THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: March 16, 2012 **IBA Report Number:** 12-13

City Council Docket Date: March 20, 2012

Item Number: S-502

Deferred Capital

OVERVIEW

The most significant issue raised in our review of the Mayor's Five-Year Financial Outlook for FY 2013-2017 related to the funding assumptions included in the Mayor's Outlook for addressing deferred capital expenditures. Our office presented our review to the Budget and Finance Committee on November 16, 2011 and to the full City Council on December 5, 2011. We agreed with the magnitude of the problem—estimated to be a backlog of $898 million for streets, facilities, and storm drains based on recent assessments. We also agreed that deferred capital should be a top funding priority over the next five years and beyond. However, we were concerned with the level of cash to bond funding, staffing capacity to expend this level of funding based on experience with the fiscal year (FY) 2009 deferred capital bonds, and the timing and uncertainty of the impacts of pending Capital Improvement Program (CIP) streamlining proposals.

In November, the Budget and Finance Committee requested that Chairman Todd Gloria form a working group including the Independent Budget Analyst's (IBA) Office and the Mayor's Office to develop a consensus five-year funding approach for deferred capital to be recommended to the Committee and subsequently City Council. The Committee requested that this matter be resolved prior to the Mayor requesting Council authorization to move forward with what is now planned to be a $75 million bond issuance in Spring 2012. As a result of the working group, the Mayor's Office issued a report for Budget and Finance Committee consideration on February 8, 2012 which presented a Status Quo Option that showed the funding necessary to prevent further deterioration and funding Options A and B, which would achieve the Status Quo funding level over a longer period of time. Both Options A and B included lower funding amounts in the early years and gradually ramped up infrastructure investment over the five-year period. While both Options A and B provided total Capital/Maintenance program funding of $713 million for deferred capital over the five-year period and were considered achievable, Option B represented greater cash contributions relative to capital bond requirements.

Our office presented our review of these options to the Budget and Finance Committee on February 8, 2012 and recommended approval of Option B over Option A or the Status Quo Option because it began to address several of our concerns. Option B increased total cash funding for operations and maintenance related to deferred projects by 30 percent from $229 million in the Mayor's original Outlook to $298 million over five years and decreased total spending of bond funds from $500 million in the Outlook to $415 million.

During the February 29, 2012 Budget and Finance Committee meeting, Committee Members discussed Option B in relationship to the Status Quo Option and expressed concerns that service levels would deteriorate below existing levels without additional funding. As part of the Mayor's Mid-Year Budget Report, our office recommended to the Budget and Finance Committee that $8.3 million of the projected $16.5 million surplus be used to increase cash funding of deferred capital projects in FY 2013. The City Council approved this as part of their Mid-Year Budget actions on March 12, 2012. This addition increases Operations and Maintenance funding from $45.8 million $54.1 million to achieve the Status Quo Funding Option for FY 2013 and is now referred to as Enhanced Option B. At the February 29 meeting, the Committee voted to forward Enhanced Option B to full Council for consideration and requested that IBA assess and provide information on other options to increase funding now or in the future to match the Status Quo Option and prevent further deterioration of assets.

FISCAL/POLICY DISCUSSION

<u>Differences in Funding Between Enhanced Option B and the Status Quo Option</u>

As shown in the chart below, the difference in funding between Enhanced Option B and the Status Quo Option is $84.7 million over five years with the largest deficit in FY 2013 and FY 2014 of ($29.9 million) and ($30.1 million), respectively.[1] With Enhanced Option B, investment is gradually increased so that by FY 2016 and FY 2017, funding levels are almost equal to the Status Quo Option. While Council is being asked to approve a five-year plan for deferred capital, it is important to note that the Mayor's Office will be bringing bond issuances for City Council approval each year and specific amounts can be adjusted at that time based on changing conditions. Additionally, Council can reconsider cash contributions and potential increases each year as part of the annual budget process.

[1] The Mayor's Office's Enhanced Option B numbers differ slightly from IBAs because we include the full $8.3 million surplus that has been dedicated to deferred capital while the Mayor's Office assumes a net surplus of $6.9 million in FY 2012 due to the delay in receipt of $1.4 million for the Early Retiree Reinsurance Program that was to be applied to the General Fund. Public Works plans to update the actual amount up to $8.3 million as more current information becomes available.

