



THE CITY OF SAN DIEGO
MANAGER'S REPORT

DATE ISSUED: October 6, 2005 REPORT NO. 05-202

ATTENTION: Honorable Deputy Mayor and City Council
Docket of October 10, 2005

SUBJECT: Fiscal Year 2006 General Fund Financial Status and Budgetary Update
Report

REFERENCE: City Council Meeting July 19, 2005

SUMMARY

Issue – Should the City Council accept the City Manager’s Fiscal Year 2006 General Fund Financial Status and Budgetary Update Report?

Manager’s Recommendations – Accept the City Manager’s Fiscal Year 2006 General Fund Financial Status and Budgetary Update Report.

Other Recommendations – None.

Estimated Fiscal Impact – The recommended actions in this report will ensure a balanced General Fund.

BACKGROUND

The Mayor and City Council approved the Fiscal Year 2006 Appropriation Ordinance on July 19, 2005. Direction was given to the City Manager to return in the fall to report how the General Fund was performing and to insure that the General Fund would remain in balance.

Subsequent to the approval of the Appropriation Ordinance, actions conducted by the State resulted in a net General Fund revenue loss of \$12.7 million. The City lost \$5.2 million in General Fund Booking Fee reimbursements when the State eliminated funding for this program. More recently, the City has been informed that it will lose an additional \$8.3 million due to erroneous calculations made by the State in Fiscal Year 2005 regarding the sales tax “triple-flip,” which became effective July 1, 2004. Partially offsetting these revenue losses is a rebate from the Vehicle License Fee (VLF) debt service of approximately \$830,000. These revenue challenges, in addition to both immediate and future spending needs, are discussed in this report.

DISCUSSION

The General Fund remains fluid throughout each fiscal year. Budget decisions are made based on estimates, historical trends and requested levels of service. However, priorities are reassigned, major events take place, and uncontrollable external actions occur. All of these influences bring about changes to both the revenue and expenditure aspects of the budget. As identified in this report, through the first quarter of the fiscal year, numerous challenges have surfaced which require consideration, discussion, and ultimately, direction for solutions.

It is important to begin the discussion of the current Fiscal Year 2006 budget status with a review of the fiscal standing of Fiscal Year 2005 year-end. The City Auditor and Comptroller reported to the City Council on September 19, 2005 that the close out of the Fiscal Year 2005 General Fund budget included additional expenditures of approximately \$37 million and additional revenue of approximately \$46 million. The \$9 million difference between the \$46 million in revenues and \$37 million in expenses was budgeted in the Fiscal Year 2006 Budget as carryover from Fiscal Year 2005. This was presented in the Fiscal Year 2006 Proposed Budget document on page 118.

The \$37 million in additional expenditure requirements were reimbursable expenditures consistent with providing existing City services. These additional expenses were fully covered by the \$46 million dollars of over-budget revenue. These expenses included increased Police Department overtime and services to non-city agencies and organizations; Fire Department overtime and support to the Port of San Diego; General Fund department services associated with Capital Improvement Program (CIP); and TransNet funded activities.

The identification of additional Fiscal Year 2005 expenditures cannot be reconciled without also taking into consideration the existence of increased revenues; neither one can be viewed in isolation. While it is technically accurate to state that the General Fund had “\$46 million in over-budget revenue” in Fiscal Year 2005, it is critical to realize that this additional revenue was absolutely necessary to fund the \$37 million in additional expenditures. Furthermore, gains in the major revenues were generally within one to two percent of the budgeted amounts. In no way should the existence of this revenue be interpreted to mean that there is \$46 million of “free” money available for discretionary projects or programs. The primary source of the additional revenue was reimbursement of City labor costs for services performed, State and federal grants, FEMA reimbursements, and tobacco settlement revenue. The tobacco settlement revenue is consistently budgeted as carryover in the subsequent fiscal year and not generally counted as over-budget revenue. In past practice, revenue balances were typically handled administratively under the authority of the Appropriations Ordinance. The City’s new Auditor and Comptroller has indicated, in the spirit of public awareness, that actions such as these should be presented for discussion

Separate from the previously identified carryover of \$9 million dollars, the City Auditor also identified an additional \$15 million dollars during the closing of the Fiscal Year 2005 books. The net effect of this additional \$15 million was reflected within the Fiscal Year 2005 expenditure and revenue balances in the September 19, 2005 report to the City Council by the Auditor. As reported to the City Manager’s office, the Auditor transferred available funds to various accounts in anticipation of funding Fiscal Year 2006 obligations. One example of this was to record the Fiscal Year 2006 General Fund budget allocation for Public Liability as a “pre-

payment” in Fiscal Year 2005. The result of this approach is that the Fiscal Year 2006 Budget was relieved of approximately \$15 million in budgeted obligations, freeing up an equivalent amount of revenue. These actions were fully consistent with authority provided in the Appropriation Ordinance which is consistent with Generally Accepted Accounting Principles (GAAP). This excess funding is one-time revenue that could be used at the discretion of the City Council. It is recommended that this additional revenue be used as the solution to the net loss of \$12.7 million in General Fund revenue as a result of State impacts, as well as a partial funding source for immediate unbudgeted spending needs.

