THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Deferred Capital Bond 3 and the Paramount Infrastructure Issue

OVERVIEW

The City of San Diego owns and maintains a large and complex network of infrastructure assets, including streets, bridges, parks, public facilities, and airports. Underinvestment in infrastructure due to tight financial constraints in the City has resulted in deteriorating infrastructure and a significant backlog of deferred capital projects, currently estimated to be $898 million for streets, facilities, and storm drains. However, this estimate is likely much higher since it is based on an outdated and partial condition assessment of the City's buildings/facilities and only includes three asset types. Infrastructure issues impact the public health, safety, and the quality of life for San Diego communities as well as the tourism industry which is an important part of the City's economy. Addressing infrastructure issues is clearly one of the highest priorities for the City.

The City has been working to address its deferred capital backlog over the past several years. In March 2009, the City issued $103 million in General Fund backed lease-revenue bonds (known as DC 1) to fund deferred capital projects.[1] In March 2012, the City Council approved the City's first Five-Year Deferred Capital Funding Plan (FY 2013-2017) known as Enhanced Option B to begin to address the estimated $898 million backlog. Although the plan did not provide the level of funding desired by Council or necessary to stop the deterioration, it was determined to be the most realistic and fiscally sound approach to address much needed capital projects, such as street resurfacing. Enhanced Option B provided a mix of lease revenue bond funding for capital projects and cash funding for ongoing maintenance & repair (M&R) and was anticipated to slow the rate of deterioration of assets to 5-10% over the five-year period.

The first bond issuance as part of Enhanced Option B (known as DC 2) was issued in June 2012 for $75 million. As of November 2013, the City has encumbered or spent about $39 million or 49% of the DC 2 bond proceeds. The City Council approved an additional bond issuance for

[1] Although initially issued with a 10-year maturity, these bonds were refinanced to be 30-year bonds in May 2010 as part of the Master Refunding lease-revenue bond issue.

capital improvement projects (known as DC 2a) for $35 million in FY 2013 that was not part of the original deferred capital bond schedule. However, the scheduled third deferred capital bond issuance (known as DC 3) of $80 million was delayed from FY 2013 to reduce debt service for the General Fund in the FY 2014 Budget. As part of the Five-Year Financial Outlook (FY 2015-2019), the City anticipated increasing DC 3 from $80 million to $120 million.[2] The proposed authorization of $120 million for DC 3, including projects to be funded with the bond proceeds, was approved by the Infrastructure Committee on October 28, 2013.

This report discusses the proposed authorization of $120 million for DC 3 that is going to Council on January 14, 2014. We also address the transitional period the City will go through in the coming year as it gains a more accurate and comprehensive understanding of infrastructure needs through ongoing condition assessments and the development of a Citywide Multi-Year Capital Improvements Plan. Finally, we discuss the paramount issue related to infrastructure – given limitations associated with lease revenue bond financing and the magnitude of infrastructure needs on the horizon, the City must consider pursuing alternative sources of revenue to more comprehensively address infrastructure over the long term.

FISCAL AND POLICY ANALYSIS

Deferred Capital Bond 3

The $120 million bond issuance for the DC 3 and remaining on track for future planned bond issuances (as indicated in the Five-Year Outlook) will put the City within $800,000 of the Council-adopted Enhanced Option B and $106.8 million of the Status Quo Option by the end of FY 2017. This is slightly more aggressive than the "Catch-Up" plan that the IBA recommended in our review of the FY 2014 Proposed Budget (IBA-13-19). We believe following through with Enhanced Option B planned bond issuances is essential, particularly considering that this funding level is anticipated to slow, but not stop, the rate of deterioration.

$ in millions	FY 2012	FY 2013	FY2014	FY 2015	FY 2016	FY 2017	TOTAL
Preventing Further Deterioration (Status Quo Option) (Staff analysis reported in March 2012)							
Deferred Capital Net Bond (Capital Projects)	$ 105.5	$ 105.2	$ 105.2	$ 105.2	$ 105.2	$ 105.2	$ 631.5
Maintenance & Repair (previously called O&M)	59.1	53.8	54.9	56.0	57.1	58.2	339.1
Total	**$ 164.6**	**$ 159.0**	**$ 160.1**	**$ 161.2**	**$ 162.3**	**$ 163.4**	**$ 970.6**
Council-Approved Plan (Enhanced Option B) (March 20, 2012)							
Deferred Capital Net Bond (Capital Projects)	$ 75.0	$ 80.0	$ 81.0	$ 90.0	$ 84.2	$ 84.2	$ 494.4
Maintenance & Repair (previously called O&M)	59.1	54.1	50.0	62.0	66.0	79.0	370.2
Total	**$ 134.1**	**$ 134.1**	**$ 131.0**	**$ 152.0**	**$ 150.2**	**$ 163.2**	**$ 864.6**
Difference (Enhanced Option B minus Status Quo)	**$ (30.5)**	**$ (24.9)**	**$ (29.1)**	**$ (9.2)**	**$ (12.1)**	**$ (0.2)**	**$ (106.0)**
Five-Year Outlook (FY 2015-2019)							
Deferred Capital Net Bond (Capital Projects)	$ 75.0	$ 35.0	$ 120.0	$ 90.0	$ 84.2	$ 84.2	$ 488.4
Maintenance & Repair (previously called O&M)	59.1	54.1	55.2	62.0	66.0	79.0	375.4
Total	**$ 134.1**	**$ 89.1**	**$ 175.2**	**$ 152.0**	**$ 150.2**	**$ 163.2**	**$ 863.8**
Difference (Five-Year Outlook minus Status Quo)	**$ (30.5)**	**$ (69.9)**	**$ 15.1**	**$ (9.2)**	**$ (12.1)**	**$ (0.2)**	**$ (106.8)**

