FILED
June 30, 2012
CLERK, U.S. BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
0004317708

57

MARC A. LEVINSON (STATE BAR NO. 57613)
malevinson@orrick.com
NORMAN C. HILE (STATE BAR NO. 57299)
nhile@orrick.com
JOHN W. KILLEEN (STATE BAR NO. 258395)
jkilleen@orrick.com
ORRICK, HERRINGTON & SUTCLIFFE LLP
400 Capitol Mall, Suite 3000
Sacramento, California 95814-4497
Telephone: (916) 447-9200
Facsimile: (916) 329-4900

Attorneys for Debtor
City of Stockton

UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	Case No. 2012-32118 D.C. No. OHS-1 Chapter 9 **EXHIBIT P TO THE DECLARATION OF LAURIE MONTES IN SUPPORT OF CITY OF STOCKTON'S STATEMENT OF QUALIFICATIONS UNDER SECTION 109(C) OF THE UNITED STATES BANKRUPTCY CODE** Date: TBD Time: TBD Dept: TBD Judge: TBD

Attachment C

City of Stockton
Financial Condition Assessment

February 2012

Management Partners

Management Partners

February 23, 2012

Mr. Bob Deis
City Manager
City of Stockton
325 North El Dorado Street
Stockton, California 95202

Dear Mr. Deis:

Management Partners is pleased to transmit this report providing a financial condition assessment for the City of Stockton. We conducted a high level "second opinion" of the City's financial estimates and staff's direction to address its financial challenges. We were engaged to assess the reasonableness of financial assessments produced by City staff and the policy recommendations that flow from those assessments. Our review was conducted between mid-December 2011 and mid-January 2012, which was a limited period of time for such a review.

Our conclusion is that staff's assessment of the City's financial condition and the approach being taken by the City is reasoned and valid. The City is in a very serious financial crisis and Management Partners recommends the City take immediate steps to protect itself as best as possible from the potential for uncontrolled debt default or contract breach due to lack of unrestricted available funds.

We offer three summary observations about the City's financial condition:

1. The General Fund is insolvent from a service delivery perspective as it cannot fund the full cost of consistently providing the current level of service. No plan exists for future financing of deferred maintenance, actuarial and contingent liabilities, adequate reserve levels or other costs not funded in the current budget. The City Council and staff are concerned that the current service levels are inadequate for the health, safety and welfare of the community.

2. The General Fund is insolvent from a budget perspective and the City must transition to lower service costs in order to align expenditures with projected revenues. This is shown by the fact that the City has used fund balance and contingency monies to cover deficits since at least FY 2008-09. The City passed balanced budgets for the prior and current year (FY 2010-11 and FY 2011-12), however a combination of factors (mainly newly discovered accounting issues and unforeseen General Fund liabilities), have resulted in continued reductions in the unrestricted available General Fund balance.

1730 Madison Road • Cincinnati, OH 45206 • 513 861 5400 • Fax 861 3480
2107 North First Street, Suite 470 • San Jose, CA 95131 • 408 437 5400 • Fax 453 6191
5 Park Plaza, Suite 1520 • Irvine, CA 92614 • 949 222 1082 • www.managementpartners.com

Current projections indicate that the City will exhaust available unrestricted fund balances in several funds and contingency appropriations in the General Fund. This will leave the City with a small negative balance in the General Fund that will have to be managed through expense control. In addition, weak revenues and increasing debt and pension costs will create large budget gaps in the next three years and beyond, with very limited, difficult options to bridge the difference.

3. Cash solvency in the General Fund is tenuous. Known contingent liabilities that may come due in the next six months as well as newly discovered accounting issues identified by City staff, as well as budget estimation and economic risks may tip the General Fund into cash insolvency before the end of this fiscal year.

   The reasons for this situation occurred over many years and can be summarized as follows.