Aside from the revenue shortfall brought about by State action, numerous immediate and future spending needs have been identified that may change the bottom line of the General Fund. These challenges will continue to pose significant strain on the General Fund, and could impact the financial position of the City as well as the services provided. It is ultimately the authority of the City’s legislative body that will determine appropriate action; however, as directed, the facts and issues presented herein serve as recommendations for appropriate action to maintain a balanced General Fund.

The challenges discussed in this report are categorized into three groups: 1) Fiscal Year 2006 State revenue impacts; 2) immediate spending needs and; 3) future spending needs. Within each of these sections, proposed solutions to address each of the respective challenges are identified and discussed. While the challenges outlined in this report are not in any particular order of priority, it is widely understood that the City’s top priority is the completion of the ongoing investigations and the Fiscal Year 2003, 2004, and 2005 Financial Statement audits.

STATE IMPACTS

Actions by the State of California will result in a substantial loss in revenue for the City of San Diego in Fiscal Year 2006. These actions will result in a net loss of approximately \$12.7 million in General Fund revenue that will affect the Fiscal Year 2006 Budget. As a result, mitigation will be required to maintain financial balance in the General Fund. This section describes the revenue impacts that have been brought about by State action.

State Triple-Flip Correction - \$8.3 million net revenue loss

On August 31, 2005, the State Department of Finance (DOF) notified the County of San Diego that there would be a large negative adjustment or “settle-up” due to a one-time correction related to the triple-flip, a complex revenue shift enacted by the State in Fiscal Year 2005 (Attachment 1). The negative adjustment will result in a loss of up to \$9.0 million in revenue for the City of San Diego in Fiscal Year 2006. However, the State’s estimate of the Fiscal Year 2006 reimbursement is approximately \$0.7 million greater than that which the City budgeted, resulting in a net loss of \$8.3 million, as shown in the table on the following page. This loss was unknown and not anticipated during the development of the Fiscal Year 2006 Budget.

TRIPLE-FLIP CORRECTION	
FY06 Reimbursement Estimated by the State	\$54.4 million
FY06 Correction for Overpayment in FY05	(\$9.0 million)
Net FY06 Reimbursement	\$45.4 million
FY06 Budgeted Reimbursement	\$53.7 million
Net FY06 Reimbursement (from above)	\$45.4 million
FY06 Net Loss to the City	(\$8.3 million)

According to State law, the property tax reimbursement in any given year is based on sales tax receipts in the prior fiscal year. The law provides for a “settle-up” in the following year, or reconciliation between the reimbursement amount and the actual loss due to the triple-flip. If the reimbursement amount is less than the actual loss, then there will be a positive settle-up; if the reimbursement is greater than the actual loss, then the settle-up will be negative. A detailed description of the triple-flip may be found in Volume I of the Annual Fiscal Year 2005 Budget Document, and in the Fiscal Year 2005 Financial Review and Status Report.

In Fiscal Year 2005, the first year of implementation, the property tax reimbursement amounts were calculated by the State Department of Finance. However, as the first settle-up period approached in Fiscal Year 2006, the State Board of Equalization (BOE) informed the DOF that it had erred in its initial estimate of the reimbursement amounts, and that a Statewide total of approximately \$173 million had been overpaid to local governments in Fiscal Year 2005. While this issue continues to be negotiated at the State level, the final impact to the City of San Diego may be as high as \$9.0 million;

Since Fiscal Year 2005 was the first year of implementation of the triple-flip, local governments had no established methodology upon which to base their budget projections. Furthermore, no guidance or direction was given by the State, presumably because the various State agencies were still in the process of determining the correct methodologies themselves. As a result, the City of San Diego independently estimated that the Fiscal Year 2005 reimbursement amount would be approximately \$49.2 million – an estimate that proved to be quite close to the DOF’s initial estimate. Since the City’s estimate and the figure reported by the DOF were so close, there was no indication that an error had been committed by either party. In fact, correspondence with the League of California Cities and the DOF during the course of the year indicated that there would likely be a positive true-up in Fiscal Year 2006. Fortunately, it appears that both agencies are now using the same methodology, so such a large negative true-up should not occur in the future.