Differences in Funding between Status Quo/Preventing Further Deterioration Option and Enhanced Option B, FY 2013-2017

Status Quo/Preventing Further Deterioration Option	2013	2014	2015	2016	2017	Total
Operations & Maintenance	53.8	54.9	56.0	57.1	58.2	280.0
Net Bond (for Capital Projects)	105.2	105.2	105.2	105.2	105.2	526.0
Total	**159.0**	**160.1**	**161.2**	**162.3**	**163.4**	**806.0**

Enhanced Option B	2013	2014	2015	2016	2017	Total
Operations & Maintenance	54.1[a]	50.0	62.0	66.0	73.8	305.9
Net Bond (for Capital Projects)	75.0	80.0	81.0	90.0	89.4	415.4
Total	**129.1**	**130.0**	**143.0**	**156.0**	**163.2**	**721.3**
Difference	**(29.9)**	**(30.1)**	**(18.2)**	**(6.3)**	**(0.2)**	**(84.7)**

[a] This number includes the initial $45.8 million from Option B plus $8.3 million in from the projected FY 2012 budget surplus.

<u>Other Options for Achieving the Status Quo Level in the Future</u>

Our office has confirmed that all traditional existing capital funding sources—such as TransNet, Gas Tax, and Proposition 42— are included in Enhanced Option B. No additional funds in these areas have been identified. To close the gap between the Status Quo Option and Enhanced Option B would require identifying $29.9 million for FY 2013 and $84.7 million over the five-year period. This significant amount of funds is difficult to identify in the short term and would likely require undesirable tradeoffs with other priority services and programs. We have identified options for possible consideration in the future once the City's financial condition is stabilized for a period of time and a successful track record for expending authorized funding has been firmly established.

Funding options identified include: Future Economic Growth and Surplus, General Fund Reserves, Capital Outlay Fund, Development Impact Fees (DIF), Park Services District Funds, and voter-approved General Obligation Bonds.

<u>Future Economic Growth and Surpluses</u>

General Fund Revenues have increased significantly from both the FY 2012 Adopted Budget and First Quarter Budget Monitoring Report primarily due to the General Fund's three largest revenues: Property Tax, Sales Tax, and Transient Occupancy Tax (TOT). If the current trend of sales tax performance and the growth trend for TOT continue, revenue performance will exceed the current projections. Each additional 1 percent increase in sales tax growth over FY 2011 performance for the remainder of the fiscal year would provide about $1 million in additional revenue. Each 1 percent increase in the growth rate for TOT above the current assumption of 5 percent for the remainder of the fiscal year would provide about $350,000 in additional revenue above the current projection. While economic growth is promising, there will be changes in projected revenues and expenditures several times before year end and final numbers are uncertain. In addition, numerous other funding priorities identified in the City Council Budget Priorities Resolution will also be competing for these resources.

General Fund Reserves

The FY 2012 reserve target of 8 percent of projected General Fund revenues was surpassed as of the First Quarter Budget Monitoring Report. The Mid-Year Report projects a total ending reserve balance of $130.4 million or about 11.4 percent of current General Fund revenues; $38 million in excess above the policy level of 8 percent. The City Council approved the following on March 12, 2012 which utilizes $16.5 million of the excess reserve balance:

- Mayor's re-budgeting of $3.2 million from FY 2012 to FY 2013 for Council Community Projects, Programs, and Services, Kinder Morgan litigation, and community plan updates;
- utilization of $5 million for recreation and library hours, 15 police recruits, CIP emergency fund, and the fire alert system; and
- dedication of up to $8.3 million for operations and maintenance related to deferred capital projects.

The remaining reserve balance is $113.9 million or 10 percent of General Fund revenues; this is 2 percent above the 8 percent target or $22.9 million over the City's goal.

This is a significant increase in reserves over the 4 percent level in FY 2006. Nevertheless, the City is facing many unknown factors which could impact the budget, particularly in relation to the dissolution and unwinding of the Redevelopment Agency. Several payments included in the City's Enforceable Obligation Payment Schedule are based on agreements between the former Redevelopment Agency and the City and may not be allowed under AB 26. Payments that are not approved could impact the City's General Fund. While reserves are up due to increased revenues, the economy is still uncertain.