   - The sustained recession has reduced revenues significantly.
   - In the years prior to the recession, the City took on a large amount of debt in anticipation of ongoing growth that now exceeds the City's ability to pay.
   - Compensation packages exceeded sustainable levels and the City assumed a significant liability for improved retiree health coverage without sufficient recurring revenues to cover growing costs.
   - Prior fiscal management practices obscured problems.

We appreciate the assistance of City staff in providing data and a variety of information essential to our review. Thank you for the opportunity to serve the City of Stockton.

Sincerely,

Gerald E. Newfarmer
President and CEO

Table of Contents

Executive Summary **1**
- Analytical Framework 2
- City Efforts to Address Fiscal Condition 3
- Key Observations 3
- Recommended Actions 7
- Conclusions 9

Project Approach **11**
- Interviews 11
- Documents Reviewed 11
- Study Limitations 12

Background **13**
- Deteriorating Fiscal Condition 13

Analysis and Observations **16**
- Significant Risks and Increasing Costs 17
- Service Delivery Solvency 18
- Budget Solvency 22
  - *Structural Imbalance Since FY 2008-09* 22
  - *City of Stockton Debt* 24
  - *General Fund Supported Debt (On Behalf of Other Funds)* 28
  - *Retiree Medical Benefit Costs* 31
  - *Accounting Errors* 33
- Cash Insolvency 34
- Other Financial Risks 36
  - *Insufficient Contingency* 36
  - *Litigation Risks* 37
  - *Property Tax Revenues* 38
  - *CalPERS Rates* 39
  - *Wind-Down of Redevelopment Agency* 39

Unfunded Actuarial Liabilities *40*
Fees *42*
Recommended Actions **43**
Conclusions **48**

Tables

Table 1. Pro Forma General Fund Budget Without Debt Service and Retiree Medical 19
Table 2. Seven-Year Perspective of General Fund Revenues and Expenses 23
Table 3. Direct General Fund Debt and Settlement Obligation 25
Table 4. Estimated General Fund Risk for Public Facility Fee Fund Debt Service 27
Table 5. General Fund Supported Debt (on behalf of other funds) 29
Table 6. City of Stockton Unfunded Actuarial Liabilities (UAL) and Long-Term Self-Insured Claim Liabilities (Most Recently Reported – January 2012) 41

Executive Summary

Management Partners was engaged by the City of Stockton to conduct an independent review of the City's fiscal condition. Members of the management team have termed this work a "second opinion" on staff's assessment of the current and anticipated financial challenges facing the City. This document contains our observations and recommendations, based on analysis conducted between mid-December 2011 and mid-January 2012.

Management Partners has reviewed, validated and in some cases recommended relatively minor adjustments to the City's financial forecast and perspective. We conducted a review of the General Fund as well as an assessment of the stability of internal service funds and special funds that have the potential to impact the General Fund, and a brief review of key service costs. In addition, we have identified risks to the City's financial position. Finally, we have identified areas where additional attention should be paid to fully address the City's financial challenges.

It is important to note that the review being performed by Management Partners is not an audit. The City of Stockton has annual independent audits which focus primarily on the City's adherence to generally accepted accounting principles. This evaluation is not designed to serve that purpose or to be a precise representation of all fiscal issues facing the City. Rather it is an overview, serving as a second opinion on the estimates and direction recommended by the City Manager and staff. It is designed to be a review of the reasonableness of the financial assessment prepared by staff and the policy recommendations which flow from that assessment. In conducting this study, Management Partners relied on documents provided by the City of Stockton and representations from staff.

Even given the limitations of this evaluation, there can be no doubt that the City of Stockton is facing a very serious financial crisis. As is summarized below this situation was brought on by a number of factors and decisions made in the last decade, coupled with the crushing

economic recession that has impacted the local economy since 2008. While the City has taken numerous steps to solve these problems over the last several years, it has not been able to completely address the situation. This is largely because it has been limited to considering only a part of the problem, current expenditures and revenues, when a large part of the underlying problem involves long-term debt and other obligations.

Accordingly, this evaluation recommends that the City take immediate steps to protect itself as best as possible from the potential of uncontrolled debt default or contract breach due to a lack of unrestricted available cash.