[2] City of San Diego, Five-Year Financial Outlook (FY 2015-2019), November 14, 2013.

It is important to note that the City plans to split the $120 million into two series of bond issuances, with about $65 million likely issued in April 2014 and $54 million issued in April of 2015. This is intended to make funds available when needed by the Public Works Department based on a projected 80% spend down of existing bond funds (for DC 2 and subsequently the first series of DC 3), and will prevent the City from paying interest on funds that are not ready to be utilized.

We believe this is a fiscally sound approach, although it raises some concerns relating to Public Works' and other departments' capacity to expeditiously implement capital projects and spend bond funds. Public Works staff noted that they will likely request 32.50 additional positions as part of the FY 2015 Budget to meet increased demand for projects funded by the deferred capital bonds and other funds, such as water, wastewater, TransNet, and Development Impact Fees. Note that Public Works – Engineering & Capital Projects' (E&CP) positions are considered to be cost neutral since they are reimbursed from project delivery costs (also known as soft costs).[3]

Splitting the $120 million bond issuance also increases the potential for the next scheduled issuance of $90 million to be delayed beyond FY 2015, since the second series of DC 3 is anticipated to be issued in April 2015. However, we do not believe the potential concerns related to DC 3 are significant nor should they be the primary focus. The deferred capital bond program continues to be an important source of funding for infrastructure, but 2014 will be a transitional period as the City gains a greater understanding of the magnitude of the infrastructure problem and begins to identify a comprehensive, long-term solution.

Better Understanding the Magnitude of the Problem

In the coming year, the City is anticipated to gain a more accurate and comprehensive understanding of infrastructure needs through both ongoing condition assessments to update the deferred capital backlog and the development of a Citywide Multi-Year Capital Improvements Plan which will include needed projects for existing and new infrastructure.

Updating the Deferred Capital Backlog – City staff agree that the deferred capital backlog far exceeds the current $898 million estimate which only includes three types of assets (streets, storm drains, and facilities) and was based on limited, outdated assessments of facilities. Staff have surmised that the deferred capital backlog could be $2 billion. The City is currently conducting condition assessments for facilities, sidewalks, and some park assets. These assessments are anticipated to be completed by January 2015 and will be used to revise the estimated backlog. This information will be critical to better understanding the magnitude of the City's deferred capital problem and establishing priorities for limited funds.

Developing a Multi-Year Capital Improvements Plan – The City's infrastructure needs go far beyond deferred capital and include annual maintenance & repair (M&R) for existing assets as well as needed new assets. For example, the City has identified significant storm water capital projects in the Watershed Asset Management Plan needed to comply with more stringent water quality regulations; critical fire stations in the Citygate report; and libraries, parks, and other needed public facilities in community and Public Facilities Financing Plans (PFFP). In addition,

[3]Public Works – E&CP has previously been funded through the City's General Fund, but is planning to change its accounting structure to an internal service fund in FY 2015. E&CP staff noted that staffing requests are made at the macro level and take into account anticipated funding from all sources for capital projects.

the new public input process for the annual CIP budget identified extensive community needs and priorities.

City staff are currently developing the City's first Multi-Year Capital Improvements Plan in conjunction with the FY 2015 CIP Budget. The draft plan, anticipated to be completed in April 2014 as part of the FY 2015 budget process, will provide an overall, transparent view of where the City is with regard to infrastructure, including needed projects for existing and new assets. We believe this plan will be an important tool for comprehensively assessing infrastructure needs and priorities, determining existing funding, and ultimately identifying a strategy for financing priority unfunded needs.