Capital Outlay Fund

The Capital Outlay fund includes about $2.3 million from the recent sale of the Crabtree Building on 303 A Street on February 14, 2012. Proceeds from land sales are generally dedicated for Americans with Disabilities Act (ADA) projects, and the initial project list for the second Deferred Capital Bond included $10 million for ADA projects. The $2.3 million from the recent land sale and proceeds from future sales potentially could be used to offset the $10 million in deferred capital bond funding.

Development Impact Fees

The Development Services Department has identified about $2.5 million from Development Impact Fees (DIF) funds that is planned for ADA projects in FY 2013. These funds could potentially be used to offset the $10 million in deferred capital bond funding that the Mayor's Office initially dedicated to ADA. Note that DIF must be spent on capital projects and within the appropriate communities.

Park Services District Funds

Development Services has identified a total of $2.6 million from 54 Park Services District Funds that could be used for capital projects that add new Park & Recreation facilities or upgrade facilities that will expand their use.[2] These funds must be spent within the service area and range from a few hundred dollars in some district funds to $1.1 million in the Del Mar/Carmel Valley District Fund. Given the amounts and limitations on spending, the funds could potentially supplement other funding sources for capital projects. These funds are appropriated by City Council.

Community Development Block Grants

The U.S. Department of Housing & Urban Development (HUD) provides funds each year through the Community Development Block Grant (CDBG) Program to benefit low and moderate income citizens through improvements to local communities. The City is planning to use $9 million in CDBG funds for Community Economic Development and CIP projects in FY 2013. Both HUD and the City have imposed certain restrictions on the use of CDBG funds, such as requiring that projects be completed in a timely manner and not allowing funds to be used for Project planning and design or delivery costs. Although restrictions have created challenges for Public Works in the past, CDBG funds could be a good source for deferred capital projects. It would require that Public Works strategically plan for their use on shovel-ready projects and identify supplemental funds that could be used to cover project delivery costs, such as DIF or Park Service District Funds.

Voter-Approved General Obligations Bonds

When approved, General Obligations (GO) Bonds are an important potential source of funding for deferred capital because they typically are the least expensive type of debt available to municipalities, significantly reducing the final cost of a capital improvement project as the bonds are paid off over a 20 to 30 year period. The two-thirds voter approval requirement has led many California cities to finance capital infrastructure through Revenue Bonds rather than GO Bonds. However, cities like San Francisco, CA, Phoenix, AZ, and San Antonio, TX have ongoing successful GO Bond Programs to finance improvements to streets, parks, public buildings, and other infrastructure. Citizens' General Obligation Bond Oversight Committees are used to develop community priorities for capital projects and provide independent oversight of the spending of bond funds. The use of GO Bonds has enabled the cities to accomplish more infrastructure improvements at a lower cost and with support of the voters.

Factors to Consider Before Increasing Deferred Capital Funding

While the sources discussed above could provide additional funds for deferred capital projects, they would require tradeoffs and increase potential risks to the General Fund given unknown circumstances.

[2] Park Services District Funds are essentially Quimby fees allowed by the State Subdivision Map Act and were collected at building permit issuance up until the sections of the Municipal Code were omitted from the 2000 Update. For this reason, the funds have finite balances and will be closed once the balance is expended. The City initially had 58 funds, but 4 of these have no available balance.

Unknown Risk to General Fund

While projected economic growth is promising, there will be changes in revenues and expenditures several times before year end and final numbers are uncertain. In addition, the City is facing many unknown factors, particularly in relation to the dissolution and unwinding of the Redevelopment Agency. Several payments included in the City's Enforceable Obligation Payment Schedule are based on agreements between the former Redevelopment Agency and the City and may not be allowed under AB 26. Payments that are not approved could impact the City's General Fund. Use of future revenue growth or reserves for deferred capital now is also a risk given the current uncertainties. Also, after years of reductions, numerous other priorities are competing for these resources.

Capacity and CIP Streamlining

Enhanced Option B includes $75 million in bond funding in FY 2013 and ramps up to about $90 million in FY 2017. Department staff have noted that their delivery of this level of funds depends on City Council approval of all CIP streamlining recommendations and six additional positions in the FY 2013 Operating Budget estimated at $539,779.[3] The Mayor's Office estimates that the CIP Streamlining Recommendations, which will be presented to the full Council on March 20, 2012, can trim an additional 3 to12 months off the life cycle of each project, providing added capacity and mitigating some staffing needs to provide quicker project delivery. Since streamlining measures will not be implemented until FY 2013, the full impact on project schedules and staff capacity is unknown.