State Booking Fee Reimbursements - \$5.2 million revenue loss

The Governor’s Fiscal Year 2005-2006 Proposed Budget, released in January 2005 and revised in May, did not include funding for booking fee reimbursements. The City’s Fiscal Year 2006 Proposed Budget retained the \$5.2 million for booking fees reimbursements in anticipation that the appropriation would be restored, as was the case in the previous year. The City Council was

informed that staff would continue working with the State to reach a solution. As State budget negotiations progressed, it appeared that the Legislature was poised to adopt a substitute program whereby cities would be able to apply for “hardship” funding related to the loss of booking fees. This program would have allowed the City to recoup at least a portion of the \$5.2 million that was budgeted for booking fees. However, when the 2005-2006 State Budget was signed into law on July 11, the substitute program was not included, leaving the City with a revenue shortfall of \$5.2 million.

Vehicle License Fee Debt Service Savings - \$830,000 revenue gain

The City has received a rebate of approximately \$830,000 as a result of the early repayment of the Vehicle License Fee (VLF) Gap Loan by the State of California, partially offsetting the revenue losses previously discussed. A detailed explanation of the VLF Gap can be found in City Manager’s Report 05-035. On February 14, 2005, the Mayor and City Council authorized the sale of the City’s VLF Gap receivables to the California Statewide Communities Development Authority (CSCDA), a joint powers authority sponsored by the League of California Cities and the California State Association of Counties. The CSCDA coordinated a pooled financing to issue “VLF Notes,” enabling CSCDA to use the note proceeds to purchase local entities’ VLF receivables, which would then be paid by the State directly to CSCDA for the purpose of retiring the notes. City Manager’s Report 05-035 explains the securitization program in greater detail. Originally, repayment of the VLF Gap Loan was scheduled for August 15, 2006; however, the State has repaid the VLF Gap Loan early, thereby relieving CSCDA from one scheduled debt payment. The savings generated by this early repayment will be rebated to the City in the amount of approximately \$830,000.

The table below summarizes the unanticipated Fiscal Year 2006 State Impacts:

Fiscal Year 2006 Unanticipated State Impacts						
	Triple-Flip Correction					(\$8.3 million)
	Booking Fees					(\$5.2 million)
	VLF Debt Service Savings					\$0.8 million
	Estimated Surplus/(Deficit)					(\$12.7 million)

Proposed Solution: Additional Fiscal Year 2005 Surplus Carryover

As previously identified, the unanticipated Fiscal Year 2005 surplus carryover identified in the previous section is sufficient to fully mitigate the revenue losses due to the State. This surplus carryover is a one-time revenue gain that compensates for a one-time revenue loss. While it may be tempting to use this surplus carryover to restore programs that have been reduced or eliminated, such an approach will not benefit the City in the long-term, and could prove detrimental to the City’s financial situation. Even with the significant budget reductions that were included in the Fiscal Year 2006 Budget, Moody’s Investor Services, in their most recent action against the City, stated that, “In adopting its budget for fiscal 2006 the city’s council adhered to its policy with respect to budgeted reserves, but did not appear to be prioritizing

structural balance.” Moody’s also noted that the City Council increased the City Manager’s Proposed Budget by approximately \$7 million, funded primarily with one-time revenues.

The table below summarizes the Fiscal Year 2006 State Impacts and the proposed solution.

Proposed Solution to State Impacts						
	State Revenue Impacts					(\$12.7 million)
	Additional Carryover from FY 2005					\$15.0 million
	Surplus/(Deficit)					\$2.3 million

As this chart indicates, even after mitigating the revenue losses resulting from State impacts, an additional \$2.3 million remains available for use as a partial solution to the immediate spending needs, discussed in the next section.

IMMEDIATE SPENDING NEEDS

This section discusses immediate spending needs for Fiscal Year 2006. The items discussed in this section are not presented as discretionary priorities, but rather as required expenditures for the continued progress of City operations. These expenditures are unanticipated and were not included in the Fiscal Year 2006 Budget; therefore, appropriate mitigating solutions will be identified in order to keep the General Fund in balance.

Audit, Financial Investigation and Legal Expenses - \$6.9 million spending need

While it is anticipated that the ongoing independent audit of the City’s Fiscal Year 2003 Comprehensive Annual Financial Report will reach a conclusion at or near the end of this calendar year, the City continues to incur substantial expenses related to the financial investigations, actuarial requirements and legal defense. To date, total funds authorized for these purposes exceed \$18 million; of that amount, \$5.75 million has been approved in Fiscal Year 2006, with approximately \$4.1 million attributable to the General Fund.

In Fiscal Year 2006, the City increased the Public Liability Fund by approximately \$1.4 million in anticipation of increased General Fund liabilities, including ongoing costs related to the external audit and financial investigation. However, authorized General Fund expenses to date have already exceeded this amount by approximately \$2.7 million. In addition, based on current spending rates, another \$4.2 million in General Fund expenditures is estimated to be required for the financial investigations, actuarial requirements and legal defense expenses through January 2006, resulting in a total need of approximately \$6.9 million which represents the General Fund allocation.

Document Repository - \$2.5 million spending need

The City of San Diego continues to fully cooperate with ongoing SEC investigations. City employees have complied with numerous subpoenas, producing more than one million pages of paper and over sixty thousand electronic files to date. In order to assist in reviewing the voluminous number of documents, a centralized document repository has been established to coordinate and streamline response efforts. On September 12, 2005, the City Council approved \$2.5 million for the various expenses related to the document repository (Resolution R-300822), including \$750,000 for attorney and paralegal services, \$85,000 for leased office space related to the repository, and \$727,000 for an electronic conversion and hosting service for document review. These expenditures are necessary in order for the Audit Committee to complete its independent investigation by December 2005.

Stormwater Monitoring - \$1.5 Million

On May 6, 2005, the City of San Diego received a Notice of Violation (NOV) from the San Diego Regional Water Quality Control Board, Region 9 (Regional Board), for failure to conduct required follow-up investigations of dry weather field screening results. The NOV requires that the City ensure that adequate corrective measures are implemented immediately to address these violations. The City provided an interim response to this NOV to the Regional Board on Friday, August 26, 2005. Funding of \$1.1 million will be required to allow the Storm Water Pollution Prevention Division to hire as-needed consultant services to perform follow-up investigations as required by the Regional Board.

Additionally, there are three areas that may potentially cause significant costs or fines should the City neglect to immediately address these issues. The areas and required amounts are as follows:

1. Chollas Creek Total Maximum Daily Loads (TMDL) - \$75,000
2. Areas of Special Biological Significance - \$75,000
3. Cleanup and Abatement Order – \$250,000

Further detail is provided on Attachment 2 in a memo to the Deputy Mayor and City Council.

Publishing Services Move to Community Concourse – \$500,000

The lease of the Publishing Services Division facility will expire in October 2005. In anticipation of a possible relocation, and under the direction of the City Council to maximize City owned facilities, Plaza Hall of the Concourse was identified as the likely candidate for relocation. This City-owned downtown location would provide Publishing Services with a convenient location for its customers in City Hall, the Development Review Center, Civic Center Plaza, and the Executive Complex. Also, this would enable the Division to consolidate its CAB Quick Print/Copy Center (currently located in the basement of City Hall) to the larger, full-service operations at Plaza Hall.

Before this relocation could occur, the facility required tenant improvements to provide an area suitable for Publishing Services, including the assembly of office space, electrical upgrades, and

installation of voice and data lines. These improvements, to be completed by City forces, are estimated to cost approximately \$500,000. Initially, these costs were to be funded by the lease payment from a prospective Golden Hall tenant. However, since this funding was not made available, the General Fund will provide the funding up front and the Publishing Services revolving fund will then repay the General Fund over seven years.

Upon successful completion of this relocation, Publishing Services will begin paying annual rent of approximately \$250,000 to the General Fund that had previously been expensed to a private landlord.

San Diego Concourse Fire – \$ 1.0 million

On August 18, 2005, the City of San Diego's Civic Theatre had a backstage fire when a control panel apparently malfunctioned, causing the halogen lights to come on and ignite the stage curtains. The fire was quickly extinguished by the automatic sprinkler system. While the fire did little physical damage, there was extensive water damage to the stage area and basement below the stage, where up to four inches of water were left in some places.

Eventually, the majority of these bills will be reimbursed by the insurer, if they relate to the structure or contents that belong to the City. The San Diego Convention Center Corporation and San Diego Theatre are also involved in the losses. The projected repair costs are between \$500,000 and \$1,000,000. The City must pay the contractors up-front and then be reimbursed through insurance proceeds. Because of the lag time involved in getting reimbursement, up to \$1 million will be needed to keep positive cash flow.

The table below provides a summary of the unbudgeted immediate spending needs:

Fiscal Year 2006 Unbudgeted Immediate Spending Needs			
	Audit, Financial Investigation and Legal Expenses		\$6.9 million
	Document Repository		\$2.5 million
	Stormwater Monitoring		\$1.5 million
	Publishing Services Move to Community Concourse		\$0.5 million
	San Diego Concourse Fire		\$1.0 million
	Total Estimated Immediate Spending Needs		\$12.4 million

PROPOSED SOLUTIONS

The immediate spending needs outlined in the preceding sections represent the ongoing operating requirements that are critical for the continued provision of City services. The expenditures identified in this section should be regarded as the normal costs of doing business, since unanticipated events such as these are bound to occur in each fiscal year. Regardless, these unanticipated expenditure requirements create an additional burden on the General Fund, and will need to be mitigated through either midyear budget cuts or the use of surplus General Fund revenue. While both of these potential solutions are discussed below, it is strongly

recommended that the immediate spending needs be mitigated with midyear budget cuts. These unbudgeted spending needs are not brought about by State action, nor are they the result of revenue deficits; rather, they are operating expenditure challenges and as such, should be addressed through expenditure reductions. Both of the potential solutions are presented in the following tables.

UNBUDGETED IMMEDIATE SPENDING NEEDS

Potential Solution #1 (Recommended): Midyear Budget Cuts	
Immediate Spending Needs	\$12.4 million
<i>Less: Surplus Carryover Revenue</i>	\$2.3 million
Net Immediate Spending Needs	\$10.1 million
Midyear Budget Cuts	(\$10.1 million)
Surplus/(Deficit)	-

Potential Solution #2: Over-Budget Revenue	
Immediate Spending Needs	\$12.4 million
<i>Less: Surplus Carryover Revenue</i>	\$2.3 million
<i>Less: Over-budget General Fund Revenue</i>	\$5.5 million
Net Immediate Spending Needs	\$4.6 million
Midyear Budget Cuts	(\$4.6 million)
Surplus/(Deficit)	-
<i>Future Midyear Budget Cuts</i>	<i>\$5.5 million</i>

What is important to note about these tables is that even if the \$5.5 million in projected over-budget revenue is used as an immediate solution (Potential Solution #2), it will not be sufficient to fully mitigate the immediate spending needs. Furthermore, it will increase the likelihood of additional midyear budget cuts later in the fiscal year to address future spending needs. These two potential solutions are discussed in greater detail below.

Midyear Budget Cuts

During Fiscal Year 2005, all non-Public Safety General Fund departments were asked to identify expenditure savings that resulted in midyear savings of approximately \$10.4 million. These budgetary savings were needed to fund required General Fund expenditures, including Police and Fire needs; audit, investigation and legal expenses; and retiree health care payments. It is recommended that a similar Budgetary Savings Plan be implemented in Fiscal Year 2006 in order to address the immediate spending needs. Based on an estimated need of \$10.1 million, an estimated three percent budgetary savings from all non-Public Safety General Fund departments

should be sufficient to address the unanticipated immediate expenditure requirements.

Given the known structural budget deficit, in conjunction with the required expenditure needs of the City, the recommendation to implement midyear budget cuts is considered the most prudent financial option. Any use of increased forecasted revenue as an immediate solution is not recommended for three primary reasons.

First, the over-budget revenue that is currently projected would be insufficient to fully mitigate all of the immediate spending needs, meaning that budget cuts would still be necessary. Furthermore, if over-budget revenue is used in lieu of budgetary savings at the current point in time, it is almost certain that a second round of budget cuts will be necessary to address future spending needs.

Second, as mentioned, it is too early in the fiscal year to forecast with any degree of certainty how the major General Fund revenues will fare at year-end. It would be imprudent to employ a tentative revenue forecast as the only solution to known and immediate expenditure needs.

Finally, there is less risk in making difficult budget cuts earlier in the fiscal year. For instance, suppose that a full three percent savings plan is implemented at the present time. If the major revenues perform better than expected or the future spending needs fail to materialize, then the encumbrances may simply be released. On the other hand, if a second round of budget cuts is required later in the fiscal year, it will be more difficult to achieve the desired level of savings since a larger percent of each department's budget will have already been spent.

Nevertheless, the ultimate authority rests with the City Council as to which course of action will be taken. The following sections summarize the preliminary major General Fund revenue projections, and the option to use this revenue surplus as a solution to the immediate spending needs.

Fiscal Year 2006 Over-Budget General Fund Revenue

In Fiscal Year 2006, the City budgeted \$864.9 million in General Fund revenue. Of that amount, \$565.5 million, or approximately 65.4 percent, is comprised of just four revenue sources: property tax, sales tax, transient occupancy tax (TOT), and franchise fees. As such, the financial status of the General Fund depends greatly of the performance of these revenues. While it is still too early in the fiscal year to conclude with any certainty how these revenues will perform, preliminary indications suggest that most of the major General Fund revenues will finish the year over-budget. This section provides a summary of the preliminary year-end estimates of the major General Fund revenues, and a few other General Fund revenues that warrant consideration. These year-end estimates are summarized in the table below.

Fiscal Year 2006 General Fund Revenue Status				
	REVENUE TYPE	BUDGET	PROJECTED as of 9/30/05	SURPLUS/ (DEFICIT)
	Property Tax	\$290.4 million	\$294.8 million	\$4.4 million
	Sales Tax	\$144.1 million	\$145.6 million	\$1.5 million
	TOT	\$67.3 million	\$68.4 million	\$1.1 million
	Franchise Fees	\$63.5 million	\$63.5 million	-
	Property Transfer Tax	\$14.9 million	\$14.0 million	(\$0.9 million)
	Vehicle License Fees	\$9.5 million	\$8.9 million	(\$0.6 million)
	Net Total Surplus/(Deficit)			\$5.5 million

The revenues listed in the table above are discussed in greater detail below.

Property Tax

Property tax revenue is projected to end the year over-budget by approximately \$4.4 million due to supplemental property tax receipts that came in stronger than anticipated in Fiscal Year 2005. As a result, the projected growth rate in Fiscal Year 2006 is applied to a larger base. In addition, there have been indications that the Fiscal Year 2005 VLF-property tax swap payment was underestimated, which would result in a positive true-up payment in Fiscal Year 2006. However, these figures will not be released by the State until October 12, and are not included in the present estimates. Further updates will be provided as information becomes available.

Sales Tax

Sales tax revenue is projected to exceed the budget by approximately \$1.5 million due to the September clean-up payment that was greater than expected. The City was projecting to receive a clean-up payment of approximately \$3.8 million; the actual payment received was \$5.3 million. It should be noted that the year-end estimate for sales tax does not include the \$9 million shortfall that resulted from the triple-flip correction, explained in the State Impacts section of this report.

Transient Occupancy Tax

TOT receipts in August (which reflect lodging activity from July) came in considerably stronger than anticipated, resulting in the estimated \$1.1 million surplus. This estimated surplus also reflects an increased transfer from the Special Promotional Program, since any fluctuation in the TOT allocation to Special Promo will roll through to the General Fund.

Franchise Fees

Initial receipts from the City's franchises are not significantly different than projected, and thus do not warrant a revised year-end projection.

Property Transfer Tax

The projected deficit in property transfer tax revenue is largely the result of the final payment for Fiscal Year 2005 being lower than projected. Much like the variance in property tax, the lower payment for Fiscal Year 2005 meant that the Fiscal Year 2006 projection was adjusted using a

lower base.

Vehicle License Fees

Vehicle License Fees (VLF) are projected to finish the year approximately \$600,000 under-budget. This projected deficit is due to greater administrative costs withheld by the State prior to allocation of the funds. When the budget projection was developed, the administrative costs for Fiscal Year 2006 were not known.

It should be reiterated that the revenue projections listed above are based on extremely limited data, and are subject to change in either the positive or negative direction. Despite their preliminary nature, they are the best estimates to-date, and offer at least a prospective glimpse at the year-end status of the City’s major General Fund revenues.

FUTURE SPENDING NEEDS

Aside from the known unbudgeted expenditure requirements that were discussed in the previous section, there are a number of concerns which are likely to impact the General Fund at a later point in the fiscal year. While the precise fiscal impact of these challenges is not known with any certainty at this point, estimates have been provided where possible. Despite this ambiguity, these future concerns should not be disregarded or taken lightly. Although this report has already identified numerous challenges that the City must address immediately, it is prudent to remember that the fiscal year just barely one-fourth completed; history has shown that unanticipated challenges arise throughout the fiscal year. The future spending needs that are anticipated at this point in time are summarized in the table below.

Fiscal Year 2006 Unbudgeted Future Spending Needs			
	Financial Investigation/Litigation Expenses		\$0.7 million
	Public Safety Spending Needs		\$12.0 million
	Increased Fuel Expenses		\$2.0 million
	Total Anticipated Future Spending Needs		\$14.7 million

Financial Investigation/Litigation Expenses – \$0.7 million estimated

The previous section describes the immediate need for \$6.9 million to fund audit, investigation and legal expenses through March 2006. While it is still anticipated that the independent audit will be completed by then, it is likely that additional expenditures will be required from March through the end of the fiscal year for the ongoing SEC investigation and legal representation for City employees. Based on an average expenditure rate of \$300,000 per month for investigation and legal expenses, an additional citywide total of \$1.0 million would provide sufficient resources through the remaining three months of Fiscal Year 2006. Of this amount, approximately \$700,000 is attributable to the General Fund.

In addition to the identified costs associated with the ongoing audit and financial investigation, the City is currently exposed to a number of pending lawsuits. The Police Officers Association

has recently filed suit against the City alleging that police union members were harmed by City official who allowed the underfunding of the employees pension system. If this lawsuit is lost the cost to the City could be in the millions. Additionally, SDCERS has filed suit against the City in relation to pension benefits, one of several pending between the Retirement System and the City. Although the City is committed to responding to each request in a timely manner, each new allegation levied against the City is likely to results in additional investigations that will further strain the City's resources. Furthermore, many of the publicly announced proposals for financial recovery, if attempted, would likely result in legal challenges.

Public Safety Needs – \$12 million estimated

The Public Safety departments, namely Police and Fire-Rescue, are structurally under-funded in a number of areas. Year after year, these departments routinely exceed their budgets, particularly in the areas of special pay and overtime. Despite attempts in recent years to increase funding to these departments, challenging budget environments have made it difficult to fund these departments at adequate levels. As a result, the Police and Fire-Rescue departments continue to exceed their budgets. In Fiscal Year 2005, the Public Safety Departments exceeded their appropriation by approximately \$12 million. While it is still too early in the current fiscal year to determine the financial status of the Public Safety Departments, initial estimates indicate that these departments are expending their budgets at a rate that is roughly equivalent to Fiscal Year 2005. As a result, the General Fund must be prepared to address the deficits in these departments that will inevitably result from years of under-funding. The City Manager will continue to work with these departments to mitigate these potential future over-budget requirements.

Increased Fuel Expenses - \$2.0 million estimated

Nationwide gas prices have experienced drastic fluctuations, which have had an impact to prices in the San Diego area. The current county average of \$3.01 per gallon reflects a 25 percent increase, or \$0.60 per gallon, in the last 9 months. The City of San Diego has numerous departments that are directly affected by rising gas prices, including the Police Department, Fire-Rescue, the Water Department, and Park & Recreation. These are the departments that rely most heavily on gasoline; however, other departments may be indirectly impacted as well. These departments will have to absorb the increased costs at the expense of other competing priorities. The service level impacts of rising fuel costs will need to be examined, as well as future impacts due to further price increases.

Proposed Solution: Over-Budget Revenue

As previously described, it is currently projected that General Fund revenues will end the year with a \$5.5 million surplus. For the reasons stated in the Immediate Spending Needs section, it is recommended that this projected surplus revenue is used as a partial solution for the anticipated future spending needs. The table below reflects this recommendation.

ANTICIPATED FUTURE SPENDING NEEDS

Proposed Solution: Over-Budget Revenue	
Future Spending Needs	\$14.7 million
<i>Less: Over-Budget General Fund Revenue</i>	\$5.5 million
Net Future Spending Needs	\$9.2 million
Future Solutions	(\$9.2 million)
Surplus/(Deficit)	-

As this table indicates, based on the anticipated future spending needs, additional solutions will need to be identified to fully mitigate the deficit. However, using the projected over-budget revenue as a solution to the future spending needs is still the recommended course of action, since future conditions will likely fluctuate from the current outlook. Major General Fund revenues may come in higher than anticipated, individual departments may realize over-budget revenue, or the Police and Fire Departments may spend less than expected. Either way, reserving the over-budget General Fund revenue will allow for the greatest flexibility in identifying additional solutions in the likely event that future conditions change.

The table below summarizes the various challenges and recommended solutions that have been discussed throughout this report.

SUMMARY OF FISCAL YEAR 2006 BUDGETARY CHALLENGES AND PROPOSED SOLUTIONS	
CHALLENGES/ PROPOSED SOLUTION	SURPLUS/ DEFICIT
State Revenue Impacts	(\$12.7 million)
Proposed Solution: Additional Surplus Carryover	\$15.0 million
Surplus/(Deficit)	\$2.3 million
Immediate Spending Needs	\$12.4 million
<i>Less: Surplus Carryover Revenue</i>	\$2.3 million
Net Immediate Spending Needs	\$10.1 million
Proposed Solution: Midyear Budget Cuts	(\$10.1 million)
Surplus/(Deficit)	-
Future Spending Needs	\$14.7 million
<i>Less (Proposed Solution): Over-Budget Revenue</i>	\$5.5 million
Net Future Spending Needs	\$9.2 million
Solutions Yet to be Determined	(\$9.2 million)
Surplus/(Deficit)	-

Cash Flow Challenges

On August 2, 2005, Moody's Investors Service downgraded the City's General Obligation Bonds, citing a financial position that "appears to be narrowing somewhat." Moody's stated that a significant factor in the downgrade was the fact that the City's liquidity appeared to be narrowing to very thin levels. According to the Moody's report, ending cash balances for Fiscal Year 2006 are projected to be at 1.7 percent of receipts, down from a projected 5.4 percent in Fiscal Year 2005, 4.7 percent in 2004, and 5.7 percent in Fiscal Year 2003. In addition, the report notes that the City's cash flow needs are anticipated to be \$145 million in the current fiscal year, up from \$114 million in Fiscal Year 2004.

The City's narrow cash flow position is the result of several factors. Among the most prominent is the fact that over the past several fiscal years, the City has been forced to rely on fund balance transfers in order to balance the General Fund budget. These transfers have come from funds such as the Equipment Operating Fund, the QUALCOMM Stadium Fund, and the Fire and Lifeguard Facilities Fund. By Fiscal Year 2006, the continual need to use fund balance transfers to balance the General Fund has largely depleted the available fund balances in many non-General funds thus shrinking the liquidity available to front-fund reimbursement type expenses. It should be noted that this is not specifically a General Fund issue. The General Fund will remain in balance and will have the necessary resources to pay for approved expenditures. The cash-flow impact to the General Fund occurs when it is used to front-fund expenditures that have lengthy reimbursement delays such as grants.

Whether from the State, the federal government, or any other agency, grants are often awarded in order to fund a particular program or activity. As such, the grant funds are typically disbursed as reimbursements instead of up-front cash awards, allowing the granting agency to ensure that the funds were used for the intended purpose. In the past several years, the City's grant-funded programs have had a difficult time funding up front the expenditures required to receive the reimbursement grant funding. In other words, grants will only be disbursed on a reimbursement basis, but the majority of the City's grant-funded programs do not have sufficient cash to fund these expenditures prior to receiving the grant funding. As a result, the General Fund has had to provide the necessary funding for these programs to be able to receive their grant awards. Several examples include the "6-to-6" Program in the Community and Economic Development Department, Homeland Security Grants and the High Intensity Drug Trafficking Area (HIDTA) Grants.

State and Federal grants for before-and-after school programs in California are managed by the California Department of Education (CDE). Grants are paid on a reimbursement basis, and claims can only be submitted on a quarterly basis. The payment schedule posted by the CDE commits to processing reimbursements within 60 days of the end of each quarter in which expenses were incurred. In reality, however, the City has received reimbursements as late as 9 months after the end of a quarter. While there was some improvement in the timeliness of reimbursements in Fiscal Year 2005, there remains an average lag time of four months from the end of the quarter. Given the magnitude of the grant funding that the "6-to-6" Program relies upon, it does not take long before the State owes the City several million dollars in reimbursements. With a General Fund budget of just \$500,000 for the "6-to-6" in Fiscal Year 2006, these outstanding reimbursements create a considerable cash flow burden for the General

Fund.

City staff is currently working to identify solutions to the grant problem. Potential solutions include establishing a revolving fund to provide up-front funding, working with departments to streamline the billing process, and working with State and federal agencies to shorten the timeframe in which reimbursements are disbursed. The City Manager forwarded a letter to Governor Schwarzenegger in early September addressing the delay in grant reimbursement. Additional updates will be provided as appropriate solutions are identified and implemented.

CONCLUSION

This report has presented three aspects of the current Fiscal Year 2006 General Fund fiscal status:

- General Fund State revenue impact and proposed solution
- Immediate General Fund unbudgeted spending needs and solution options
- Future General Fund unbudgeted spending needs and partial solution

Although each aspect was presented separately for discussion, the combined impact will affect the total outcome of the Fiscal Year 2006 General Fund budget. The proposed solutions included in this report are not without hardship to non public-safety department budgets. However, implementing the recommended spending cuts and reserving forecasted revenue for future spending needs will better balance immediate impacts to City operations. The continued monitoring of General Fund revenue and expenses will further refine impacts and may minimize necessary mitigation. Postponing prudent fiscal action now may only serve to increase negative consequences further in the fiscal year.

As previously stated, the General Fund must remain fluid throughout the fiscal year to adjust to the various challenges. Although past practices have warranted different results, the strengthening of the City's fiscal health, in anticipation of future requirements in Fiscal Year 2007 and beyond, is the core mission of this administration. The direct participation of City departments, City stakeholders and the policy makers will strengthen the momentum gained by making these difficult decisions.

Concurrence by the City Council to pursue a prudent course of action and follow the recommended options for spending needs and revenue mitigation is crucial. Through the prudent oversight of fiscal resources, such as reprioritizing expenditures and saving for future requirements, the legislative body of the City of San Diego will be demonstrating leadership in managing the financial challenges of this City.

As previously stated, the General Fund must remain fluid throughout the fiscal year to adjust to the various challenges. Although, past practices have warranted different results, the Financial Management Department will be prepared to discuss Fiscal Year 2007 budget priorities in November 2005.

ALTERNATIVE

Do not accept the City Manager's recommendations.

Respectfully submitted,

Ronald H. Villa
Financial Management Director

APPROVED: P. Lamont Ewell
City Manager

RHV/TH

Attachments: [1. Department of Finance notification letter to the County of San Diego.](#)
[2. Stormwater Monitoring Memorandum](#)