Identifying a Comprehensive, Long-Term Solution for Infrastructure

The City clearly has significant infrastructure needs on the horizon. And, it is evident from the Five-Year Financial Outlook that the City continues to face significant financial constraints and competing priorities for its General Fund. The City has used General Fund lease revenue bonds which do not require voter approval as its primary means of financing infrastructure.[4] This source has also avoided the need to increase service fees and/or assessments to citizens. However, the continued exclusive use of lease revenue bond borrowing is not sustainable or recommended. Given limitations associated with lease revenue bond financing discussed below and the magnitude of the City's infrastructure needs on the horizon, it is clear that the City must consider pursuing alternative revenue sources to comprehensively address infrastructure over the long term.

The Exclusive Use of Lease Revenue Bonds Is Not a Sustainable Solution to Address Significant Infrastructure Needs

The continued exclusive use of lease revenue bonds in not sustainable or recommended due to limitations on available leasable properties and more importantly the 30-year obligation placed on the General Fund which essentially locks down a large portion of the Fund and significantly limits discretionary spending over the long-term. Note that we are not discussing lease burden as a measure for determining how much debt that the City can take on without impacting its financial health and ratings. This is because rating agencies are beginning to look more broadly at cities' fixed obligations as a percentage of total revenues to measure financial health, rather than narrowly focusing on debt obligations metrics, such as lease burden.

Limitations on Available Leasable Properties – In simple terms, lease-revenue bonds involve creating a lease between the City and the Public Facilities Financing Authority for a nominal rent, for example $1. The Authority subsequently leases back those same facilities to the City at a rate sufficient to cover the debt service. However, there is a limit to the essential unencumbered properties available to the City to pledge for these bonds. Debt Management staff indicated that pledgeable assets are available for the remaining three deferred capital bond issuances of Enhanced Option B (totaling about $260 million). Beyond that there is a concern regarding both

[4] Lease revenue bonds are commonly used in California because the debt instrument is structured as a lease and not classified as debt for purposes of debt limit or voter approval.

available properties to address the significant infrastructure needs and whether the City would want to pledge all of its assets, which would limit flexibility.[5]

The Bigger Issue: Long-term Obligations on the General Fund – Revenue bonds place a 30-year debt service obligation on the General Fund which essentially locks down a large portion of the fund. Over the period of the Five-Year Outlook (FY 2015-2019), deferred capital bond debt service is about $160 million. But it is important to note that the City's debt service is only one component of the City's non-discretionary long-term obligations. When combined, these long term obligations—including the Annual Required Contribution (ARC) and Other Post Employment Benefits (OPEB) coupled with the City's other existing outstanding debt—will account for about 26 percent of General Fund revenues in FY 2015.

Standard & Poor's (S&P) increased the City's credit rating on lease-revenue bonds from "AA-" to "A+" on December 20, 2013. In providing their supporting rationale, S&P noted several of the City's financial/economic strengths and a few weaknesses. One of the two weaknesses they cited was a "very weak debt and contingent liabilities profile." <u>This, in part, reflects concern about the total amount of long-term fixed obligations (ARC, OPEB, and debt service) as a percentage of the total budget. It is apparent that continuing to layer on additional debt service obligations over 30 years will significantly reduce the General Fund's financial flexibility and limit discretionary spending over the long term.</u>

CONCLUSION/RECOMMENDATION

Council's adoption of Enhanced Option B in March 2012 was very important since it was the first Five-Year Deferred Capital Funding Plan in the City and provided a significant new investment and source of funds for capital projects. The $120 million bond issuance for the DC 3 and remaining on track for planned future bond issuances will put the City within $800,000 of the Council-adopted Enhanced Option B by the end of FY 2017. We believe following through with planned Enhanced Option B bond issuances is essential, particularly considering that this funding level is anticipated to slow, but not stop, the rate of deterioration.

Splitting DC 3 into two issuances raises concerns regarding Public Works capacity to expeditiously implement projects and spend bond funds as well as the potential for the next planned bond issuance to be delayed. However, we do not believe the potential concerns related to DC 3 are significant nor should they be the primary focus. The deferred capital bond program continues to be an important source of funding for infrastructure, but 2014 will be a transitional period as the City gains a greater understanding of the magnitude of the infrastructure problem through ongoing condition assessments and the development of a Multi-Year Capital Improvements Plan which will include and prioritize needed projects for existing and new assets.

The City clearly has significant infrastructure needs on the horizon. And, it is evident from the Five-Year Financial Outlook that the City continues to face significant financial constraints and competing priorities for its General Fund. The City has used General Fund lease revenue bonds which do not require voter approval as its primary means of financing infrastructure. This source

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[5] While the City would retain the assets on its balance sheet, it would lose control and flexibility for property management of the assets. For example, the City would not have flexibility to liquidate these assets if the need arose.

has also avoided the need to increase service fees and/or assessments to citizens. However, the continued exclusive use of lease revenue bond borrowing is not sustainable or recommended. Given limitations associated with lease revenue bond financing and the magnitude of infrastructure needs, it is clear that the City must consider pursuing alternative revenue sources to comprehensively address infrastructure over the long term. We believe it is critical to begin those discussions in 2014.

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