It is important to note that CIP streamlining recommendations address efficiency improvements in planning, design, and award phases of projects, not the construction or post-construction phases. Public Works is scheduled to go through Managed Competition for CIP Program Delivery. During that process ways to increase the efficiency and effectiveness of how the Field Division manages construction contracts will be explored. The Field Division is responsible for performing quality control and assurance via inspection of CIP projects, among other things. Public Works staff told us that they would augment existing Field Division staff with Construction Management Consultants, as has been done before for other Capital Improvement Programs, to manage any additional contracts beyond the $75 million in bond funding. Since the bond funds will not be available until FY 2013, most of the impact of the funds will affect the Field Division in FY 2014.

Existing Services Levels and Long-term Goal

Understanding where the City is in terms of service levels and setting future goals is important for addressing the deferred capital backlog. Each asset type generally has a specific condition index to determine their service level:

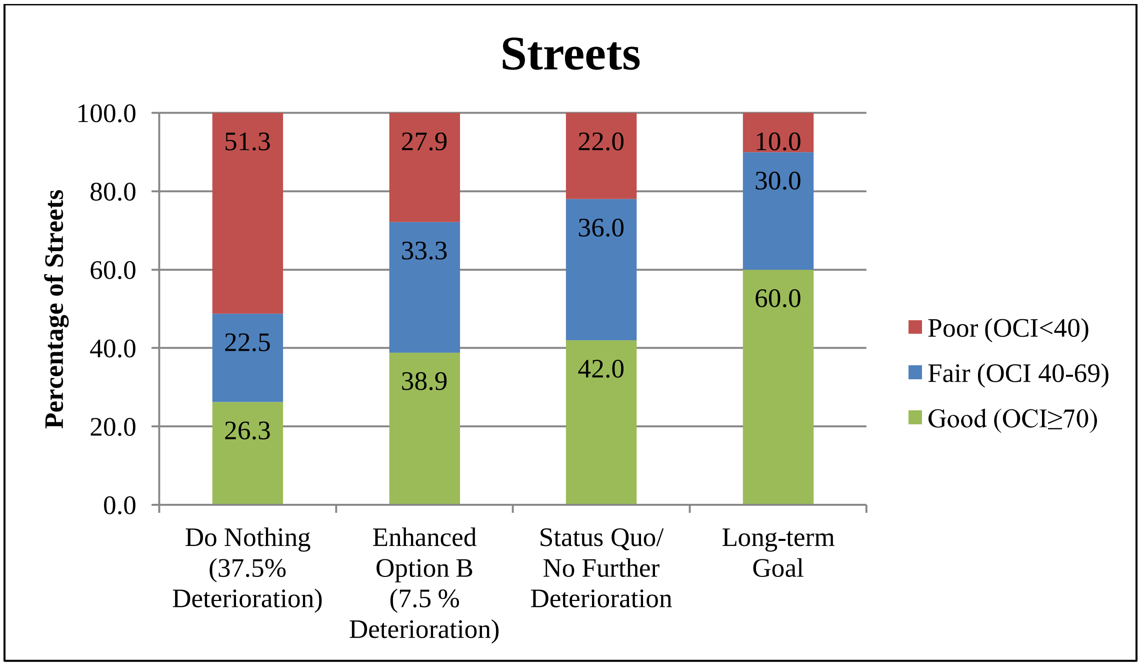
- **Streets** – The pavement condition is generally measured by a weighted index—called the Overall Condition Index (OCI)—which is calculated using weighted attribute characteristics, such as surface distress and ride quality. The OCI generally ranges from 0 to 100 with 100 representing the best street condition.

[3] The six positions include: two engineers for Design, one engineer for Field, one contract specialist, one public information officer for the website, and one financial analyst to manage the bond funds and reporting.