This Executive Summary briefly presents the approach used to assess the fiscal condition of the City, the background on how the current situation unfolded, our key results and observations, and our priority recommendations.

Analytical Framework

For the purposes of this project, we analyzed the City's financial condition from the perspective of three metrics of fiscal health for municipal organizations: 1) service delivery solvency, 2) budget solvency and 3) cash solvency. Each is defined below.

> *"**Service delivery solvency**" is defined as a municipality's ability to pay for all the costs of providing services at the level and quality that are required for the health, safety and welfare of the community.*
>
> *"**Budget solvency**" refers to the ability of an agency to create a balanced budget that provides sufficient revenues to pay for its expenses that occur within the budgeted period.*
>
> *"**Cash solvency**" is defined as an organization's ability to generate and maintain cash balances to pay all its expenditures as they come due.*

One can think of these measures as a pyramid which builds a fiscal foundation for a city. At the bottom is cash solvency, which is absolutely essential for day-to-day operations. Above this comes budget solvency, a necessary condition for sustainable operations. Finally at the top of the pyramid is service solvency, which denotes the ability to provide for the municipal operations at a level consistent with community needs and expectations. While a municipality can operate in a condition of service

insolvency or even budget insolvency for some period of time, cash solvency must always be maintained.

City Efforts to Address Fiscal Condition

The Great Recession, which began in December 2007, had a significant impact on the City's finances. In the three fiscal years following the start of the recession, the total revenue to the City's General Fund decreased by $30 million (from $203 million in FY 2008-09 to $173 million by FY 2010-11).

The City has taken significant actions to reduce expenditures to align with its lower revenues. In 2010, the City declared its first fiscal emergency, followed by a second fiscal emergency declaration in 2011. The City imposed significant cuts in employee positions and employee pay and benefits as part of its restructuring to resolve a $37 million General Fund deficit in FY 2011-12. In total, the City's adopted budget for FY 2011-12 represents a cumulative 25% reduction in staffing since FY 2008-09.

Unfortunately, while the City has made significant headway to contain costs, Stockton's financial condition continues to worsen. The reasons for this, and most importantly the public policy implications which flow from the downward trend of the City's finances, are briefly discussed below.

Key Observations

1. **The City faces significant risks and increasing costs that weaken its financial position and continue to erode its ability to provide fundamental services.**
    a. Issuance of debt in 2004, 2006, 2007 and 2009 increased debt service payments linked to the General Fund by 600% between FY 2006-07 and FY 2012-13, creating major cash flow demands after revenues and reserves plummeted.
    b. The City has variable rate debt structures that can rapidly increase debt service requirements or accelerate payment to seven years from the current 30 years, if investors lose confidence in the City or in the banks that provide letters of credit to back the debt.
    c. Issuance of pension obligation bonds just before the 2008-09 financial crisis was followed by a loss of almost a third of the debt proceeds that were deposited in the California Public

Employees Retirement System (CalPERS) investment portfolio over the next two years (FY 2009-10 and FY 2010-11).

d. Portfolio losses and the rising cost of retiree health care will rapidly increase the cost of benefits for active and retired employees despite significant efforts to contain those costs.
e. Continued declines in ongoing revenues such as property tax and development-related revenues could result from the combined pressure of foreclosures, reduced property values, vacant buildings, unemployment and reduced city services.
f. Possible infrastructure failures resulting from deferred maintenance may result in significant costs. In addition, equipment and systems replacement that cannot be deferred will increase future budgets.

2. **The City can be considered insolvent from a service delivery perspective.** While every community is different and there is no specific minimum level of service required of cities, the level of reductions made in Stockton's services are significant relative to the needs of the community. Management Partners notes that serious reductions have been made in all areas and that adequate financial support for the full costs of delivering services including associated equipment and supplies does not exist. Available revenues in the General Fund are not sufficient to cover the cost of current service levels even without considering debt and retiree medical obligations.

   While many cities might regard themselves as providing less than their community needs or desires, when a city cannot pay for (or does not have a reasonable plan to fund) basic services, including preventive and regular maintenance of assets or employee benefit costs, then that city is insolvent from a service delivery standpoint. The City of Stockton meets this definition on several levels.

3. **The City can be considered insolvent from a budget perspective.** Despite adopting balanced budgets at the beginning of each fiscal year, the General Fund has operated at a deficit for the last three years. Though reductions in revenue sources have been anticipated and built into the budget fairly accurately, the last two budget years have been severely affected by corrections to accounting records to address errors that were discovered by the new City Manager and Chief Financial Officer. Based on current service levels, accounting corrections and known budget variances revenues will not match expenditures in the current fiscal year, nor for the next three fiscal

years. With major expenditure reductions already in place, further financial restructuring must occur to prevent sustained budget and cash insolvency.

Restatements and corrections of accounting errors in prior periods reduced the available General Fund balance at July 1, 2010 from $11.4 million to a $3.5 million deficit. That deficit grew to $6.2 million by the end of FY 2010-11 and General Fund cash, excluding payroll trust cash, dropped to an $11.7 million deficit. Collections of accrued revenues and receivables were expected to cover deficit cash as this fiscal year began.

During the FY 2011-12 budget development process, City staff noted that certain Public Facility Fee (PFF) interfund loans could not be repaid because of declines in Public Facility Fee revenue and, in the foreseeable future, debt service payments will consume all available resources in those funds with both debt service and interfund loan obligations. The Community Center Fund owes $2.8 million, the Fire Station Fund owes $2.4 million and the Police Station Fund owes $1.2 million, for a total of $6.4 million in interfund loans. Legal compliance issues relating to the use of fees and multi-year borrowing could be cured by using $6.4 million of available unrestricted fund balances outside the General Fund to clear uncollectible PFF interfund loans.

The effective date for this transaction would be June 30, 2011, consistent with the year revenues fell so low as to make the loans uncollectible. However, using all available unrestricted resources would require the City to strip all the funds that the City Council can now use at its discretion to remain solvent. These are all one-time sources of cash. Taking all the funds would take remaining available resources from functions like libraries, parks, the General Fund portion of internal service funds and Measure W tax funds making the General Fund immediately responsible for unexpected shortfalls in those funds.

City staff also noted that the City did not use best practices in allocating investments in its pooled cash accounts in FY 2010-11 and were considering a recommendation to immediately correct the error. The effect of immediate remedy would reduce General Fund cash by $1.1 million.

Based on our experience, Management Partners believes there are alternatives to an immediate repayment of the PFFs, such as a phasing

schedule. We communicated our thoughts on this to the City Manager and advised that legal advice should be sought to ascertain whether an immediate remedy for all PFF and interest allocation compliance issues is required or whether a phased-in approach, an administrative action, or fixing the problem on a go-forward basis could be used to provide more time for the City to restructure its finances. As a result of our conversation with the City Manager about this, his office arranged a conference call with Management Partners, City management, the City Attorney and the City's special legal counsels to review the legal issues. The consensus opinion during the call was that immediate action is not necessary. The City Attorney is continuing the discussion with special counsel and will advise the City Council on the recommended course of action separately. The recommended solution for these issues will not result in risks more serious than the risks it would face if it consumed available unrestricted fund balances immediately.

4. **The City's General Fund is nearly cash insolvent and is likely to run out of unrestricted available fund balance by the end of the fiscal year.** Estimates of collections of receivables, the liquidity of other fund assets, legal and contractual restrictions and future revenues attributable to the current period affect the timing of insolvency. When conversion of assets to cash and collection of revenues associated with the current period will not repay advances from pooled cash within the fiscal year cash insolvency will result. We base the conclusion that cash insolvency is near on our review of the City's unrestricted available fund balances at the beginning of FY 2010-11, restatements and revised deficits figures for FY 2010-11 as well as year-to-date revenues and expenses and estimates in the current 2011-12 fiscal year and other known issues. We have also had several discussions with the Chief Financial Officer and have reviewed the City's four-year forecast and the "scorecard" dated November 11, 2012, which contains potential issues affecting cash solvency in FY 2010-11, FY 2011-12 and future budgets.

   Because the City did not have an updated cash projection for the General Fund at the time of this report, we cannot precisely predict when the City will run out of unrestricted cash to pay its employees, retirees and investors. However, the factors noted above make it very likely that the City could face uncontrolled debt default or contract breach due to a lack of unrestricted available cash within the calendar year if immediate action is not taken.

5. **The weakness of the City's financial condition as represented in documents prepared by City management for FY 2011-12 and FY 2012-13 is not overly conservative.** Indeed, Management Partners believes it is likely too optimistic, as a number of contingent liabilities related to legal, budget, and financial risks have not been factored into this year's cash forecast or the four-year budget forecast.

   Management Partners believes that these additional risks listed below may further contribute to the City's longer-term fiscal challenges or, in the worst case, may create immediate cash insolvency in the General Fund.

   a. The General Fund is about to exhaust its unrestricted available fund balances and has an insufficient contingency, given the risks that must be covered.
   b. The City has significant litigation risks that could result in additional expenditures not currently budgeted.
   c. The City could experience acceleration of variable rate interest debt or higher interest rates, resulting in higher costs.
   d. The City is at risk of defaulting on its direct General Fund and cross-collateralized debt.
   e. The City may experience further declines in property tax revenues.
   f. The City could see higher California Public Employees Retirement System (CalPERS) rates than currently forecast after FY 2012-13.
   g. The City could have unexpected costs associated with winding down its Redevelopment Agency following the California Supreme Court's decisions regarding Propositions 26 and 27.
   h. The City has unfunded actuarial liabilities and growing pay-as-you-go costs for employee benefits in its internal service funds and has significant unfunded actuarial liabilities in both its CalPERS pension plans and its Enhancement Plan.

Recommended Actions

Given the severity of the City's financial condition, Management Partners provides seven recommendations for action.

1. ***Preserve General Fund liquidity within legal limits.***
   - All legally available cash will be needed by the General Fund to deal with the City's solvency risks and the costs of using restructuring tools as part of the City's financial recovery plan.

- Finalize legal analysis to determine the City's flexibility to address outstanding liabilities associated with the Public Facilities Fee interfund loans and interest allocations to ascertain alternatives to immediate use of available unrestricted resources.

2. ***Immediately prepare for AB 506 proceedings to restructure debt obligations, including unfunded liabilities.***
   - Obtain legal advice about AB 506 and implement the process.
   - Obtain advice on potential steps subsequent to AB 506 (Chapter 9 process), tactics and strategies from legal counsel.
   - Begin immediately to prepare background material for the AB 506 process.
   - Obtain legal advice about unauthorized debt remedies and potential liabilities of officers and council members.
   - Begin drafting a fiscal recovery or sustainability plan which, if necessary, will provide a foundation for a Chapter 9 Pendency Plan and Work Out Plan, if creditors do not agree to restructure the City's obligations as part of the AB 506 process.

3. ***Develop plans for lower service level scenarios or alternative service delivery approaches to further reduce costs.*** Despite the significant and sustained cost reductions it has implemented, the City's revenues will not support existing service levels. Given other obligations that are currently legally required, the City may need to further reduce services to reduce costs, despite being service insolvent. In some cases, there may be other service providers that could be contacted for proposals to maintain services at lower costs. Such alternatives should be explored.

4. ***Obtain legal advice regarding potential liabilities that may have been created as a result of past accounting errors and regarding interfund transactions that are no longer feasible because supporting revenues are so reduced.*** This applies to all instances where funds were spent or advanced in anticipation of future revenues that have now created potential legal issues because expected revenues have dropped significantly.

5. ***Begin drafting a Fiscal Recovery or Stabilization Plan that, if necessary, will provide a foundation for Chapter 9 Pendency and Work Out Plans, if creditors do not agree to restructure the City's obligations outside of bankruptcy.*** That plan should reflect the budget the City needs to adopt to make it through

FY 2011-12 and FY 2012-13, including reductions in debt, services and personnel costs.

6. ***Revise the four-year financial forecasts to include scenarios for possible higher CalPERS rate increases.***

7. ***Develop a multi-year forecast for all funds that are directly or indirectly guaranteed by the General Fund.***

In addition to these seven recommendations, Management Partners recommends that over the next two to three years, the City conduct a detailed review of the cost of services and fees to determine whether fees can appropriately be increased to recover costs. This is a lower priority, given the urgency of other actions, but should be planned.

Furthermore, Management Partners suggests that the City consider, at some point, conducting voter polling to gauge support for augmenting existing revenue sources and potentially for debt ratification to address unintended unauthorized debt as a result of interfund transfer and expenditure issues.

Conclusions

According to City management's budget forecasts, the General Fund will likely reach cash insolvency by the end of this fiscal year (FY 2011-12). Management Partners has found no reason to doubt these forecasts. To the contrary, there are numerous issues that may deepen the City's fiscal crisis.

It should be noted that this "second opinion" is based on the issues identified by City staff in the General Fund as well as related funds that receive direct support from the General Fund or funds with solvency issues that may require the support of the General Fund. Management Partners has discovered no reason to doubt the soundness of other City funds that do not face financial solvency issues, as mentioned in this report. For example, the City of Stockton operates utility water and wastewater services, which are funded by restricted revenues and are not directly affected by the insolvency issues in the General Fund.

It is clear to us that the services that depend on the General Fund are insolvent from both a service delivery and budgetary perspective. With regard to immediate cash solvency, if the City is able to defer legal compliance issues, cash insolvency in the General Fund may be delayed, but only for the short term.

We also agree with City management that the City's financial situation is very serious. Fast action identifying legal alternatives to correct possible liabilities associated with compliance issues related to transfers, restatements and interfund loans is important because conserving unrestricted cash is critical. These reserves are now at such a low level that uncontrolled debt default or contract breach due to a lack of unrestricted available cash is a real threat.

If bankruptcy can be avoided, it will largely be dependent on the willingness of creditors, including debt holders and retirees, to agree to restructure outside of a Chapter 9 filing. Conversely, if bankruptcy cannot be avoided the City's Fiscal Recovery or Stabilization Plan for the AB 506 process will serve as a foundation to manage the organization and the community through the bankruptcy process. The worst case for the City would be bankruptcy without a plan, or an uncontrolled default, because the City would lack the tools necessary for dealing with creditors in an organized fashion.

Project Approach

Management Partners conducted an independent evaluation of the financial outlook and financial challenges facing the City of Stockton. Our financial assessment review validates and in some cases recommends adjustments to the revenue and expenditure projections. We also evaluated the stability of internal service funds and special funds that have the potential to impact the General Fund, and reviewed key service costs. Lastly, we focused on areas where additional attention should be paid to fully address the City's financial challenge and developed several recommendations for City management and policy makers to consider.

Interviews

Management Partners conducted interviews with the following individuals as part of our information gathering phase.

- City Manager Bob Deis
- Deputy City Manager Laurie Montes
- Deputy City Manager Mike Locke
- City Attorney John Luebberke
- Chief Financial Officer Susan Mayer
- City Auditor Mike Taylor
- Economic Development Director Wendy Saunders
- Human Resources Director Teresia Haase
- Interim Fire Chief Dave Rudat
- Interim Police Chief Blair Ulring
- Interim Municipal Utilities Director Jeff Willett
- Public Works Director Bob Murdoch
- Interim Budget Officer Larry Lisenbee

Documents Reviewed

To provide the City with a "second opinion" on the severity of the fiscal challenges it faces, Management Partners was provided with background information on the issues noted above and other financial and operational documents. Below are the key documents that we examined.

- Adopted budgets
- Bond downgrade notices
- California Public Employees Retirement System (CalPERS) annual valuation reports
- Staff reports on financial issues including reports prepared in connection with assessment of the financial implications of labor negotiation and litigation issues
- Comprehensive Annual Financial Reports (CAFRs) and management letters
- Four-year General Fund budget forecast
- Lease, bond, and certificate of participation terms for City and related agency debt
- Legal opinions on relevant financial issues
- Material event notices
- Memoranda of understanding with bargaining groups
- Other post-employment benefits (OPEB) actuarial reports
- Property and sales tax estimation reports
- Public facility fee program annual report

Study Limitations

The review performed by Management Partners is not an audit. The City of Stockton has annual independent audits which focus primarily on the City's adherence to generally accepted accounting principles. Management Partners' evaluation is not designed to serve that purpose or to be a precise representation of all fiscal issues facing the City. Rather it is an overview, serving as a second opinion on the estimates and direction recommended by the City Manager and staff. It is designed to be a review of the reasonableness of the financial assessment prepared by staff and the policy recommendations that flow from that assessment. This study was conducted between mid-December 2011 and mid-January 2012. The data relied on were prepared prior to that time.

Background

The City of Stockton is the 13th largest city in California, with a population of 292,000. The City's $603 million budget for FY 2011-12 includes a $163 million General Fund and 1,414 budgeted employee positions citywide. Our report centers on issues within the General Fund because these are the issues that staff identified. We examined other funds that were identified by staff as having the potential to adversely impact the General Fund. We did not, however, conduct a detailed review of all special purpose and enterprise funds. Doing so was beyond the scope of this project, which centered on providing a second opinion on fiscal challenges identified by City staff.

In the three fiscal years following the start of the Great Recession, the total revenue to the City's General Fund decreased by $30 million (from $203 million in FY 2008-09 to $173 million by FY 2010-11). Stockton had enjoyed a significant housing boom in the early to mid- 2000s. In 2005, the City processed nearly 3,000 permits to develop new residential houses. Five years later, that number had dropped to 152 permits.

Continued declines in property values coupled with increases in unemployment, and a high crime rate (the highest in the state) places increased demand on already strained services. The City Manager's State of Emergency for FY 2011-12 memorandum indicates that while home prices have leveled and stabilized, the median home price of $140,000 hovers at one-third of the 2006 level ($400,000). Meanwhile, Stockton's unemployment rate (19.2% in December 2011) continues to be well above national and state averages.

Deteriorating Fiscal Condition

The City's fiscal deterioration did not happen overnight. Our assessment is that the City's slide into insolvency occurred over about 10 years, with the issuance of debt the City could not afford, improvements to retiree medical benefits that were not sustainable, and by an over-optimism that growth that occurred in the mid-2000s would continue indefinitely. Although footnotes in the City's Comprehensive Annual Financial

Reports (CAFRs) alluded to problems, no warnings had been raised in management's transmittal letter as late as December 2009. Management's Discussion and Analysis for FY 2008-09 audited financial statements stated, "Stockton remains in a stable financial condition." Ten months later the City declared a fiscal emergency. The FY 2009-10 audited financial statements documented the financial problems facing the City in much more detail. Over the past two years, the fiscal condition has been better understood and City management and policy makers have taken steps to solve the problem.

In 2010, the City declared its first fiscal emergency, followed by a second fiscal emergency declaration in 2011. The City imposed significant cuts in employee positions and employee pay and benefits as part of its restructuring to resolve a $37 million General Fund deficit in FY 2011-12.

Its 2010 "Action Plan for Fiscal Sustainability" focused on reducing labor costs and increasing management control. Among the significant actions the City has taken to implement this plan to reduce costs include:

- Freezing salaries to FY 2010-11 levels.
- Requiring employees to pay the employee share of contributions to CalPERS.
- Eliminating City contributions to Deferred Compensation.
- Eliminating various kinds of specialty pay.
- Setting limits on City contributions to health insurance plans.

Negative service impacts have been identified by staff as a result of the compensation reductions. Examples of impacts are the following.;

- Increased turnover in public safety departments.
- Decrease in service provided due to vacancies until replacements found.
- Increased training costs.
- Decreased services through work furloughs due to fewer employee hours available.
- Employees using up leave balances delays expected savings.

The City's adopted budget for FY 2011-12 represents a cumulative 25% reduction in staffing since FY 2008-09. On an organization-wide basis, staffing has been reduced by 475 positions, from a total of 1,886 positions in FY 2008-09 to 1,414 in the current fiscal year FY 2011-12. Additionally, City leadership has cited success in bringing employee compensation in line with the market. However, while the City has made significant headway to contain costs, Stockton's financial condition continues to worsen.

Between March 2010 and December 2011, the City issued 20 Material Event Notices to alert investors and financial institutions to adverse events that may affect their interest in assets owned or leased by the City or its related agencies.

Analysis and Observations

In this section, Management Partners provides a summary of our analysis and observations pertaining to the financial issues that threaten the solvency of the General Fund. Several funds outside the General Fund are also at risk because deficits within these funds may require the City to use General Fund dollars or other unrestricted funds to cover potential deficits. These other funds are the following.

- Public Facility Fee Funds
- Internal Service Funds
- Redevelopment Agency Funds
- Grant Funds

Our analysis and observations are summarized below in each of these areas.

- Significant risks and increasing costs
- Service delivery solvency
- Budget solvency
    - Debt costs
    - Retiree medical costs
    - Accounting errors
- Cash solvency
- Other financial risks
    - Insufficient contingency
    - Litigation risks
    - Property tax revenues
    - California Public Employees Retirement System (CalPERS) costs
    - Wind-down of Redevelopment Agency
    - Unfunded actuarial liabilities

Significant Risks and Increasing Costs

The City of Stockton faces significant risks and increasing costs that weaken its financial position and continue to erode its ability to provide fundamental services. While all cities face risks with financial impacts, including natural disasters and litigation, known risks identified by City staff particular to Stockton's financial position include the following. Management Partners concurs with City staff that these are critical issues for the City.

1. Issuance of debt in 2004, 2006, 2007 and 2009 increased debt service payments linked to the General Fund by 600% between FY 2006-07 and FY 2012-13, creating major cash flow demands after revenues and reserves plummeted. This cash flow demand will add another $4 million in expenditures by FY 2024-25. While current low interest rates in the municipal bond market could result is some reduction of these costs through refinancing, the City is unlikely to get access to low cost debt given its bond call limits, liquidity problems and low revenues.

2. The City has variable rate debt structures that can rapidly increase debt service requirements or accelerate payment from 30 years to seven years if investors lose confidence in the City or banks that provide letters of credit to back the debt. The risks related to variable rate debt increased as reserves were consumed and the financial condition has deteriorated because the City cannot buffer the variable risk with reserves as it did in the fall of 2008 when variable rates spiked.

3. Issuance of pension obligation bonds just before the FY 2008-09 financial crisis resulted in a loss of almost a third of the debt proceeds that were deposited in the CalPERS investment portfolio over the following two years. This erased expected cash savings in CalPERS rates and requires the City to pay debt service on the $125 million issue amount while only getting the benefit of $82.5 million in the CalPERS portfolio.

4. A risk of continued declines in ongoing revenues such as property tax and development-related revenues could result from the combined pressure of foreclosures, reduced property values, vacant buildings, unemployment and reduced City services. It should be noted that, if

crime rates remain constant or rise and service levels decrease, property values could continue to decline.

5. Possible infrastructure failures resulting from deferred maintenance, as well as equipment and systems replacements that can no longer be deferred, will increase future budgets.

6. Public Facility Fee, Stockton Redevelopment Agency (SRDA) and Marina funds will not generate expected revenue to support their debt service, and thus will impact the General Fund.

7. