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## **OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT**

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# **IBA Review of the Mayor's Five-Year Financial Outlook, FY 2011 – 2015**

## **INTRODUCTION**

The Five-Year Financial Outlook for Fiscal Years 2011-2015 represents the fourth iteration in the series of long-term financial outlooks developed under Mayor Sanders. As with the Outlooks in prior years, the FY 2011-2015 Outlook projects significant deficits in each year of the forecast period. However, due largely to a recession that has been hailed as the worst economic downturn since the Great Depression, the current Outlook presents a much gloomier forecast than in recent years. According to the Outlook, the City is facing an FY 2011 General Fund deficit of more than \$179 million, the largest annual deficit projected in any of the previous Outlooks.

The Five-Year Outlook builds upon the FY 2010 Adopted Budget as a baseline for both revenue and expenditure projections, and accounts for anticipated increases in pension contributions, post-retirement healthcare costs, and other significant policy areas such as deferred maintenance and financial reforms. General Fund revenue projections provide the foundation of the Outlook, and are based on current revenue trends and the expected economic outlook. Several of the major revenue projections rely on revised FY 2010 estimates as a baseline, partially capturing the impact of a projected deficit in the current fiscal year.

Overall, the IBA concurs with the dour financial projections reflected in the Five-Year Outlook. While we continue to have minor disagreements in certain areas, we believe that the overall message is clear: the City of San Diego is facing a calamitous financial situation. With few options available to address the projected deficits, mitigation will need to come in the form of deep budget reductions and service cuts. Given the

magnitude of the projected deficits and the severity of the budget reductions that will likely be needed, it is critical that a comprehensive and deliberate plan of action be established. To this end, we believe that a process should begin immediately to define the City's core services in order to begin establishing funding priorities.

This report begins with a review of the General Fund revenue projections, including an assessment of current and projected economic conditions. General Fund expenditures are then examined, including pension and retiree health costs, new facilities and Police and Fire-Rescue academies. Significant funding areas, such as deferred maintenance and financial reforms are then discussed, followed by a summary of various risks to the Outlook. Finally, we address a few potential solutions, or more appropriately the lack thereof, to the projected deficits.

## GENERAL FUND REVENUE

The Five-Year Financial Outlook projects General Fund revenue to increase from a revised projection of \$1.108 billion in FY 2010 to \$1.197 billion in FY 2015, an increase of \$ 89.0 million, or 8.0% over the forecast period. Much of this increase is attributed to growth in four major General Fund revenues: property tax, sales tax, transient occupancy tax, and franchise fees, that in total comprise approximately 67% of the total General Fund revenue. Of note, due to unanticipated year-end 2009 performance for property tax, sales tax, safety sales tax, and TOT, the Outlook incorporates revisions to the FY 2010 base revenue assumptions for the five-year forecast. Overall, the revisions equate to a \$21.7 million reduction to the FY 2010 revenue projection upon which the Outlook is forecast. The table below summarizes the Five-Year Outlook forecast for General Fund revenues, including a summary of the revised FY 2010 projections.

<b>GF Revenue (in Millions)</b>	<b>FY 2009 Actuals<sup>1</sup></b>	<b>FY 2010 Budget</b>	<b>FY 2010 Revised</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Property Tax	\$ 398.7	\$ 382.6	\$ 391.6	\$ 391.6	\$ 399.4	\$ 411.4	\$ 427.8	\$ 444.9
Sales Tax	\$ 206.1	\$ 210.1	\$ 185.4	\$ 176.3	\$ 186.0	\$ 193.2	\$ 200.8	\$ 211.2
TOT	\$ 74.2	\$ 75.9	\$ 71.2	\$ 71.9	\$ 74.1	\$ 76.7	\$ 79.7	\$ 82.9
Franchise Fees	\$ 65.1	\$ 73.7	\$ 73.7	\$ 75.0	\$ 76.7	\$ 78.5	\$ 80.3	\$ 82.2
Other Revenue	\$ 379.2	\$ 387.4	\$ 386.1	\$ 346.8	\$ 357.9	\$ 365.6	\$ 368.2	\$ 375.4
<b>Total GF</b>	<b>\$ 1,123.3</b>	<b>\$ 1,129.7</b>	<b>\$ 1,108.0</b>	<b>\$ 1,061.6</b>	<b>\$ 1,094.1</b>	<b>\$ 1,125.4</b>	<b>\$ 1,156.8</b>	<b>\$ 1,196.6</b>
<i>Growth</i>	-	0.6%	-1.4%	-4.2%	3.1%	2.9%	2.8%	3.4%

1. Unaudited actual

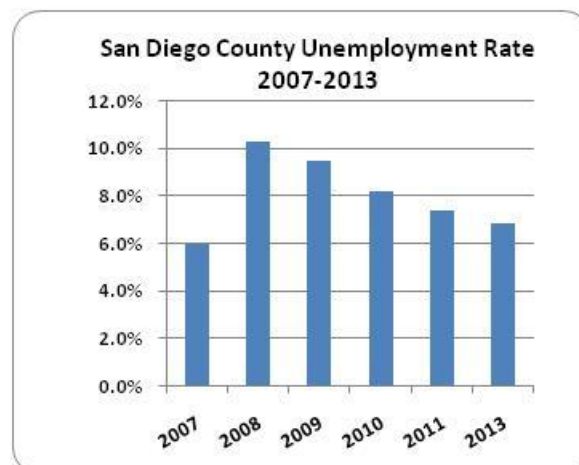
The Five-Year Outlook anticipates a 4.2% decline in FY 2011, with relatively consistent year-over-year growth ranging from 2.8% to 3.4% for the remainder of the forecast period. Overall, the projections are in line with current economic forecasts, but the IBA has concerns on whether the projections are too optimistic in specific revenue categories

in light of forecasts of a likely gradual multi-year recovery from the current recession. In this section we will review the underlying assumptions and growth projections for each of the four major General Fund revenues, while addressing areas of concern.

### ***Current Economic Forecasts***

As of the first quarter of the current fiscal year, economic indicators are showing signs of recovery from the recession, but even so, it is warned that the recovery period will be a long one. According to the San Diego County Economic Outlook for 2009-2010 by UCLA Anderson, the current U.S. recession will come to a close by the end of the first quarter of FY 2010, with the San Diego County economy to show continued weakness until the third quarter of the fiscal year. The Beacon Economics 2009 San Diego Economic Forecast surmises that the worst of the U.S. downturn occurred in the last quarter of FY 2009, with the economy to remain flat for all of FY 2010. These forecasts are consistent with the August 11-12 Federal Open Market Committee assessments that the U.S. economy is “leveling out.”

Despite the onset of the recovery, there will be a lag time before the economy returns to the strength of years past. This is particularly evident with the employment outlook. Forecasts anticipate a continued increase in the San Diego County unemployment rate up to 10.4% in the latter half of FY 2010. This forecast was already met in August of this year with a reported 10.4% unemployment rate in the County. A decline in the unemployment rate, a key to the recovery from the recession, will take some time. Businesses that have reduced investments and workforce levels will delay reinvesting in their companies until they feel comfortable with the definitiveness of the recovery, which will take a few years. UCLA Anderson forecasts that the San Diego region will not see pre-recession levels of unemployment (4.6% in 2007) until beyond calendar year 2013. The growth in income and consumer spending that will fuel the recovery, and the related growth in General Fund revenues, will trend with improvements in the job market.



Source: UCLA Anderson San Diego County Forecast

Given the time needed for a full recovery in all of the major drivers of the economy, including jobless rates, income, consumer spending, credit availability, and the housing market, economists forecast that the recovery from the current recession will be a gradual, multi-year recovery. As a consequence, economically sensitive City revenue streams, particularly property tax, sales tax, and TOT are forecast to see a gradual recovery. Complicating this recovery will be the timely reversal of contracted economic behavior on the part of consumers, financial institutions, and businesses. Consumers are saving more, and borrowing and spending less; businesses are borrowing and spending less; and financial institutions are offering less credit. This contracted behavior must ease in order to create momentum in the economy once again.

### ***Property Taxes***

The Five-Year Outlook anticipates that property tax receipts will experience flat growth in FY 2011, with a slow recovery of 2.0% in FY 2012, modest growth of 3.0% in FY 2013, and steady 4.0% growth in FY 2014 and 2015.

<b>Revenue (in Millions)</b>	<b>FY 2009 Actuals<sup>1</sup></b>	<b>FY 2010 Budget</b>	<b>FY 2010 Revised</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Property Tax	\$ 398.7	\$ 382.6	\$ 391.6	\$ 391.6	\$ 399.4	\$ 411.4	\$ 427.8	\$ 444.9
Growth	-	-4.0%	-1.8%	0.0%	2.0%	3.0%	4.0%	4.0%

1. Unaudited actual

The Outlook forecast assumes stabilization in average home prices in FY 2011, with offsetting declines in the commercial real estate market. According to current DataQuick housing data, the median sales price of homes within San Diego County has increased from \$280,000 in January of 2009 to \$325,000 in August, growth of 16.1%. Home sales are gaining momentum with consistent increases in the number of homes sold as compared to the same period in the previous year, with a 24.1% increase in the first half of 2009 per DataQuick.

While the Outlook assumptions are consistent with economic forecasts regarding a recovery in the residential housing market, there are concerns regarding the magnitude of the impact of foreclosures and a further downturn in the commercial real estate market over the Outlook period. Foreclosure rates are forecast to be in consistent decline by the end of the first half of FY 2010, but a risk remains regarding the efficacy of federal loan modification programs such as the Housing Affordability and Stability Plan in preventing foreclosures. Fluctuation away from the current declining trend in foreclosures can threaten the recovery in the housing market. Beyond this, as made mention to in the Five-Year Outlook, real estate experts anticipate further declines in the commercial real estate market, even as the residential market moves toward recovery. Some experts predict that commercial real estate will not hit bottom until up to three years from now. The FY 2010 property tax roll for the County demonstrated a slowdown of 77% in sales and new construction for commercial properties over \$50 million. The magnitude of the

impact that possible continued declines in commercial property will have on property tax revenue is unknown.

A review of historical data of the impact that a past recession had on property tax receipts can provide insight into how the current recession will impact property tax growth. In the recession of the early 1990s, City property tax receipts did not begin to show negative growth until FY 1994, a couple of years after the beginning of the recession. Once negative growth occurred, three years spanned until receipts showed modest growth of approximately 2.0%. Though each recession is unique in its own right, a possible replication of a similar recovery period should be considered given the severity and length of the current recession. Similar to the possible recovery trend gleaned from previous occurrences, Beacon Economics forecasts that the California statewide property tax roll will experience negative growth through FY 2012. In light of this information, the Outlook forecast appears to be optimistic.

The optimism of the forecast is in part supported by the reversal of temporary reductions in residential assessed valuations in future tax rolls. For the FY 2010 property tax roll, the County Assessor's Office proactively reviewed the property values for homes sold between 2003 and 2007 for a temporary reduction in assessed valuation based on the value of those homes on or around January 1<sup>st</sup> of 2009. Those properties for which the assessed valuation was temporarily lowered as a part of the FY 2010 property tax roll can be automatically increased back up to the original purchase price of the home, plus an allowable Proposition 13 CPI increase of 2%, once their market value increases back to the original sale price. As the market recovers, property tax receipts will benefit from housing market value growth on those homes for which values were temporarily reduced.

Notwithstanding the positive rebound of property tax receipts due to the reversal of temporary decreases in assessed valuation for certain properties, in light of the aforementioned potential negative impact of the decline in the commercial sector and uncertainty regarding the market recovery in the residential sector, the IBA suggests that this is a potential area of risk to the Outlook. The IBA opines that an even more conservative growth is possible through FY 2012, with gradual recovery in growth to occur in FY 2013 and beyond.

### ***Sales Tax***

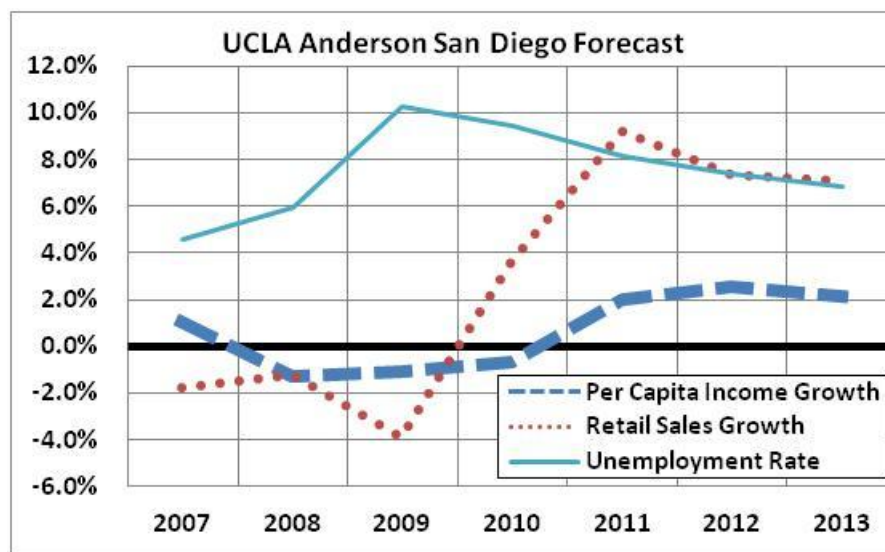
<b>Revenue (in Millions)</b>	<b>FY 2009 Actuals<sup>1</sup></b>	<b>FY 2010 Budget</b>	<b>FY 2010 Revised</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Sales Tax	\$ 206.1	\$ 210.1	\$ 185.4	\$ 176.3	\$ 186.0	\$ 193.2	\$ 200.8	\$ 211.2
Growth	-	1.9%	-10.0%	-4.9%	5.5%	3.9%	3.9%	5.2%

1. Unaudited actual

The Five-Year Outlook forecasts a 4.9% decline in sales tax in FY 2011, growth of 5.5% in FY 2012, and growth ranging from 3.9% in 2013, to 5.2% growth in FY 2015.

Underlying the forecast is the assumption of delayed improvement in sales tax revenue until the last quarter of FY 2011. This forecast is consistent with Anderson and Beacon forecasts of a slow recovery in some of the main drivers of sale tax revenue – employment rates, personal income, and savings levels – until mid-FY 2011. Though it is anticipated that the economy has begun to recover in the first quarter of FY 2010, it will take time for sales tax revenue growth to return to levels seen before the economic downturn began.

The current unemployment rate is the highest in decades. It can be years after the beginning of the recovery before those who are currently out of work return to gainful employment. The Anderson Forecast projects that by calendar year 2013 the unemployment rate will decrease to 6.9%, which is still higher than the 4.6% unemployment rate associated with calendar year 2007, before the recession hit. Per capita income and consumer spending will follow a forecasted labor market rebound in the latter half of FY 2011. The chart below details the concurrent recoveries in employment, real capita income, and retail sales in San Diego County as forecast by UCLA Anderson.



The IBA agrees that the sales tax projections in the Outlook are appropriate given their alignment with forecasted delayed growth in employment, income, and consumer spending until much after the recession ends. A worsening or improvement in any of the indicators outside of current forecasted levels would be a cause for a modification in the sales tax forecast.

### ***Transient Occupancy Tax (TOT)***

<b>Revenue (in Millions)</b>	<b>FY 2009 Actuals<sup>1</sup></b>	<b>FY 2010 Budget</b>	<b>FY 2010 Revised</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
TOT	\$ 74.2	\$ 75.9	\$ 71.2	\$ 71.9	\$ 74.1	\$ 76.7	\$ 79.7	\$ 82.9
Growth	-	2.3%	-4.0%	1.0%	3.0%	3.5%	4.0%	4.0%

*1. Unaudited actual*

The Outlook forecasts growth in TOT of 1.0% in FY 2011, 3.0% in FY 2012, 3.5% in 2013, and 4.0% in FY 2014 and 2015. Overall, the forecast reflects a conservative assessment of the impact of the trends cited in the June 2009 San Diego Convention and Visitors Bureau's (CONVIS) Quarterly Travel Forecast. Although the Five-Year Outlook projects conservative growth, the revised FY 2010 projection upon which the forecast is based may not be conservative enough. In the fourth quarter of FY 2009, TOT receipts declined by 16.5% over the same period in the prior fiscal year. This decline was significantly greater than initial forecasts of a 5.3% decline. The revised forecast for FY 2010 is representative of a 4.0% decline over FY 2009 receipts.

Per Beacon and Anderson San Diego County forecasts, consumer spending is projected to find its bottom in FY 2010, and not begin to increase until the second quarter of FY 2011. The Outlook forecast of a 4.0% decline is not consistent with this forecasted trend of continual declines in consumer spending in FY 2010. The IBA anticipates that the declines in TOT in FY 2010 will be worse than the projected decline of 4.0%, and this poses another risk to the forecast. This expectation is based on the IBA's estimate of growth in TOT revenue based on the CONVIS report's forecast of occupancy and average daily rates in calendar year 2009 and 2010.

Beyond concerns regarding the impact of lower than projected FY 2010 TOT receipts on the Outlook forecast, the assumed growth from 2011-2015 is consistent with forecasts of tourism seeing positive growth once consumer spending gradually increases as a result of growth in employment and income.

### ***Franchise Fees***

<b>Revenue (in Millions)</b>	<b>FY 2009 Actuals<sup>1</sup></b>	<b>FY 2010 Budget</b>	<b>FY 2010 Revised</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Franchise Fees	\$ 65.1	\$ 73.7	\$ 73.7	\$ 75.0	\$ 76.7	\$ 78.5	\$ 80.3	\$ 82.2
Growth	-	13.2%	13.2%	1.8%	2.3%	2.3%	2.3%	2.4%

*1. Unaudited actual*

The Five-Year Outlook forecasts overall franchise fee growth of 1.8% in FY 2011, 2.3% in FY 2012 through FY 2014, and 2.4% in FY 2015. The total growth is reflective of 3.0% growth for SDG&E franchise fees, 2.5% growth for cable franchise fees, and 3.0%

growth for all other franchise fees. In looking at the actual historical performance of franchise fees, the growth rates vary widely. For example, over the past five fiscal years, the growth in SDG&E franchise fees has ranged from a low of -2.0% in FY 2006, to a high of 12.2% in FY 2007. For other franchise fees, excluding cable franchise fees, the total growth has ranged from a low of -16.9% in FY 2009 to a high of -3.2% in FY 2008. Growth in cable franchise fees has been more consistent with positive growth ranging from 3.9% in FY 2009 to 5.6% in FY 2006.

The 1.8% to 2.4% growth in the Outlook represents conservative growth, given the volatility of franchise fees. This conservative treatment of the forecast for franchise fees is appropriate. Substantiating a more optimistic forecast would require obtaining projected gross revenue from each of the companies that remit a franchise fee to the City in order to calculate the franchise fee as a specified percentage of their projected gross revenue. This poses a difficulty given the propriety nature of such information.

### ***Other General Fund Revenues***

Beyond the four major General Fund revenues, the Outlook includes projections for other revenue sources such as property transfer tax, safety sales tax, vehicle license fees, as well as projections for the general revenue categories that includes Licenses & Permits; Fines, Forfeitures and Penalties; Revenue from Money & Property; Revenue from Other Agencies; Charges for Current Services and Transfer from Other Funds. In the forecast, these revenues account for 33% of total General Fund revenue. The following revenue forecasts are of note.

- Property transfer tax is forecast to experience a 1.8% decrease in FY 2010 from the actual receipts in FY 2009, with a spike in growth of 8.0% in FY 2011, 6.0% growth in FY 2012, and 4.0% growth consistently from 2013 through FY 2015. The forecast trend does not coincide with current housing data regarding a steady increase in the median price of homes since January 2009, and a steady year-over-year growth in the number of sales transactions. With the increase in home values and sales, FY 2010 receipts will likely come in higher than in FY 2009. The Outlook's forecast of continued growth in property transfer tax is appropriate, though the spikes in FY 2011 and FY 2012, with a tapering off of growth in outer years is not specifically supported by cited economic forecasts.
- The rental unit business tax processing fee and business tax processing fees, and associated revenue of \$1.3 million and \$2.1 million respectively, were appropriately removed from the forecast. An August State appellate court ruling found the rental unit business tax processing fee to be an unconstitutional tax. Subsequent to this ruling, the City stopped charging the fee, in addition to a similar business tax processing fee that was not a part of the court ruling. The City will issue \$1.1 million in refunds to landlords for the rental unit business tax processing fee for collections in the past year. The Outlook states that the City Attorney's Office is of the opinion that



the repayment of the rental unit and business tax processing fee is limited by a one year statute. The repayment of past business tax processing fees may be a future liability for the City, but is yet to be determined.

- Per the Municipal Code, five cents of the City's 10.5-cent TOT levy is required to be deposited in the TOT Fund. Of these five cents, four cents must be used solely for the purposes of promotion while one cent is discretionary. The FY 2010 Budget included a transfer of approximately \$24 million from the TOT Fund to the General Fund, including \$13.6 million in discretionary funds and \$10.4 million in TOT allocated for "promotion-related" expenditures within the General Fund. Transfers from the TOT Fund to the General Fund are assumed to continue throughout the Five-Year Outlook. However, as identified in the Outlook, these transfers will be significantly reduced in FY 2014 and FY 2015, when the City is scheduled to pick up the full debt service payments on the Convention Center Expansion Bonds and resume full payment of the PETCO Park Bonds, respectively.
- The FY 2010 Adopted Budget included \$39.2 million in one-time revenues. In the Outlook, these one-time revenues were properly removed from the baseline for the forecast period. Largely due to the removal of these one-times, the FY 2011 forecast reflects a 4.2% decline from the revised FY 2010 projections. If the \$39.2 million in one-times are excluded from the FY 2010 revised projection, the decline in the FY 2011 forecast over FY 2010 would be just 0.07%. This implies that there is only a 0.07% decline in actual year-over-year growth for structural revenues.

### ***Revenue Summary***

In consideration of current economic forecasts of a gradual multi-year recovery from the recession, the projections in the Outlook for the major general fund revenues are generally appropriate in reflecting a slow recovery. Even so, the IBA does have notable concerns regarding whether the property tax forecast and the revised FY 2010 base year utilized for the TOT forecast are conservative enough. The IBA recommends that more attention is given to the Low Scenario forecast in the Outlook for property tax, as we believe it is more reflective of the likely impacts of the current real estate market conditions on future receipts. TOT receipts in the current fiscal year will have to be monitored for a potential revision in the FY 2010 projection, and thus the Outlook forecast if appropriate. The IBA understands the dynamic nature of revenue projections and their variability as new economic and receipts data is available. Therefore it is expected that the overall revenue forecast will be updated as needed as conditions change.

## GENERAL FUND EXPENDITURES

The Five-Year Outlook projects General Fund expenditures to increase by a cumulative \$203 million from FY 2010 to FY 2015. This increase primarily reflects additional funding for pension contributions, OPEB and debt services on deferred maintenance bonds (discussed in the next section). This section discusses a number of expenditure categories, including Salaries and Wages, Fringe Benefits, Non-Personnel Expense, new facilities, and Police and Fire academies.

### *Salaries and Wages*

Actual expenditures within the Salaries and Wages category have increased each year, with an average annual growth of 3.7% since FY 2005. Over that period of time, salary increases have been negotiated with several of the City's labor organizations. However, the FY 2010 Adopted Budget for Salaries and Wages reflects a decrease of two percent from the actual FY 2009 expenditure levels.

Several factors other than negotiated raises (or salary reductions) can impact the Salaries and Wages expenditure category, including the actual number of city employees, and overtime costs related to emergency or unanticipated events, among other items. However, it should be noted that these factors will continue to impact the Salaries and Wages category. The Outlook assumes no salary increases over the five-year forecast period. In fact, as the adopted FY 2010 Budget is the initial basis for projection, the Outlook results in no reinstatement of the 6% reduction in compensation, and appears to reflect the continuation of mandatory furloughs that were incorporated in the FY 2009 Budget as cost-saving measures, beyond the term of current labor agreements.

Projected vacancy savings are reduced in the later years of the forecast. The Outlook also includes an additional \$11.3 million for estimated payments of accrued vacation for expected retirements. When considered together with the FY 2010 Salaries and Wages budget amount, these three items reflect an increase in total funding available for Salaries and Wages. The net increase mitigates, to a certain degree, the fact no salary increases are included. However, the amount is not sufficient to also fund salary restorals or potential salary increases that may be negotiated and approved during the Outlook period.

<b>Salaries &amp; Wages Expenditure Category (in millions)</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Salaries and Wages	\$ 547.8	\$ 547.8	\$ 547.8	\$ 547.8	\$ 547.8	\$ 547.8
Vacancy Savings	(36.0)	(38.4)	(31.4)	(26.6)	(27.1)	(27.6)
Accrued Leave Liability	4.3	2.7	4.9	6.3	16.0	2.9
<b>TOTAL</b>	<b>\$ 516.1</b>	<b>\$ 512.1</b>	<b>\$ 521.3</b>	<b>\$ 527.5</b>	<b>\$ 536.7</b>	<b>\$ 523.1</b>
<i>Change from FY 2010</i>		\$ (4.0)	\$ 5.2	\$ 11.4	\$ 20.6	\$ 7.0
<i>Annual Percentage Increase</i>		-0.8%	1.8%	1.2%	1.7%	-2.5%

The Outlook states that each one percent salary increase would result in added salary costs of \$5.5 million, with an additional \$0.5 million in salary-based fringe benefits, for the General Fund. This does not consider the added future costs to the pension system. Consideration should be given to assessing the impact of potential salary increases to provide a reasonable forecast of General Fund requirements over the next five years. Assuming no salary increases over a five-year period could be considered unrealistic for financial planning purposes.

#### *Accrued Leave Liability*

Accrued Leave Liability, previously referred to as funding of “Deferred Retirement Option Plan (DROP) participant leave balances” or “terminal leave”, represents the cost for annual leave that an employee has accrued and must be paid upon their departure from the City. Accrued Leave Liability will reflect the annual payment for all forms of departure, including termination, resignation, retirement, and/or retirement of DROP participants. The estimates included in the Outlook are based on the actual number of DROP participants, expected leave dates, and respective leave balances.

In the past, departments absorbed this expense when it occurred. However, as recent experience has shown in FY 2009, the General Fund has experienced increased costs for this purpose, and reserve funds were needed to supplement the budget of the Fire-Rescue Department.

#### *Other Salary Issues*

Of lesser significance, the FY 2010 Budget included partial funding for increased costs related to the creation of new classifications in the Police and Fire-Rescue Departments. Full-year requirements for these needs in future years as promotions occur, as well as the potential impacts of other newly created classifications will put further demands on salaries, separate from negotiated salary increases.

#### *Fringe Benefits*

Actual expenditures within the Fringe Benefits category have increased each year, with an average annual growth of 8.5% since Fiscal Year 2005. However, the FY 2010 Adopted Budget for Fringe Benefits reflects a decrease of 4.2% from the actual FY 2009 expenditure levels.

<b>Fringe Benefits Expenditure Category (in millions)</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Pension	\$ 124.9	\$ 182.0	\$ 203.1	\$ 222.6	\$ 240.5	\$ 257.5
Pension (McGuigan)	-	31.7	-	-	-	-
New Pension Plan Savings	-	(1.1)	(1.9)	(2.6)	(3.3)	(4.1)
Retirement Offset	5.2	5.2	5.2	5.2	5.2	5.2
Employee Offset Savings	10.0	10.0	10.0	10.0	10.0	10.0
OPEB/Retiree Health	39.7	43.2	46.8	50.4	54.2	57.8
Other Fringe	50.5	50.5	50.5	50.5	50.5	50.5
Flexible Benefits	39.0	39.0	39.0	39.0	39.0	39.0
Workers Compensation Reserve	-	4.1	1.9	4.3	5.5	-
<b>TOTAL</b>	<b>\$ 269.3</b>	<b>\$ 364.6</b>	<b>\$ 354.6</b>	<b>\$ 379.4</b>	<b>\$ 401.6</b>	<b>\$ 415.9</b>
<i>Change from FY 2010</i>		\$ 95.3	\$ 85.3	\$ 110.1	\$ 132.3	\$ 146.6
<i>Annual Percentage Increase</i>		35.4%	-2.7%	7.0%	5.9%	3.6%

The Fringe Benefits expenditure category consists of the costs to provide employee benefits. Typical employee benefits include the flexible benefit program, insurance, and retirement. According to the City Charter, fringe benefit expense is not considered a salary or wage expense.

#### *Flexible Benefits*

Flexible Benefits are projected to continue at the FY 2010 Budget amount of \$39 million throughout the forecast. The Buck Consultants report related to OPEB included in its assumptions a 10% increase for FY 2010, decreasing 0.5% each year to 5% for FY 2020, to reflect expected trends in health care costs. No similar increase has been projected for employee health care costs funded through the flexible benefits plan. Any actual increased health care costs could create an additional budgetary burden, or alternatively, may be shifted to employees, if they are required to fund possible shortfalls.

#### *Pension*

During FY 2009, market declines exacerbated the existing Unfunded Actuarial Liability (UAL) within the City's pension system. The City's June 30, 2009 UAL estimated by the San Diego City Employees' Retirement System (SDCERS) actuary is \$2 billion, up from \$1.3 billion at June 30, 2008.

Because of this increase, the City's FY 2011 Annual Required Contribution (ARC), which is based on the pending June 30, 2009 Actuarial Valuation, is estimated by SDCERS actuary to increase by \$70.6 million – from \$154.2 million to \$224.8 million. The impact to the General Fund will be an estimated increase of \$56.7 million – from \$125.3 million to \$182.0 million. Note that the estimated ARC, which is utilized in the Five-Year Outlook, does not include negotiated pension plan changes, salary freezes and

other changes effective July 1, 2009. Most notably, a potential savings of \$12 million for FY 2011 due to a one-year salary freeze has been estimated by the SDCERS actuary. Savings in subsequent years are anticipated if the salary freeze continues beyond FY 2011. However, increases to the pension system obligations may occur due to earlier than expected retirements. The June 30, 2009 actuarial valuation is anticipated to be completed in December, at which time the actual FY 2011 ARC will be provided.

Additionally, the residual amount owed to the pension system resulting from the settlement of *William J. McGuigan v. City of San Diego* (McGuigan settlement) is an estimated \$39.1 million, including interest, of which \$31.7 million is the General Fund portion. The City previously paid approximately \$144 million of the \$173 million settlement amount and is required to pay the entire settlement amount and interest by June 8, 2011.