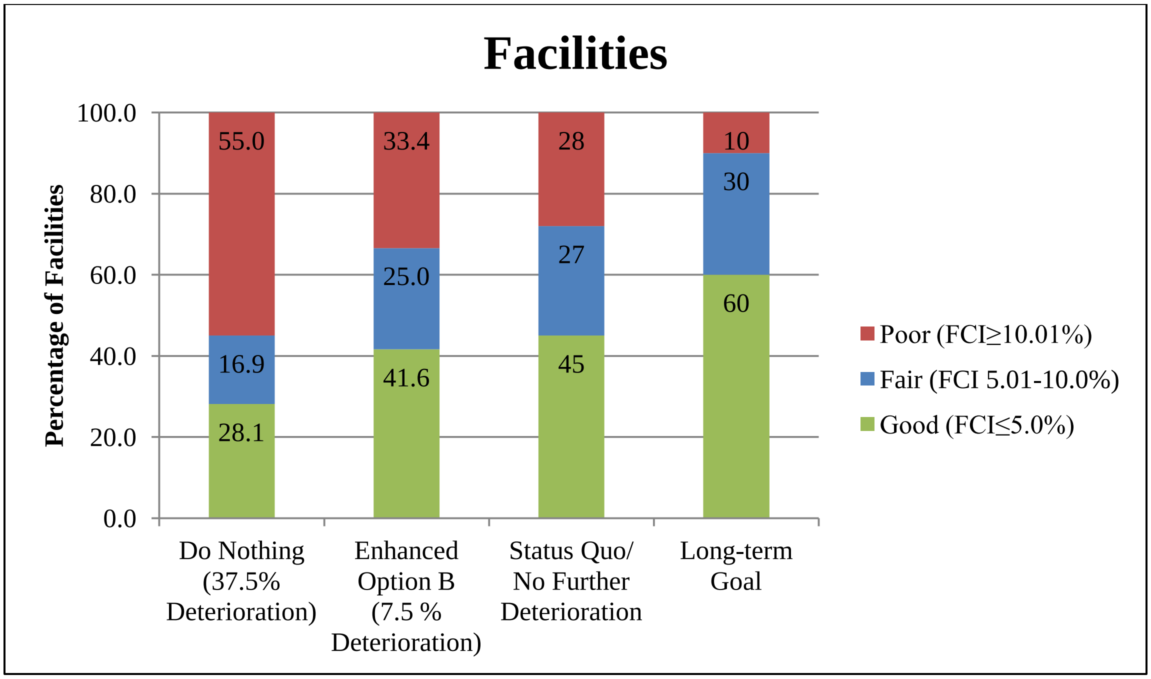
- **Facilities** – A Facility Condition Index (FCI) is used to measure the condition of each building and is represents the total cost of required repairs divided by the current replacement value. An FCI of 5.0 percent or less is considered good.
- **Storm Drain Pipes** – Although Storm Drain assets do not have a specific condition index, Storm Water staff adopted the distribution of risk measure generally used for water distribution systems as a condition index for reinforced concrete and corrugated metal pipes. This distribution of risk is based on the probability and consequences of failure. Generally, 20 or less is considered low risk.

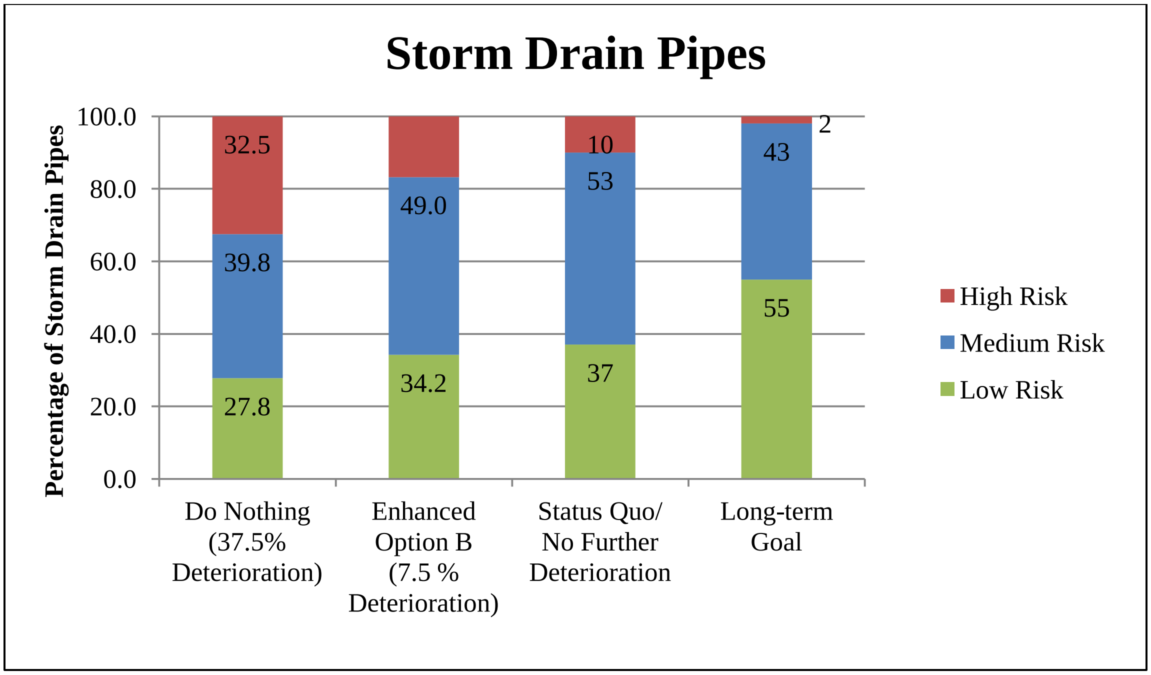
Service levels for the City's streets, facilities, and storm drains are currently below what staff consider to be a low level of service. The charts on the next pages illustrate the service levels of streets, facilities, and storm drain pipes based on funding levels. The Status Quo represents the City's existing service levels and level of funding necessary to prevent further deterioration. Enhanced Option B is expected to decrease service levels below the existing level by 7.5 percent for all asset classes over the five-year period, but this would be offset if investment levels are increased during this time period.[4] The Do Nothing Option with no funding provided for deferred capital would result in a deteriorate rate of 37.5 percent over five years.[5] The City should ultimately strive to establish a more reasonable service level represented in the charts on the next pages as the Long-term Goal.

Figure 1: Service Levels in Five Years Based on Funding Options



[4] We are using Option B service levels to illustrate Enhanced Option B, because Public Works has not calculated specific service levels for Enhanced Option B, and staff told us that the additional $8.3 million in FY 2013 would have some impact but it would not be a significant difference. We used a 7.5 percent deterioration rate from the Status Quo for the Enhanced Option B service levels since it provides an average for 5 to10 percent deterioration.
[5] We used a 37.5 percent deterioration rate from the Status Quo for the Do Nothing service levels since it provides an average deterioration of 25 to 50 percent over five years.





Notes: We used a 37.5 percent deterioration rate from the Status Quo for the Do Nothing service levels since it provides an average deterioration of 25 to 50 percent over five years.

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Storm Drain Pipes include reinforced concrete pipes and corrugated metal pipes which officials told us represent about 95 percent of the backlog for Storm Drain assets.

Funding deferred capital will remain a top priority over the next five years and beyond with the goal of improving service levels to a more reasonable level. The City has taken action to address infrastructure deficiencies, for example, by increasing street resurfacing from 115.4 to 326 linear miles or 182 percent since FY 2008.[6] Additional actions are currently underway, including the proposed CIP streamlining recommendations which are expected to reduce project cycle time and provide transparency over CIP projects. But it has taken the City years of underinvestment to get to this state and will require time for Departments to adjust capacity and operations to efficiently and effectively spend additional funds.

CONCLUSION

We are recommending that the Council approve Enhanced Option B Deferred Capital Funding Plan which includes $75 million of bond funding for deferred capital projects and a targeted cash funding amount of $54.1 million in FY 2013. The ramp up of investment will provide time for the Department to assess the true impact of CIP streamlining and adjust staffing capacity over time in a more informed and effective manner. It will also provide time for potential uncertain risks to the General Fund, such as redevelopment dissolution, to become clearer. When the Mayor's Office brings forward future Deferred Capital Bond issuances and annual cash funding recommendations, Council will have the opportunity to reassess planned investments in deferred capital based on financial conditions and priorities, potentially increasing funding beyond planned levels. Finally, given the rate of spending and project completion during the first Deferred Capital Bond (FY 2009), Public Works needs the opportunity to fully implement streamlining and demonstrate that it can complete needed projects and expend bond funds in an effective and timely manner. Public confidence and support will be needed for the City to successfully draw down the $898 million backlog, particularly if the City determines that General Obligations (GO) Bonds, which require a two-thirds majority public vote, are the most cost effective funding source for the future.

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[6] Resurfacing includes both slurry seal and asphalt overlay.