outcome of a particular proposal should govern its budget treatment. If there is a high probability that certain revenues will not be received within the fiscal year, then it is more appropriate to present the most likely scenario in the budget. If there is a high probability that the revenues will be received within the fiscal year, then it is appropriate to include them in the budget.

During the City Council's recent Strategic Budget Prioritization Process, the Council members expressed preferences, on average, to pursue alternative revenue enhancement strategies including "new or renegotiated leases" and "program cost-recovery" while indicating "across-the-board percentage reductions, "new or increased taxes" and "land sales" were least preferred options.

The need for Council authorization for the sale of each property and the potential time needed for the close of escrow, which could vary dramatically for each transaction, may put the receipt of funds within a specific timeframe at risk. Because of this, the IBA recommends inclusion of land sale revenues in the Fiscal Year 2008 Budget for those land sale transactions which have already received Council approval, or with schedules with a high probability of closing and receipt of funds during the upcoming budget year.

In addition, more information related to possible increased revenues that could be generated from renegotiating current lease arrangements could assist with determining if that option should be explored more fully, and included as a potential new source for Fiscal Year 2008.

Conclusion

Although the Financial Outlook identifies corrective actions needed to partially address and mitigate the City's significant financial shortfalls, further funding solutions are required to fully balance the General Fund. In addition, there may be some exposure in fully implementing each corrective action, as we have discussed. These concerns should be fully addressed for any corrective actions that are incorporated into the FY 2008 Proposed Budget. The IBA will examine other solutions to include possible new and increased fees to address the City's financial shortfall in the next IBA report.

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