The FY 2011 forecast includes the estimated McGuigan settlement balance of \$39.1 million, along with the estimated ARC of \$224.8 million, for a total of \$263.9 million. The General Fund portion includes the estimated McGuigan settlement balance of \$31.7 million and estimated ARC of \$182.0 million, for a total of \$213.7 million.

<b>Pension Forecast (in millions)</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Citywide Payment	\$ 154.2	\$ 263.9	\$ 250.9	\$ 274.9	\$ 297.1	\$ 318.1
<i>Increase from FY 2010</i>	<i>N/A</i>	\$ 109.7	\$ 96.7	\$ 120.7	\$ 142.9	\$ 163.9
General Fund Payment	125.3	213.7	203.1	222.6	240.5	257.5
<i>Increase from FY 2010</i>	<i>N/A</i>	\$ 88.4	\$ 77.8	\$ 97.3	\$ 115.2	\$ 132.2

#### *Pension Savings from Plan Changes*

For General Members hired on or after July 1, 2009, the Defined Benefit pension plan has been modified: the benefit cap decreased from 90% to 80% of final compensation; final compensation was redefined as the average of the three highest years during membership, rather than the highest one year period; and retirement calculation factors were adjusted.

Additionally, General Members hired on or after July 1, 2009 will not be eligible for the Supplemental Pension Savings Plan, but will be entered into the new Defined Contribution pension plan, which will be funded by a 1% employee contribution and 1% City contribution.

For Safety Members hired on or after July 1, 2009, the Defined Benefit pension plan's retirement factors changed, so that an employee will not be entitled to a retirement factor of 3% until he/she reaches the age of 55. For employees hired before July 1, 2009, the 3% factor is available once an employee reaches the age of 50.

Estimated savings for recent pension plan changes are incorporated in the Five-Year Outlook as follows: \$1.1 million in FY 2011, \$1.9 million in FY 2012, \$2.6 million in FY 2013, \$3.3 million in FY 2014, and \$4.1 million in FY 2015.

**Retiree Health (OPEB)**

In September 2009 Buck Consultants submitted the results of the actuarial analysis of the City's retiree health program, or OPEB (Other Post Employment Benefits), as of June 30, 2009. This analysis estimates that the City's OPEB Annual Required Contribution (ARC) for FY 2011 of \$120.3 million. The OPEB Unfunded Actuarial Liability (UAL) estimated for June 30, 2010 is \$1.36 billion, up from \$1.25 billion the previous year.

As described in the Outlook, the retiree health payments are comprised of a pay-as-you-go (PAYGO) portion (for employees already retired) and a prefunding portion (for the future payment of benefits currently being accrued). The PAYGO increases estimated in the Outlook are shown in the table below:

<b>Mayor's Outlook - Citywide OPEB</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Total Forecasted	\$ 57.1	\$ 62.2	\$ 67.3	\$ 72.5	\$ 77.9	\$ 83.2
Less: Prefunding	25.0	25.0	25.0	25.0	25.0	25.0
<b>PAYGO Portion</b>	<b>\$ 32.1</b>	<b>\$ 37.2</b>	<b>\$ 42.3</b>	<b>\$ 47.5</b>	<b>\$ 52.9</b>	<b>\$ 58.2</b>
<b>Percent Increase</b>	<b>N/A</b>	<b>15.9%</b>	<b>13.7%</b>	<b>12.3%</b>	<b>11.4%</b>	<b>10.0%</b>

Payment of the full ARC is not legally required. However, the Budget and Finance Committee has requested that the proposed Budget Policy include a description of how the City intends to fund retiree health costs on an annual basis. The FY 2011 forecasted retiree health contribution of \$62.2 million is 52% of the FY 2011 ARC.

A comparison of Buck Consultants' expected PAYGO future cash flows to the forecasted amounts in the Five-Year Outlook shows a cumulative shortfall of \$52.7 million.

<b>Comparison of PAYGO Estimates</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Mayor's Outlook	\$ 32.1	\$ 37.2	\$ 42.3	\$ 47.5	\$ 52.9	\$ 58.2
Buck Consultants	38.4	44.4	50.5	56.7	63.3	69.6
<b>Difference</b>	<b>\$ (6.3)</b>	<b>\$ (7.2)</b>	<b>\$ (8.2)</b>	<b>\$ (9.2)</b>	<b>\$ (10.4)</b>	<b>\$ (11.4)</b>

If the PAYGO costs reach Buck Consultants' projection during the forecasted period, the excess costs will increase the shortfall in the Outlook.

### ***Non-Personnel Expenditures***

Non-personnel expenditures (NPE) consist of supplies and services, information technology (IT), energy and utilities, and equipment outlay. In FY 2010, NPE is budgeted at approximately \$344 million, or roughly 30 percent of total General Fund expenditures. Over the past several years, NPE has steadily increased as a percentage of total General Fund expenditures, up from approximately 22.7 percent in FY 2005. The Five-Year Financial Outlook projects baseline NPE (that is, exclusive of additional funding for the significant policy areas) to grow by approximately \$23.2 million over the forecast period.

Over the past several years, growth in the various NPE categories has been wildly sporadic, as reflected in the table below.

<b>Non-Personnel Expense</b>	<b>FY 2006 Actual</b>	<b>FY 2007 Actual</b>	<b>FY 2008 Actual</b>	<b>FY 2009 Actual</b>	<b>FY 2010 Budget</b>
Supplies & Services	11.1%	38.4%	58.1%	-23.1%	3.9%
Information Technology	6.4%	41.0%	13.5%	-1.5%	-0.8%
Energy & Utilities	12.5%	32.8%	-9.2%	3.3%	1.8%
Equipment Outlay	-25.3%	36.9%	-43.7%	-46.4%	136.6%
<b>TOTAL NPE</b>	<b>8.2%</b>	<b>38.1%</b>	<b>41.2%</b>	<b>-19.8%</b>	<b>4.9%</b>

The significant variance in these growth rates reflects not just inflationary increases, but also program changes, budget reductions, and one-time expenditures. As a result, historical growth is informative, but not particularly instructive in regard to future growth projections. As significant policy issues are identified and projected separately in the Five-Year Outlook, baseline NPE growth reflects a combination of conservative inflationary factors and adjustments for one-time expenditures in FY 2010.

Supplies and services, the largest NPE category, is projected to grow by 1.5 percent annually. This reflects a reduced growth rate compared to the two percent growth applied in previous versions of the Outlook. This projection is based on the assumption that tighter spending controls will be in place over the next several years. Adjustments related to anticipated election expenditures are also included in this category. A zero percent growth rate is used in the IT category, reflecting anticipated cost savings due to the competitive contracting out of citywide IT functions. Depending on the result of the contracting process, potential cost reductions in this category may be possible. Energy and Utilities is projected to grow by five percent, consistent with previous versions of the Outlook, and Equipment Outlay is projected to remain flat as these expenditures will be tightly controlled.

Overall, the growth projections for the baseline NPE categories are conservative, but generally consistent with anticipated trends and previous versions of the Outlook.

### ***New Facilities***

The Five-Year Outlook includes the addition of operating costs for new facilities for the Park and Recreation and Fire-Rescue Departments. The IBA has reviewed the City's Capital Improvement Program budget to ensure consistency with project plans and scheduled completion dates. As part of this review, the IBA has revisited other, existing capital plans that have encountered implementation delays in recent years, and describes the continuing unmet needs that are not addressed in the Outlook for the five-year forecast period. These plans include the Fire Station Master Plan, and the Library Facilities Improvement Plan. Also described here is the new Main Library and the Civic Center Complex projects, which are contemplated to move forward.

### ***Park and Recreation Facilities***

The Park and Recreation Department prepared estimates for the opening of new facilities that are planned during the forecast period. A total of 25.61 FTEs and total costs of \$2.98 million have been determined to be required for planned improvements and construction of new park and recreational facilities at 28 locations throughout the City. The Outlook includes a listing of park and recreation facilities expected to be completed each year, and the corresponding need for staffing and the related costs.

### ***Fire Facilities***

The Fire Station Master Plan (FSMP) was presented to the Public Safety and Neighborhood Services Committee in March 2009 by the Fire Department. The FSMP is a planning tool required by the City's General Plan that seeks to ensure potential funding is identified for facilities in underserved communities. It also provides for better planning of capital and ongoing expenditure requirements.

The FSMP identifies and prioritizes 31 projects with total estimated one-time costs of \$188 million, with associated ongoing annual costs of \$74 million. The FSMP indicates that this situation has developed over several decades and a plan to correct deficiencies will require a phased approach, and cannot be immediately implemented. However, some planned fire facilities are located in communities that will receive development fees and some are eligible for funding through the city's redevelopment efforts. In those cases, capital projects will progress without the need for initial General Fund resources, or a completed funding plan, though ongoing staffing and equipment needs could require a future commitment from the General Fund.

The Outlook includes \$100,000 per year in Fiscal Years 2012 through 2015 for additional operating costs for the Bayside Fire station, which is planned to be constructed with funds from the Centre City Project Area of the Redevelopment Agency. In addition, funding in the amount of \$367,323 has been included for grant matching funds in Fiscal Year 2012 for the proposed Mission Valley station. Beyond these requirements, no



additional funding has been reflected in the Outlook for the significant needs identified in the FSMP.

#### *Library Facilities Improvement Plan*

The Library Facilities Improvement Plan, established and approved by City Council in 2002, identified 22 facilities (including the Main Library) for improvements. The Library Ordinance, requiring that 6% of General Funds be dedicated to libraries each year, was put into place that same year to secure a source of funding for newly identified operating costs, and to ensure funding for annual debt service payments. Initially, the financing plan accompanying the Improvement Plan called for the issuance of bonds, however as the City was unable to issue bonds to fully implement the plan, the anticipated bond revenue was replaced with Redevelopment Agency funding and private fundraising.

The Improvement Plan has not been comprehensively updated since it was adopted. Projects have not been reevaluated or reprioritized, and most projects have been delayed due to a lack of capital funding. The focus has shifted to those projects relying on grants, developer money or other non-City funding. The Outlook does not provide funding to restart the Improvement Plan.

