PART II – CRITICAL FISCAL ISSUES FACING THE CITY

Table of Contents

Funding the Pension Obligation

	Fiscal Year 2005	Fiscal Year 2006	Fiscal Year 2007
Funding	$86,685,110	$118,929,787	$121,242,026

Issue Statement

The City's Annual Required Contribution (ARC) has grown significantly in recent years due to a combination of factors as presented in various public reports such as those by Vinson & Elkins, Navigant and Kroll. The City is obligated by law to pay the ARC each year. Thus, as with any debt, it should be assumed in the base budget that the entire ARC will be paid. The increase in the ARC has and is expected to continue causing a strain on the City's budget, especially in the General Fund.

Related Facts

- Based on the current amortization schedule, the UAAL will be fully paid down in 27 more years.

- If the SDCERS Board reduces the amortization schedule in FY 2009, in accordance with voter approval of Proposition G in 2004, the UAAL will be retired in just 15 additional years, but will be accompanied by a higher ARC each year. Exact amounts will vary based on investment returns and assumptions.

- The Mayor's Five Year Outlook assumes paying down the UAAL in 20 years, thereby avoiding any negative amortization in the upcoming years. The IBA will be providing further analysis on this assumption in our second report on the Mayor's Five Year Financial Outlook.

- Negative amortization occurs when the payment schedule is such that more interest accrues than is paid, thus increasing the total outstanding debt. It is projected that, under the current amortization schedule, there may be several years of negative amortization.

Challenges/ Activities

- While SDCERS will approve the City's ARC, the City Council will ultimately have to decide if additional funds above the ARC can or should be contributed.

- The City should also pursue analysis of revising the pension plan in the near future. IBA Report 06-52 provides baseline research on many options to modify retirement benefits for employees to balance the City's goal to attract and retain high quality employees in a fiscally responsible manner.

Increasing the City's Reserves

Issue Statement

Establishing and maintaining a General Fund Reserve level that is sufficient to address unforeseen contingencies such as natural disasters, catastrophic occurrences, or excess liabilities or judgments against the City has proven challenging given recent fiscal constraints. The City maintains several reserves for its operations. Reserves supporting General Fund operations include the Allocated Reserve, used to carry forward funds for specific projects, and the Unappropriated Reserve, established to fund major General Fund emergencies. Workers' Compensation liabilities continue to grow and public liabilities fluctuate each year. Presently, the City has $150 million in outstanding workers' compensation claims and $18 million in reserves, and $100 million in potential public liability claims and $4 million in reserves. Should the City be required to make a large payout on a claim, it would likely be a significant impact to the General Fund.

Related Facts

- Section 91 of the City Charter stipulates that "The Council shall create and maintain a permanent revolving fund, to be known as the General Reserve Fund, for the purpose of keeping the payment of the running expenses of the City on a cash basis." In FY 07, the City's Allocated and Unappropriated Reserves were initially 5.4%. Based on the fiscal year 2007 year-end estimates, the total projected ending balance is estimated to reach $61.7 million, which represents 6% of the fiscal year 2007 General Fund budget.

- The City Council adopted a reserve policy in October 2002 providing for a General Fund Reserve at a minimum of 3.0%, and defines a goal of a 5.0% reserve to be achieved by 2014. Although not always adhered to, the Council Policy suggests that when General Fund revenues increase by at least 2.0%, an increase in the General Fund Reserve equal to 10.0% of any General Fund revenue increase in excess of 2.0% should be included in the budget.

- The Five-Year Financial Outlook contemplates increasing Unappropriated Reserve levels to 6.0%, 6.5%, 7.0%, 7.5%, and 8.0% for fiscal years 2008, 2009, 2010, 2011, and 2012, respectively. GFOA recommends that cities maintain a General Fund reserve of a least 5 – 15% of general fund revenues, which would include all reserve needs.

- The CFO has recommended that the Workers' Compensation and Public Liability Funds should each maintain reserves equal to no less than 50% of the value of the outstanding claims. Based on current claim levels, reserves should approximate $50 million and $75 million, respectively.

- Funding has been included in the Financial Outlook to begin building both a Workers' Compensation and Public Liability reserve. Five million has been allocated in fiscal year 2009 and $10 million for each year thereafter for Workers' Compensation, while the Public Liability Reserve will receive $5 million each year for fiscal years 2008, 2009, and 2010, increasing to $10 million per year thereafter.

- Rating agencies view formalized, well-defined operating reserve policies, and the ability to historically adhere to them, as an integral factor in the credit rating process of a governmental entity. As part of a formal reserve policy, it will be important to determine the types and uses of reserve accounts, appropriate reserve levels, and criteria or conditions for the use of reserve funds.

Deferred Maintenance & Capital Improvements Program

Issue Statement

The City's deferred maintenance and capital improvements includes all needed repairs to City facilities as well as repairs and improvements to storm drains and streets. The Capital Improvements Program (CIP) Budget supports construction projects such as the development of parkland, the construction of a sewer pump plant, the acquisition of land for City use, the installation of a traffic signal and street lighting system, or the construction or remodeling of a City facility. According to the Mayor's Five-Year Financial Outlook, the City's deferred maintenance/capital needs, excluding those of Water and Wastewater, is estimated to be at least $800 to $900 million.

Related Facts

- The Capital Improvements Program uses a variety of revenue sources to fund projects including TransNet, grants and reimbursements, Community Development Block Grants, Development Impact Fees, Facilities Benefit Assessments and Enterprise Fund

- Capital assets or improvements should receive appropriate consideration in the budget process to assist the City in planning for large expenditures and reducing deferred maintenance.

- The FY 2007 CIP budget is $292 million of which only $447,000 is funded by the General Fund and $125,000 funded by the Capital Outlay Fund. The FY 2007 Budget also includes $10.6 million for deferred maintenance.

- The Mayor's Financial Outlook includes funding for deferred maintenance/capital improvements by using a combination of cash and financings. The total funding for deferred maintenance/capital improvements over the five year outlook totals $578 million.

Challenges/Activities

- Each year, the demand for projects exceeds the available funding, causing projects to compete for funding. It is essential that the City prioritize all City capital improvement projects to ensure efficient and effective allocation of funding. The Mayor's staff is presently compiling an inventory of all needs and will have a completed list along with projected costs in Fiscal Year 2008.

Retiree Healthcare

Funding	Fiscal Year 2005	Fiscal Year 2006	Fiscal Year 2007
Pay-As-You-Go	$4,100,000	$10,392,732	$14,521,891
Trust Fund	$0	$0	$3,275,882

Issue Statement

For as long as the City has provided health benefits to retirees, it has been funded on a pay-as-you-go basis, which means money is allocated to cover the projected expenses in that year. In FY 2008, GASB Statement 45 will go into effect, requiring the City of San Diego to quantify the actuarial liability associated with this benefit and report it on financial statements. The City has already conducted its first actuarial study of retiree healthcare and the liability is projected at approximately $1.4 billion. While GASB only requires reporting the liability, there is some expectation in the financial community that municipalities will work toward funding the liability in some manner (see IBA Report 06-18, p. 26).

Related Facts

- In mid-FY 2005, the City took back the obligation of paying retiree healthcare expenses from SDCERS. Originally, there was no funding allocated in the FY 2005 budget for this, but a mid-year Council action budgeted $6.5 million citywide for the purpose.

- In FY 2007, a trust fund is to be established for the purpose of pre-funding this liability. The City allocated $5 million across all funds in this year's budget for this purpose.

- The amortization period used in the recent actuarial valuation was 30 years.

- The 5 Year Financial Outlook plans to allocate $25 million in FY 2008 and $50 million in FY 2009 in addition to the pay-as-you-go requirements. In FY 2010 and beyond, the Outlook assumes full payment of the ARC, which is projected at approximately $75 million.

- The IBA will release a further analysis of the 5 Year Financial Outlook on this issue in our second report.

Federal Mandates Impacting the City's General Fund Budget

The Americans with Disabilities Act of 1990, addresses the right of people with disabilities to obtain equal access to services, programs, buildings, facilities and employment. The law has far reaching impacts on local jurisdictions both architecturally and programmatically. The City of San Diego has utilized Community Development Block Grant Funds (CDBG) as the primary funding source for retrofitting non-compliant public infrastructure. In part, the law requires local jurisdictions to make all public infrastructure physically accessible to people with disabilities.

The ADA Act originally called for jurisdictions to complete this effort by 1995. However, the federal government recognizes that the cost and burden of meeting that deadline can be extraordinarily burdensome for some jurisdictions. As such, the City is required to have a "Transition Plan" which documents non-compliant facilities and infrastructure and to make continued progress towards retrofitting those projects. The City is currently reviewing that effort to ensure that adequate and timely progress is occurring.

The Mayor's Five Year Outlook calls for stepping up the pace. To some extent, this funding need overlaps with the deferred maintenance category, i.e. as deferred maintenance needs are addressed and facilities are improved, ADA requirements will be addressed as well. Total ADA compliance needs are speculated to be in the hundreds of millions of dollars. The Mayor's Financial Outlook includes $10 million per year for ADA related improvements, in addition to $205 million to address deferred maintenance over the five-year outlook period.

"Storm Water Management" includes all of the activities associated with operating the storm drain infrastructure, including operational (General Services-Street Division) and environmental (Storm Water Pollution Prevention Division) matters. Past under-funding of these programs, coupled with an increase in enforcement of storm water regulations by the State government, have resulted in the following funded and un-funded needs:

	FY06 Budget	**FY07 Budget**	**FY 2008-FY 2012 Program Needs**
Drain Infrastructure O&M	$10.7 M	$11.4 M	$180.8 M
SWPP Division	$3.2 M	$13.6 M	$164.7 M

In 1990, the City of San Diego began collecting a storm drain fee, via the City's water and sewer utility customers, to reimburse the General Fund for storm drain maintenance costs. Fund revenues of approximately $6 million per year are used by five City departments (General Services, Metropolitan Wastewater/SWPPD, Engineering and Capital Projects, Water, and Risk Management), but do not meet the City's existing annual budget of $25 million or provide for any future anticipated needs for these programs as shown on the table above.

The Mayor's Financial Outlook only includes projected costs associated with new permits, including $18.2 million in FY08, $37.2 million in FY09; $37.1 million in FY10, and $36.1 million in FY11 and FY12. No additional funds for infrastructure operations and maintenance have been included in the Five Year Outlook.

A long-term financial commitment and strategy is necessary to successfully implement the Storm Water Pollution Prevention Program, particularly given that program requirements are rapidly expanding. Increased fees should also be considered as part of this strategy.

Police Officer Recruitment and Retention

Issue Statement

The City's Police Department has found it to be increasingly difficult to recruit and retain sworn officers. Although the City has experienced comparatively low crime rates over the last few years compared with other major cities, crime rates can change quickly for a variety of reasons and we have unique law enforcement challenges (e.g., gangs, homelessness, and periodic spikes in various crime categories). It is particularly troubling that the City has been losing experienced sworn officers faster than it can recruit new sworn officers with less experience.

Related Facts

- Sworn Officer Status: As of January 9, 2007, the Department has 1,890 (90%) of 2,109 budgeted sworn positions filled. Of the 1,890 sworn personnel, 156 are unavailable for service (due to various forms of leave or light duty assignments) leaving 1,734 available sworn personnel – 82.2% of total FY 07 budgeted positions.

- In FY 07, the department is losing approximately 6 sworn officers a month to attrition (retirement, moving away, etc.) and another 6 sworn officers a month to other law enforcement agencies. The total number of sworn officer vacancies has steadily increased in recent years. The number has increased from 51 sworn officer vacancies on January 9, 2004 to 219 as of January 9, 2007 further reducing the strength of budget-authorized services.

- The Police Department estimates that they invest approximately $560,000 to train new police officers over their first 5 years of service. The pattern of losing experienced officers to other agencies/jurisdictions and struggling to find/train new officers is costly, inefficient and potentially compromises the quality of our police services.

- Several factors, such as the war in Iraq, changing demographics and a healthy job market have decreased the available pool of individuals seeking police service careers while the demand for police services is increasing.

- In December 2006, the City received the results of the Police Compensation and Benefits Survey. This study summarizes "that while some of San Diego's salary and benefits are on par with other agencies, the costs of healthcare, particularly to those providing family coverage, in conjunction with employee pension contributions results in San Diego police sworn employees' take home pay falling in the bottom quartile of the survey group." Sworn officer salary increases have not been included in the Mayor's Five-Year Financial Outlook.

Challenges / Activities

- Further exacerbating existing compensation disparities, some jurisdictions (e.g., Chula Vista) have guaranteed their officers generous raises in the coming years.

- The Police Department initiated a Recruitment & Retention plan in July 2006. A recruiting consultant will be hired in January 2007.

Replacing Needed Police Officer Equipment/Facilities

Issue Statement

In their Five-Year Plan dated December 15, 2005, the Police Department identified budgetary issues, related to police services, that they anticipated facing over the next five years. In addition to staffing shortages, historically, the Police Department has been underfunded in many other important areas including equipment for sworn officers, vehicle maintenance and replacement, data processing and facilities. The Five-Year Plan estimates the cost of addressing these police service issues to be in excess of $100 million over the next five years.

Related Facts

- Due to the budget shortfalls of recent years, the City's Police Department has deferred the replacement of needed equipment for its sworn personnel. The types of equipment that needs to be replaced includes: ballistic vests, portable radios, tasers, riot gear, cell phones, SWAT equipment, canines, paging equipment, flashlights and other forms of equipment. The department has estimated the cost of replacing this equipment over the next five years to be approximately $12.9 million.

- Based on population growth and staffing projections through FY 2011, the Police Department estimated that they were short 100 patrol vehicles based on staffing and that they would be short an additional 50 vehicles through 2011. The costs to operate and maintain the fleet could grow rapidly based on the increased age and mileage of the fleet if capital vehicle expenditures are not made in a timely manner. Capital vehicle expenditures required to return the fleet to a normal life cycle replacement profile were estimated to be approximately $30.9 million over the next five years.

- Data processing is another area that has been underfunded for many years according to the December 2005 Five-Year Plan. Data processing expenditures include DPC labor, network access, microcomputers, equipment & software maintenance contracts, non-SDDPC items and telephone. In FY 06, $4.5 million was budgeted for data processing costs yet they projected expenditures of $9.3 million. If the FY 06 data processing level of $4.5 million is maintained, the Police Department estimates that they would be underfunded in data processing by approximately $33.5 million over the next five years. The Department had been using salary savings to mitigate data processing overexpenditures; however, there is concern that these savings will not be available as the Departments moves toward full staffing.

- The Five-Year Plan also identified new facilities and maintenance issues as priorities for the Department over the next five years. These include: renovation of the Police Pistol Range (estimated cost: $8 million); new property storage facility (to secure impounds and evidence); a permanent Canine/SWAT facility (to replace the old facility that was used the Central Police Garage); a Regional Public Safety Institute (to provide training for law enforcement, fire, lifeguard, emergency medical, and other regional emergency response personnel); and continued maintenance of police facilities.

Funding Fire-Rescue Stations, Equipment and Staffing

Issue Statement

The Comprehensive Public Safety Needs Assessment presented to the Public Safety and Neighborhood Services Committee on March 12, 2004, documented the challenges faced by the Fire-Rescue Department in meeting its many missions. One of the key findings of that report was that chronic funding shortfalls in Fire-Rescue had created a backlog of needs estimated to require $159 million to correct over a five-year period. The Fire-Rescue Department recently reported that it has made significant progress in its efforts to address the backlog; however, significant additional expenditures will be necessary to fund facilities, equipment and staffing.

Related Facts

- Fire-Rescue failed to achieve national accreditation in 2005. The department was informed that their inability to achieve compliance with national emergency response time standards of 5 minutes 90% of the time weighed heavily in the decision to deny accreditation. Fire-Rescue staff's analysis of City-wide response times indicated that an additional 22 fire stations would need to be built and appropriately staffed to meet this national standard.

- Of the additional 22 fire stations needed to address sub-national standard response times, 9 are contemplated for construction over the next fiver years. These nine stations have been identified for development based on the impacts of increased density, traffic congestion, increased demand for service, and the effect of added stations on surrounding area response times. Annual operating and maintenance costs for the nine stations has been included into the Mayor's Five-Year Outlook; however, other costs (particularly construction and equipment acquisition costs) have yet to be identified.

- It currently costs between $6.5 and $8 million to design and construct a station depending on size and configuration. It should be noted that fire station construction costs have increased dramatically in recent years. Staffing a station with either a 4 person engine company or 4 person truck company costs approximately $2 million annually, or $4 million annually for both. A fire engine costs approximately $600,000 and a fire truck costs approximately $950,000.

- As is the case throughout the City, maintenance of Fire-Rescue facilities has been deferred due to a limited availability of funds. Fire stations and lifeguard towers are in serious need of repair. It is anticipated that Fire-Rescue needs will be addressed as part of the City-wide effort to address deferred maintenance.

- Progress has been made to replace outdated emergency and support apparatus in the past year; however, to ensure future progress and provide budgeting predictability, an ongoing fleet replacement plan must be developed and adequately funded. It is also recommended that the cost-effectiveness of purchasing versus leasing fire engine/trucks be further studied.

- The footprint of the Regional Public Safety Training Institute at the former Naval Training Center, Fire-Rescue's only training facility, is being eroded by ongoing development. In addition, use of this single facility causes emergency crews to be out of their response districts for long periods of time. The development of three smaller, strategically located training centers would better serve the needs of Fire-Rescue and free the NTC site for other revenue generating development.

Addressing Public Safety Communication System Needs

Issue Statement

The City's wireless communication systems are comprised of four major City-owned networks. These include the 800 MHz Radio Network, the Mobile Data Network, the Digital Microwave Network and the Digital Paging Network. These networks and the related systems that make up the City's public safety wireless communications system infrastructure are nearing the end of their service and maintenance life cycle. In order to guarantee that the critical communications requirements of our public safety services will be met in the future, it is imperative that they be replaced over the next several years. The cost of replacing key public safety communication system infrastructure within the next 5 to 6 years is estimated to be more than $150 million.

Related Facts

- Within the next 5 to 6 years, the City must replace three components of its public safety communications infrastructure. These components include the 800 MHz radio Network, the Fire-Rescue Department's Station Alerting System and the replacement of Fire-Rescue's 800 MHz Mobile Radios.

- Temporary upgrades to the infrastructure as well as the decision to move mobile data terminal and other data transmissions from the **800 MHz radio system** to a commercial wireless vendor (Sprint) has helped to extend the life of the aging 800 MHz radio system until approximately Fiscal Year 2012. The 800 MHz radio system is the backbone of the City's public safety communications network. As the City's primary public safety communications system, the 800 MHz radio system is critical to emergency communication, dispatch communication and ultimately emergency response times. Known as the Public Safety Communications Project, replacement of the 800 MHz radio system will cost approximately $150 million. It is possible that the City could issue bonds to replace the radio system that would be funded by a combination of grant and General Fund revenue.

- Replacement of Fire-Rescue's **Station Alerting system** is an immediate need as the current system relies on outdated technology that is no longer supported by the manufacturer and has replacement parts that cannot be purchased through conventional means. The Station Alerting system is responsible for alerting fire personnel within a station to effectively respond to emergencies. The Fire-Rescue Department needs to issue a RFP to identify an appropriate vendor for the new system soon. The estimated cost for a new Station Alerting system is approximately $2 million.

- In order to increase emergency interoperability within our region, Fire-Rescue needs to replace 250 mobile radios that are installed on emergency fire vehicles. Replacement of the **800 MHz Mobile Radios** will enable the region to utilize common digital channels and a common fleet radio channel map regardless of jurisdictional boundaries. The City currently uses analog radios, while many surrounding jurisdictions and supporting agencies use digital radios which are more powerful and safer. The cost of replacing these 15 year old radios is approximately $1 million.

- On January 5, 2007, the Department of Homeland Security announced that the City had been placed back on the list of high-risk areas eligible for security grants. With a focus on the interoperability of emergency communications, the City should aggressively pursue grant opportunities from UASI and other grant providers.

Kroll Report: Recommended Remediation Costs

Issue Statement

On August 8, 2006, the Audit Committee ("Kroll") presented findings of deficiencies in the City's internal controls, disclosure and other practices. The Kroll Report presented a package of recommendations in a Remediation Plan to remedy the deficiencies. Several of the Kroll recommended remediations have an associated fiscal impact including items such as establishing a new financial and accounting system, hiring an Oversight Monitor for a period of 3 years, and consulting with an actuary regarding pension obligations. The Mayor estimates that the total cost of complying with the Kroll recommended remediations to be $45 million over the next seven years.

Related Facts

- While many of the Kroll recommended remediations represent one-time costs for one to three years (e.g., Oversight Monitor/Independent Consultant), others represent permanent, ongoing costs (such as any applicable costs for the new Audit Committee and enhanced staff training).

- The Mayor's Five Year Outlook proposes approximately $4.5 million of General Fund expenditures for planned remediations in Fiscal Year 2008.

- The Enterprise Resource Planning System is the single largest cost component and is estimated to require $25-28.5 million across City funds in that year, which may be financed.

- The Oversight Monitor/Independent Consultant has been contracted for a total of $4 million over a three year period, part of which will have to be appropriated in Fiscal Year 2008.

- There will likely be operating costs associated with the City's new Audit Committee. Examples of such costs could include expert consultant support, staff support, training, educational materials, supplies, etc. The Mayor preliminarily estimated these costs to be $150,000 a year.

- The establishment of an Auditor General (or Auditor) and supporting audit staff may necessitate additional annual expenditures if an equivalent amount of savings cannot be transferred from the existing Auditor & Comptroller Office.

- Kroll recommended that the CFO develop an adequate and effective training program for finance employees to ensure they maintain competency and remain current in such areas as financial management, external and internal reporting and reliable public disclosure. The Mayor preliminarily estimated that an additional annual appropriation of $500,000 would be needed to meet citywide training requirements in this area.

Challenges / Activities

- To accomplish the above referenced objectives, significant funding will be required beginning in Fiscal Year 2008.