The Library Ordinance has been waived since 2004 to provide funds for other priority areas. As no bonds have been issued, funding for debt service requirements is no longer needed, and the IBA has suggested that the 6% funding goal be reevaluated. The Outlook assumes the Ordinance will be waived for the entire forecast period.

#### *Branch Library Facilities*

In 2002, the cost for various library branch improvements was estimated at \$162.8 million. Although some projects have been completed since 2002, the City's FY 2010 Capital Improvements Program (CIP) Budget indicates that there are still currently 16 identified branch library facility projects in various stages of planning and/or construction. According to the CIP Budget, 14 of these projects are awaiting approximately \$102.6 million in unidentified funding for future construction and on-going operational costs.

The Library Department is scheduled to open the new replacement Logan Heights Library on December 11, 2009. Previously scheduled to open in August, the FY 2010 budget includes the addition of 4.25 FTEs at a cost of \$275,000, and non-personnel costs of \$318,000, totaling \$593,000. Previously published information indicated higher costs were expected (an additional \$267,000). The adopted budget indicates the funding of \$593,000 will support needs for a full year of operations. It remains unclear at this time if additional funding will be required in subsequent years to supplement the initial funding level, which has been significantly reduced from previous estimates. However, the Outlook includes no additional funding for newly opened branch libraries during the forecast period.

### New Main Library

The proposed San Diego Main Library is currently scheduled to open in FY 2014. Although the Outlook acknowledges that the Main Library may open in this timeframe, it assumes no financial impact to the General Fund.

Library staff has estimated that an increase of \$2.7 million and a net 1.00 FTE to the Central Division budget will be needed for operation of the Main Library. Staff anticipates offsetting these expenses with approximately \$2.8 million in new revenue and donations for the first five years. The Library Foundation has confirmed that \$2 million of the \$2.8 million in private donations has been secured for five years beginning in FY 2014, for a total of \$10 million through FY 2018.

The IBA notes that any shortfalls in donations could result in the need for additional General Fund requirements or alternatively, a reduction to planned services. Therefore, while it is possible that there may be no General Fund impact for the first five years of operations, there is a risk to the Outlook that donations may fall short of fundraising goals.

Beginning in FY 2019 and beyond, the City will assume funding obligations at an estimated additional cost of \$2 million per year. To resolve the question of funding in future years, Library staff has suggested that it anticipates a return to the goals set out in the Library Ordinance, which the IBA believes may be unrealistic.

### Civic Center

The Five-Year Financial Outlook discusses two scenarios related to the construction of a new Civic Center Plaza, and two scenarios related to the continued occupancy of the existing facilities for at least five years. These scenarios include:

Outlook Scenario	Expenditures addressed in Scenarios	General Fund Expenditures	Citywide Expenditures <sup>(1)</sup>
1	<ul style="list-style-type: none"><li>Expenses associated with moving employees and equipment from CAB into new City Hall in 2014.</li><li>No funding included to address deficiencies with facilities.</li></ul>	\$1.3 Million <sup>(2)</sup>	\$1.3 Million <sup>(2)</sup>

2	<ul style="list-style-type: none"> <li>• “5-Years” deficiencies outlined in the DMJM, Inc. Facilities Condition Assessment 2009 Supplemental Analysis (Does not include expenses associated with the Concourse).</li> <li>• Costs associated with temporarily moving employees out of CAB to address deficiencies.</li> <li>• Expenses associated with moving employees and equipment from CAB into new City Hall in 2014.</li> </ul>	\$14.0 Million	\$19.5 Million
3	<ul style="list-style-type: none"> <li>• “Hold Steady 10-Years” deficiencies outlined the DMJM, Inc. Facilities Condition Assessment 2009 Supplemental Analysis (Includes all facilities).</li> <li>• Costs associated with temporarily moving employees out of CAB to address deficiencies.</li> <li>• Renewal of current leases in City-occupied properties.</li> </ul>	\$33.0 Million (\$32.5 million to address deficiencies and \$500K for lease renewals)	\$40.1 Million
4	<ul style="list-style-type: none"> <li>• Installation of Fire Sprinklers on the remaining floors of CAB.</li> </ul>	\$5.6 Million	\$5.6 Million

<sup>(1)</sup> Based on DMJM's May 2009 Facilities Condition Assessment Supplement.

<sup>(2)</sup> CCDC estimate.

It is important to note the underlying assumptions regarding the Civic Center Plaza included in the Five-Year Outlook. These assumptions include:

- With the exception of \$5.6 million to install Fire Sprinklers on the remaining floors of CAB (Scenario 4), no capital outlays are included to address the deferred maintenance items included in the other scenarios.
- Lease savings realized from the consolidation of City employees located downtown into a new Civic Center have not been reduced from the bottom line. Staff assumes that the savings in lease payments would be offset by debt service payments for the construction of a new Civic Center Plaza.
- Scenario 3 includes an additional \$500,000 for lease renewal of City-occupied properties in FY 2013 and 2014. However, the increased lease costs have not been included in the bottom line.
- Costs of seismic retrofitting for the Civic Center Complex facilities, estimated by DMJM, Inc. to be \$19.6 - \$33.6 million for CAB, COB, and the Concourse, have not been included in the scenarios.

In DMJM's May 2009 Facilities Condition Assessment Supplement, they conclude that costs to maintain the safety and functionality of Civic Center Plaza facility totals \$19.5 million for five years, and \$40.1 million for 10 years. These costs include fire and life safety, mechanical, and structural expenditures. It is important to note that these

projected expenditures are estimated expenses and represent the minimal amounts required for occupant safety or ongoing operation of the building, and exclude costs associated with seismic retrofitting. The total cost to completely renovate the Civic Center Facilities is estimated to be \$124.3 - \$138.3 million including seismic retrofitting. The City Council is expected to take up the discussion of an Exclusive Negotiation Agreement (ENA) with Gerding Edlen Development Corporation (GED) in October 2009. However, regardless of the outcome of the discussion on the ENA, funds will need to be expended on the current facilities. The scope of the deficiencies that should be addressed will need to be discussed with the City Council. To address the General Fund obligations for the deficiencies in the Civic Center Plaza Facilities, the City currently has the following options for funding:

<b>Funding Source</b>	<b>Impact of Using Funding Source</b>
General Fund	Increased General Fund deficit.
Proceeds from current or future Deferred Maintenance Lease Revenue Bonds	Delaying other critical deferred maintenance projects. This funding is an option only for deficiencies that will extend the useful life of the facility.
Proceeds from Land Sales	Delaying other critical deferred maintenance projects and ADA projects.

One final item that is not anticipated in the Five Year Outlook is the probable need to relocate the City's Emergency Operations Center, currently located in the City Operations Building, to another location. The GED redevelopment proposal does not assume that the EOC will be located in the current location or in the redevelopment footprint. In addition, it is unclear if the City would be able to continue to operate the EOC in its current location even if COB underwent a renovation. Depending on the scope of the project, the costs could be significant. For comparison purposes, the City of San Antonio, Texas, completed a new EOC in 2007 at a cost of \$24.5 million. The costs associated with the relocation of the City's EOC should be considered a risk to the Five-Year Outlook.

### ***Police and Fire-Rescue Academies***

As one of many solutions to the forecasted deficit in FY 2009, the City Council approved midyear adjustments that reduced fire and police recruit academies. Fire academies were reduced from two to one annually, and the number of police recruits in the remaining academies was reduced from 50 to 25. These reductions were subsequently adopted as a part of the Fiscal Year 2010 Budget. For the Fire-Rescue Department, the elimination of one academy equated to a reduction of \$715,731 in the overtime budget related to the staffing of the academy. The Police Department budget was reduced by \$1,500,000 for the elimination of non-personnel expenses associated with less recruits.

At the end of FY 2009, a significant number of sworn police officers and fire fighters retired in response to changes in salary and benefits for their respective labor negotiation units, primarily related to a change the interest rate for the DROP program. Though a

portion of the retirements were anticipated due to the benefit changes, the full magnitude of them, and the vacancies that they created, was not taken into account in the FY 2010 Adopted Budget. In the Mayor's May Revision to the Fiscal Year 2010 Proposed Budget, the Police Department's vacancy factor was increased by \$2,500,000 in anticipation of additional retirements as a one-time resource. The Fire Department's vacancy factor remained unchanged. The Mayor's Office indicated that they would monitor attrition and vacancies during FY 2010 and adjust the number of academies if deemed appropriate. For the FY 2010 Budget, the vacancy factors for the Police and Fire-Rescue Departments are \$20.7 million and \$8.8 million, respectively.

A September 21, 2009 memorandum from the Chief Operating Officer announced a hiring freeze for all vacant positions supported by the General Fund, including the cancellation of all future police and fire academies until further notice. With this policy in place, using data from department staff regarding vacancy totals at the beginning of the fiscal year, the IBA calculates potential FY 2010 vacancy savings for the Police Department of approximately \$40.0 million, which includes a 65 percent salary and 35 percent fringe benefit assumption. These estimated salary and benefits savings could exceed the budgeted vacancy factor by approximately \$19.0 million. Given that \$2.5 million of the budgeted vacancy factor in FY 2010 was budgeted as a one-time savings factor, removing this one-time would increase the amount of the salary and benefits savings above the budgeted vacancy factor by \$2.5 million to \$21.8 million beyond FY 2010. The Fire-Rescue Department's budgeted vacancy factor of \$8.8 million is very close to the IBA estimate for FY 2010 vacancy savings. With both the Police and Fire-Rescue Departments, since overtime is utilized to ensure that critical staffing levels are met, it is assumed that some of the savings related to vacancies will be offset in part by an increase in overtime.

If the Police hiring freeze is lifted, academies could be funded through department salary savings. Alternatively, if the freeze remains in place, these significant savings will continue helping to offset other funding categories. However, this represents a significant policy decision, and the impact on public safety services would need to be carefully weighed. The Fire-Rescue Department would need to receive additional funding or find savings in other areas of department operations to fund additional academies.

## SIGNIFICANT POLICY AREAS

The Five-Year Outlook includes funding for several significant policy areas that continue to be priorities, including pension funding, OPEB, deferred maintenance, reserve funding, and Storm Water Compliance. Funding for these areas is projected to increase by approximately \$113 million from FY 2010 to FY 2011. Several of these policy areas, such as pension and OPEB, have been discussed previously. This section provides an overview of other significant policy areas.

### ***Deferred Maintenance***

To address the backlog in deferred maintenance costs, the Five-Year Financial Outlook proposes to secure funding for projects by the issuance of long-term debt. In prior Outlooks, a combination of funding including Proposition 1B, land sales, and debt financing was proposed, and ultimately budgeted, to address the backlog. In FY 2009 the City received \$16.1 million in Proposition 1B funding. In FY 2010 the State issued a supplemental release of \$187 million, but the City did not receive funding from this second release. An additional release of Proposition 1B is anticipated, but given the state's continuing cash flow situation, this funding may be frozen. The Outlook does not assume additional funding will be received via Proposition 1B.

The current economic situation has also had an impact on the sale of City assets. Since FY 2008 the City has budgeted \$53.9 million from the sale of underperforming assets to be used to address Deferred Maintenance and ADA needs. Of the \$53.9 million, \$34.0 million has been realized, \$6.0 million of which is related to Water Department assets. The Five-Year Financial Outlook does not assume additional funding for deferred maintenance from the sale of City assets.

On March 19, 2009 the City executed a private placement Bond Purchase Agreement for \$102.7 million. This bond financing is the first of three contemplated issuances for a total of \$300 million in net construction proceeds. The Five-Year Outlook includes the debt service payments for these bond issuances. For Fiscal Year 2011, staff plans on refinancing the initial \$102.7 million private placement bonds with more traditional long-term bonds sold in the public capital markets.

The switch from shorter-term debt with interest only payments to long-term debt with annual principal and interest payments increases the annual debt service from \$4.9 million to \$9.5 million. It is important to note that \$4.9 was included in the FY 2010 Adopted Budget to cover interest only payments on the initial private placement bonds. Additional debt service payments for the subsequent issuances are included in FY 2012 (FY 2011 issuance) and 2014 (FY 2013 issuance). The following table reflects the funding required for debt service payments through FY 2015:

<b>Deferred Maintenance Funding (in Millions)</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Bond Funding	\$ -	\$ 110.1	\$ -	\$ 110.1	\$ -	\$ -
Debt Service (GF)	\$ 4.9	\$ 9.5	\$ 18.7	\$ 18.7	\$ 27.9	\$ 27.9

*Note: Issuance amount is estimated to be approximately \$110 million for additional net construction proceeds of \$100 million in both FY 2011 and FY 2013.*

Since the issuance of the last Five-Year Financial Outlook, staff has refined the projected deferred maintenance liability for streets, facilities, and storm drains based on recently

completed Condition Assessments. The following table outlines the updated cost estimates associated with the deferred maintenance backlog:

<b>City Asset<sup>1</sup></b>	<b>Total with Streets at 100% Acceptable</b>	<b>Total with Streets at 75% Acceptable</b>
Streets	\$491.0 million	\$227.0 million
Facilities <sup>2</sup>	\$97.4 million	\$97.4 million
Storm Drains <sup>3</sup>	\$100.0 million	\$100.0 million
<b>TOTAL</b>	<b>\$688.4 million</b>	<b>\$424.7 million</b>

1. Does not include sidewalks

2. Does not include Civic Center Complex

3. Estimate

An important note on the projected costs for Streets is that the \$491.0 million in expenditures would bring all City streets up to a 100% “Acceptable” level. The current industry standard includes 75% “Acceptable”, 20% “Fair”, and 5% “poor”. If the City were to adopt the industry standard, the estimated costs for Streets would be reduced from \$491.0 to \$227.0 million bringing the total deferred maintenance costs to \$424.4 million. The condition level of streets and what standard the City should implement is a policy decision that needs to be discussed with the City Council.

Another policy discussion that the IBA recommends the City Council have concerns deferred maintenance expenditures related to public facilities. Depending on the needs and the overall condition of a facility, replacement might be more cost effective than expending funds to address long neglected deferred maintenance. It would be beneficial for staff to identify those facilities for which costs for deferred maintenance exceed the expenses related to the building of a new facility. The following table outlines the needs of 380 of the City’s major facilities (excluding the Civic Center Complex):

<b>Maintenance Need</b>	<b>Total Costs</b>
Critical/Immediate	\$2.1 million
Potentially Critical	\$8.6 million
Necessary	\$85.3 million
Recommended	\$1.4 million
<b>TOTAL</b>	<b>\$97.4 million</b>

In an August 17, 2009 Memorandum to the Chief Operating Officer, Councilmember DeMaio requested that the City develop a process for calculating and presenting annually the City’s Deferred Maintenance funding needs. This process would also ensure that the

City does not fall behind in addressing the deferred maintenance needs. The IBA has been working with Councilmember DeMaio's staff to develop a formula to meet this goal.

### ***Reserves***

The Outlook includes annual funding to meet the targets called for in the City's Reserve Policy for the General Fund Reserve, the Workers' Compensation Reserve, and the Public Liability Reserve. Over the five-year period, \$99.5 million is shown to be required to appropriately fund the three reserves: \$20.3 million for the General Fund; \$47.5 million for Public Liability; and \$31.7 million for Workers' Compensation.

#### ***General Fund Reserve***

The FY 2010 Adopted Budget includes no budgeted contribution to the General Fund reserve, though the budget reflects a \$1.66 million Appropriated Reserve. Together, the reserve balance totals \$75.4 million. Based on the FY 2010 Adopted Budget of \$1,129.7 million, a 7% reserve would require \$79 million on hand, leaving the current reserve \$3.6 million short. As estimated revenues are reduced for the General Fund, the 7% reserve target may be achieved without further contribution. The FY 2011 contribution shown in the Outlook reflects increased funding to bring the reserve level to the required 7.5%. In addition, the Outlook reflects annual contributions to meet the increasing reserve targets in order to achieve the 8% General Fund Reserve by FY 2014, and to maintain it through the remainder of the forecast period.

#### ***Workers' Compensation Reserve***

In recent years, the total outstanding liability of workers' compensation claims has decreased from \$160.7 million to \$156.1 million, and most recently, based on the latest estimate as of June 30, 2009, to \$148.2 million. As a result, the reserve target of 50% of claims by FY 2014 has dropped from a high of \$80.4 million to \$74.1 million.

According to the FY 2010 Adopted Budget, \$20.6 million has been budgeted for annual program costs, with an additional \$5 million budgeted for contribution to the reserve. The \$5 million contribution will bring the reserve balance to \$34.3 million. This is the appropriate amount to reach the reserve policy goal of 22% of claims, based on the FY 2008 claims valuation. To meet the increasing reserve requirement of 30% of claims for FY 2011, a reserve total of \$44.5 million is needed, requiring an additional contribution of \$10.2 million on a citywide basis, with \$8.1 million required from the General Fund. This is consistent with the information shown in the Outlook. The Outlook reflects contributions needed to achieve the increasing reserve policy targets.

With the reduction to the total claims liability of \$7.9 million, there is a corresponding reduction in the FY 2010 reserve requirement from \$34.3 million to \$32.6 million, or a drop of \$1.7 million. This could be considered as an area for review to generate savings that could mitigate the FY 2010 budget deficit.



### *Public Liability Reserve*

According to the Outlook, a draft June 30, 2009 valuation for public liability reflects total liability claims of \$129.4 million, which is an increase over the prior year's \$114.5 million. If the claims level remains steady, the Public Liability Reserve should reach \$64.7 million by FY 2014 to comply with the target of 50% of total claims as required by the Reserve Policy. As currently budgeted, it appears the 15% reserve target would require \$19.4 million, while the reserve balance is estimated to reach \$17.1 million by year-end. To meet the increasing reserve requirement of 25% of claims for FY 2011, a reserve total of \$32.3 million is needed, requiring an additional contribution of \$15.2 million, as shown in the Outlook. The Outlook reflects contributions needed to achieve the increasing reserve policy targets.

### ***Storm Water Permit Compliance***

Storm Water Permit compliance continues to be a significant policy area. The funding forecast in the Mayor's Outlook includes a budget of \$37.7 million for FY 2011 and remains at this level through the out-years. This reflects a significant reduction in projected funding when compared to prior versions of the Outlook. For example, in the Five-Year Outlook for FY 2008-2012, funding in FY 2009 was projected to reach \$57.8 million before leveling off in subsequent years. However, in FY 2009 the Department's budget was \$48.8 million.

The IBA recognizes the importance of maintaining an appropriate funding level for this significant area and in finding a balance between what is allocated to the Department and what can be spent in a fiscal year. Finding this balance is especially important in difficult economic times. The Storm Water Department was subject to nearly \$12 million in budget reductions in the FY 2009 First Quarter Adjustments and the FY 2010 Budget. These reductions were implemented to help better align allocated funding with spending trends. Despite the reductions that have been taken, in addition to the decrease in projected funding from prior Outlooks as explained above, the Storm Water Department has indicated that they will remain in compliance with the current Municipal Storm Water Permit.

It is important to note, the Municipal Permit was issued by the San Diego Regional Water Quality Control Board and became effective on March 24, 2008. It has a five-year life span and therefore, expires in the middle of the Outlook's forecast period. Once the new Municipal Permit is issued, the City may become subject to additional regulations. Storm water funding should continue to be closely monitored through the out-years as any additional regulations that are imposed may result in added costs to the City. And because funding is not expected to increase over the next five years, any future liability should be considered a risk to the Outlook.

In addition to the \$37.7 million budget, Storm Water is also utilizing a portion of the \$102 million Deferred Maintenance bond that was issued in March 2009. Of this

amount, Storm Water received \$13.9 million in order to complete twenty-eight storm drain replacement/repair projects.

### ***San Diego Chargers***

While not discussed in the Outlook as a significant policy area, the possibility of the San Diego Chargers terminating their agreement with the City has been the subject of recent discussion. The Chargers are obligated to pay the City a termination fee if they exercise their option to terminate their agreement between February 1<sup>st</sup> and May 1<sup>st</sup> of any year through 2020. The termination fee of \$54.7 million is significantly reduced to \$25.8 million in 2011. After 2011, the termination fee is gradually reduced annually from \$25.8 million in 2011 to \$3.5 million in 2020, and is eliminated after 2020. The City must make annual debt service payments of approximately \$5.8 million on Stadium Renovation Bonds (Bonds) through their maturity in 2027.

It is important to note that the Chargers will likely need an agreement with another city (which could take approximately two to three years for development of a new stadium) before they could reasonably opt to leave and terminate their agreement with the City. If the Chargers opt to leave, related net revenue to the General Fund is unlikely to be reduced and the City's ability to pay annual debt service on the outstanding Bonds would not be impacted. If, however, the Chargers were to terminate the agreement with the City in February 2011, the City will have at least three options:

- 1) Use the \$25.8 million termination fee to pay off an equal amount of the outstanding \$53 million of Bonds. If this option were pursued, the City would continue to make annual debt service payments on the Bonds through 2027; however the annual debt service payment would be reduced from \$5.8 million to approximately \$3 million saving the General Fund \$2.8 million annually.
- 2) Identify an additional \$21.4 million in the General Fund (to combine with the \$25.8 million termination fee and the \$5.8 million debt service reserve) to completely pay off all \$53 million of outstanding Bonds. If this option were pursued, the City's annual debt service requirement of \$5.8 million to be paid through 2027 (totaling approximately \$92.3 million) would be eliminated saving the General Fund approximately \$39.3 million.
- 3) Leave all of the Bonds outstanding and use the \$25.8 million termination fee for other purposes. Although the IBA believes there are no restrictions on how the termination fee can be used, we recommend that permissible uses of the termination fee be further reviewed by the Office of the City Attorney. If this option were pursued, the City would continue to make the current annual debt service payment of \$5.8 million through 2027.

## RISKS TO OUTLOOK

This section provides a summary of potential risks to the Outlook, most of which have been discussed in prior sections of this report. While not intended to be comprehensive, these risks are deemed to be significant, with the potential to exacerbate the deficits reflected in the Five-Year Outlook.

### ***Revenue Assumptions***

As outlined earlier in this report, the IBA has concerns regarding the risks associated with the property tax and TOT forecasts in the Outlook. Particularly for the property tax forecast, further than anticipated declines in the commercial real estate market and an uptick in foreclosure rates can prolong the recovery period. A slower recovery in property tax receipts, as depicted by the Low Scenario of the property tax sensitivity analysis, would equate to a cumulative reduction of \$128.8 million in the forecasted receipts over the five year period, as reflected in the table below.

<b>Property Tax Risk (in millions)</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Mayor's Outlook	\$ 391.6	\$ 399.4	\$ 411.4	\$ 427.8	\$ 444.9
Low Scenario	\$ 380.0	\$ 380.0	\$ 383.8	\$ 395.3	\$ 407.2
<b>Difference</b>	<b>\$ (11.6)</b>	<b>\$ (19.4)</b>	<b>\$ (27.6)</b>	<b>\$ (32.5)</b>	<b>\$ (37.7)</b>

For the TOT forecast, assuming lower than expected performance in FY 2010 would equate to a cumulative loss of \$4.0 million over the five year period for every percentage point decrease beyond the projected 4.0% decline. An additional 4% decline would equate to a cumulative reduction of \$16 million in TOT revenue, as shown below.

<b>TOT Risk (in millions)</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Mayor's Outlook	\$ 71.9	\$ 74.1	\$ 76.7	\$ 79.7	\$ 82.9
Potential Decline <sup>1</sup>	\$ 68.9	\$ 71.0	\$ 73.5	\$ 76.4	\$ 79.5
<b>Difference</b>	<b>\$ (3.0)</b>	<b>\$ (3.1)</b>	<b>\$ (3.2)</b>	<b>\$ (3.3)</b>	<b>\$ (3.4)</b>

1. Assumes an additional 4 percent decline in FY 2010 receipts over FY 2009.

### ***Salary Increases***

The Outlook assumes no salary increases over the five-year forecast period. In fact, as the adopted FY 2010 Budget is the initial basis for projection, the Outlook results in no reinstatement of the 6% reduction in compensation, and appears to reflect the continuation of mandatory furloughs that were incorporated in the FY 2010 Budget as cost-saving measures, beyond the term of current labor agreements. The Outlook states that each one percent salary increase would result in added salary and fringe benefit costs

of \$5.2 million for the General Fund. Given the 6% reduction to compensation in Fiscal Year 2010, we do not believe it is realistic or a sound business decision to assume no salary increases for the entire forecast period.

The IBA prepared estimates of annual salary increases during the forecast period, reflective of a one percent increase in Fiscal Year 2012 and Fiscal Year 2013, with an additional two percent increase in both Fiscal Years 2014 and 2015. This scenario would effectively restore the 6% reduction that became effective in Fiscal Year 2010. These estimates include a conservative estimate of 20% for the portion of fringe benefits that would correspondingly increase as salaries rise. Many components of fringe benefits are fixed, including the annual pension contribution, and would not immediately increase because of salary increases. As shown in the table below, the IBA's analysis of this particular salary increase scenario would result in annual increases to the General Fund ranging from \$6.3 million to \$38.4 million (for a total of \$72.2 million) over the forecast period. These estimates do not consider the added future costs to the pension system.

<b>General Fund Impact of Possible Salary Increases (in millions)<sup>1</sup></b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Salaries and Wages Forecast	\$516.1	\$512.1	\$521.3	\$527.5	\$536.7	\$523.1
Increased Salaries and Wages				\$533.8	\$549.4	\$548.9
<i>Annual Percentage Salary Increase</i>	-	0%	1%	1%	2%	2%
Increase to Salaries and Wages	-	\$ -	\$ 5.2	\$ 5.3	\$ 11.0	\$ 10.5
Increase to Fringe Benefits	-	\$ -	\$ 1.0	\$ 1.1	\$ 2.2	\$ 2.1
Subtotal Annual Impact	-	\$ -	\$ 6.3	\$ 6.4	\$ 13.2	\$ 12.6
<b>TOTAL GENERAL FUND IMPACT</b>		<b>\$ -</b>	<b>\$ 6.3</b>	<b>\$ 12.7</b>	<b>\$ 25.8</b>	<b>\$ 38.4</b>

1. Estimates assume an increase to fringe benefits of 20% of amount of salary increases for variable fringe benefit items. Typical fringe benefit rate as reflected in forecast ranges from 68% to 80%.

### ***State Impacts***

Future impacts to the City as a result of chronic State budget deficits continue to be a significant risk to the Outlook. In FY 2010, the State raided City funds in addressing its own budget deficit through the borrowing provision under Proposition 1A and ERAF shifts from Redevelopment. These actions are anticipated to result in a \$36 million loss of property tax for the General Fund in FY 2010, and a \$55 million loss of tax increment for the Redevelopment Agency. While it is anticipated that the State will establish a securitization program for the Proposition 1A borrowing in order to hold cities harmless, details of this program have yet to be finalized.

Despite the actions already taken by the State in FY 2010, it remains likely that subsequent actions will further impact City revenues. In FY 2010, California cities narrowly avoided a State proposal to take local Gas Tax revenues, and it is highly probable that these revenues will once again be sought by the State as further deficits are

addressed in either the current year or future fiscal years. An update on the State budget presented by the Intergovernmental Relations Department to the Budget and Finance Committee on September 9, 2009 indicated that the State budget was already out of balance by \$8 – \$10 billion in the current year. In addition, the California Redevelopment Association has filed suit against the State over the FY 2010 ERAF shift. If this lawsuit prevails, the gap in the State budget would be widened considerably. Since the State has already exercised its option to borrow property tax revenues under Proposition 1A, local Gas Tax revenues will likely be among the first funding options considered under future actions.

The Five-Year Outlook maintains Gas Tax revenues at the FY 2010 Budget level of \$24.6 million (\$23.1 million General Fund) throughout the Outlook period. Given the current year deficit at the State level, and the anticipated deficits in future years, Gas Tax should be considered an at-risk revenue source for the City of San Diego.

### ***Retiree Health***

As previously discussed, the Five-Year Outlook forecasts a \$62.2 million payment to the retiree medical program for FY 2011, which is 52% of the FY 2011 Annual Required Contribution (ARC). This does not reflect a risk to the Outlook, as payment of the full \$120.3 million ARC is not legally required. However, the growing Unfunded Actuarial Liability (UAL) – estimated at \$1.36 billion for June 30, 2010 – continues to be an obligation which needs to be addressed long-term.

Additionally, a comparison of Buck Consultants' expected pay-as-you-go (PAYGO) future cash flows to the FY 2010 through FY 2015 forecasted amounts in the Five-Year Outlook shows a cumulative shortfall of \$52.7 million. If the PAYGO costs reach Buck Consultants' projection during the forecasted period, the excess costs will increase the shortfall in the Outlook, as shown in the table below.

<b>Comparison of PAYGO Estimates</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Mayor's Outlook	\$ 32.1	\$ 37.2	\$ 42.3	\$ 47.5	\$ 52.9	\$ 58.2
Buck Consultants	38.4	44.4	50.5	56.7	63.3	69.6
<b>Difference</b>	<b>\$ (6.3)</b>	<b>\$ (7.2)</b>	<b>\$ (8.2)</b>	<b>\$ (9.2)</b>	<b>\$ (10.4)</b>	<b>\$ (11.4)</b>

### ***Storm Water Compliance***

As stated previously, the current Storm Water Municipal Permit has a five-year life span and is scheduled to expire by 2013, in the middle of the Outlook's forecast period. Once the new Municipal Permit is issued, the City may become subject to additional regulations in areas such as Total Maximum Daily Load (TMDL) and Areas of Special Biological Significance (ASBS) regulations, Cleanup and Abatement Orders (CAO), channel clearing mitigation costs for the Master Storm Water Maintenance Plan, and

other regulatory and operational needs. These increased regulations may require the allocation of additional General Fund resources.

***Emergency Operations Center Relocation***

The proposed redevelopment of the Civic Center Plaza does not assume that the City's Emergency Operations Center (EOC) will be located in the new facilities. Depending on the scope of the project, the costs to relocate and build a new EOC could be significant and are undetermined.

The following chart shows the potential impact of the identified risks to the Mayor's Five-Year Outlook:

	FY 2011 Forecast	FY 2012 Forecast	FY 2013 Forecast	FY 2014 Forecast	FY 2015 Forecast
<b>Five-Year Outlook Projected Deficit</b>	<b>\$ (179.1)</b>	<b>\$ (158.8)</b>	<b>\$ (155.9)</b>	<b>\$ (165.9)</b>	<b>\$ (136.5)</b>
<b>Risks</b>					
<b>Revenue Scenarios</b>					
Property Tax	\$ (11.6)	\$ (19.4)	\$ (27.6)	\$ (32.5)	\$ (37.7)
TOT	\$ (3.0)	\$ (3.1)	\$ (3.2)	\$ (3.3)	\$ (3.4)
<b>Potential State Impact</b>					
Gas Tax	\$ -	\$ (23.1)	\$ (23.1)	\$ (23.1)	\$ (23.1)
<b>Expenditures</b>					
Potential Salary & Fringe Increases	\$ -	\$ (6.3)	\$ (12.7)	\$ (25.8)	\$ (38.4)
Retiree Health Difference from Buck Consultant's PAYGO Estimates	\$ (7.2)	\$ (8.2)	\$ (9.2)	\$ (10.4)	\$ (11.4)
Storm Water Compliance	TBD	TBD	TBD	TBD	TBD
Emergency Operations Center Relocation (Based on Civic Center Redevelopment)	TBD	TBD	TBD	TBD	TBD
<b>Total:</b>	<b>\$ (200.9)</b>	<b>\$ (218.9)</b>	<b>\$ (231.7)</b>	<b>\$ (261.0)</b>	<b>\$ (250.5)</b>

## POTENTIAL SOLUTIONS

This section identifies a few potential solutions that may help to mitigate the projected deficits. In contrast with our review of the Outlook in prior years, relatively few meaningful solutions appear to exist short of budget and service reductions. Furthermore, a number of the solutions identified below are longer-term in nature, and cannot be relied upon to address the projected shortfall in FY 2001.

### *Delay Reserve Contributions*

The Outlook reflects the annual contributions needed to meet the increasing reserve policy targets for the reserves for the General Fund, Workers' Compensation, and Public Liability. The Reserve Policy requires the General Fund reserve reach 8% of total General Fund revenues by Fiscal Year 2012, and that both the Workers' Compensation and Public Liability reserves reach 50% of the respective outstanding claims by Fiscal Year 2014.

In order to achieve these goals, the Outlook includes \$27.5 million in reserve contributions from the General Fund for Fiscal Year 2011, declining to \$3.2 million in Fiscal Year 2015, as shown below.

Forecast - Annual Reserve Contributions (in millions)	FY 2010 Budget	FY 2011 Forecast	FY 2012 Forecast	FY 2013 Forecast	FY 2014 Forecast	FY 2015 Forecast
General Fund Reserve	\$ -	\$ 4.2	\$ 7.9	\$ 2.5	\$ 2.5	\$ 3.2
Workers' Compensation Reserve	4.1	8.1	5.9	8.3	9.4	-
Public Liability Reserve	7.1	15.2	12.9	12.9	6.5	-
<b>TOTAL</b>	<b>\$ 11.2</b>	<b>\$ 27.5</b>	<b>\$ 26.7</b>	<b>\$ 23.7</b>	<b>\$ 18.4</b>	<b>\$ 3.2</b>

Because of the significant financial constraints facing the General Fund in Fiscal Year 2011, consideration could be given to extend the period of time to reach the reserve policy goals. One scenario could be to eliminate the 2011 contribution to the Workers' Compensation and Public Liability reserves, and postpone achieving the 50% of claims target by one year to Fiscal Year 2015. In essence, this scenario reduces the reserves amount and the reserve percentage to below the targets called for in the Reserve Policy. By postponing the goal by one year, these contributions would be needed instead in Fiscal Year 2015.

<b>Workers' Compensation Reserve Scenario (in millions)</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
WC Reserve Policy Target	22%	30%	35%	42%	50%	50%
WC Reserve Contribution	4.1	8.1	5.9	8.3	9.4	-
Eliminate 2011 funding of \$8.1 M	\$ 4.1	\$ -	\$ 5.9	\$ 8.3	\$ 9.4	\$ 8.1
Revised Reserve Balance		\$ 34.3	\$ 42.3	\$ 52.1	\$ 63.6	\$ 74.2
Revised Reserve Percent of Claims		23%	29%	35%	43%	50%

*Note: assumes total claims amount of \$148.2 million*

For the Workers Compensation Reserve, eliminating the \$8.1 million contribution for next year would maintain the reserve balance at \$34.3 million and keep the reserve as a percentage of claims at 23%, instead of 30% as the policy requires.

For the Public Liability Reserve, eliminating the \$15.2 million contribution for next year would maintain the reserve balance at \$17.1 million and keep the reserve as a percentage of claims at 13%, instead of 25% as the policy requires.

<b>Public Liability Reserve Scenario (in millions)</b>	<b>FY 2010 Budget</b>	<b>FY 2011 Forecast</b>	<b>FY 2012 Forecast</b>	<b>FY 2013 Forecast</b>	<b>FY 2014 Forecast</b>	<b>FY 2015 Forecast</b>
Public Liability Reserve Policy Target	15%	25%	35%	45%	50%	50%
Public Liability Reserve Contribution	\$ 7.1	\$ 15.2	\$ 12.9	\$ 12.9	\$ 6.5	\$ -
Eliminate 2011 funding of \$15.2 M	\$ 7.1	\$ -	\$ 12.9	\$ 12.9	\$ 6.5	\$ 15.2
Revised Reserve Balance		\$ 17.1	\$ 30.0	\$ 42.9	\$ 49.4	\$ 64.6
Revised Reserve Percent of Claims		13%	23%	33%	38%	50%

*Note: assumes total claims amount of \$129.4 million*

Together, this scenario would provide budgetary relief of \$23.3 million to the General Fund. However, this is just one proposal; other scenarios to alter the reserve contribution schedules could be reviewed and considered.

In the FY 2008 City's Comprehensive Annual Financial Report, it was discussed that reserve goals were being reassessed due to the economic downturn, and continued decline in General Fund revenues. The IBA has previously recommended that the City Council may wish to discuss with the Chief Financial Officer the status of any reassessment. Further, the implications of postponing the attainment of the Reserve Policy goals on the City's credit rating, if any, should be considered, and balanced with other priority needs, given the City's current budgetary situation, and the economic environment.



### ***Unanticipated Vacancy Savings***

The City currently has an estimated 800 vacant positions, many of which were anticipated and captured in the FY 2010 Annual Budget's Vacancy Savings projections. However, a significant number of employees decided to retire late in FY 2009 due to changes in the interest rate for the DROP Program. As a result, additional unanticipated vacancies have occurred which will likely reduce salary costs. As discussed in the Police and Fire-Rescue Academies section of this report, the IBA estimates that the Police Department's vacancy savings could exceed budgeted projections by \$19.0 million if positions were to remain vacant. On September 21, 2009 the Chief Operating Officer announced a hiring freeze for all vacant positions supported by the General Fund. Given the freeze, additional unbudgeted salary savings could bring some relief in the current year and beyond depending on the length of the freeze; however, further analysis is needed to definitively determine whether this is the case. In addition, these vacant positions should be carefully reviewed for potential reduction which would result in permanent savings.

### ***Managed Competition***

On November 7, 2006 San Diego voters approved Proposition C, which amended the City Charter to allow the contracting out of non-Public Safety services by utilizing a "managed competition" method. However, prior to execution of the program, AFSCME Local 127 (later joined by MEA) filed an Unfair Labor Practices Charge, which was upheld by the California Public Employment Relations Board (PERB). As a result, ongoing negotiations have been occurring between the two labor unions and the City.

Since then, on September 29, 2009, it was announced that after several months of negotiations the parties were not able to reach an agreement on various guidelines for the program. Therefore, an impasse has been declared.

The IBA believes the Managed Competition program is important for the City and may incur needed savings during the forecast period. However, it is important to note that once the program is executed, it should not be relied on to drastically reduce the FY 2011 or any future deficits. Furthermore, at this point it is uncertain whether it can be implemented in time to achieve any cost savings for FY 2011.

### ***Pension & Benefit Reform***

Savings to the pension system and City expenses could be explored through suspension of retirement benefit Cost of Living Adjustments (COLA's), as well as changes to the Deferred Retirement Option Plan (DROP). The City is exploring the cost neutrality of DROP, as well as the possibility for elimination of the program. Additionally, the City is endeavoring to change from a defined benefit to a defined contribution postretirement healthcare plan for employees hired before July 1, 2005. While potential saving from these reforms may be significant, they are long-term in nature and cannot be relied upon to address near-term deficits.

### ***New Revenues***

In the IBA's review of the Five-Year Financial Outlook for FY 2010-2014 (Report No. 09-02), a number of new or increased revenue options were presented as possible solutions to the projected deficits, including a storm water fee and a refuse collection fee. However, there has been little political support for significant new revenue increases, and no action has been taken to date to place a revenue measure on the ballot. While increasing revenues remains an option for balancing projected future shortfalls and addressing the City's structural deficit, it is not a viable option for FY 2011.

## **CONCLUSION**

Significant actions have been taken over the past four years to move the City toward financial health. General Fund expenditures have been reduced; City operations have been streamlined to achieve efficiencies; best practice goals for the City's reserves have been established and met; pension benefits have been reformed for all new employees; the City's outstanding Comprehensive Annual Financial Reports have been completed; and the City's bond ratings have been reinstated. Without these accomplishments, the City's fiscal challenges would be even more daunting. That aside, it is devastating to this City's residents and businesses as well as City officials and city employees to now be facing the largest budget deficit in its history. Pension underfunding of the past, overlaid with the negative effects of the recession on pension investment returns as well as City revenues, are the principal factors behind the financial outlook as it stands today.

The IBA largely concurs with the financial projections reflected in the FY 2011-2015 Outlook. Through our review and analysis, we have also identified a number of potential risks that could potentially exacerbate the projected deficits during the Outlook period. As in the past, we have also identified some factors that could help mitigate the shortfalls, though none of these items can generate the necessary savings or be enacted in time to address the FY 2011 deficit in any significant way. More notable, and in contrast with our three prior reviews of the Mayor's Outlooks, is that we believe there are few viable solutions available short of reductions to City services and positions. Given the likely magnitude of the reductions that will be needed, we believe that a process should begin immediately to define the City's core services in order to begin establishing funding priorities.

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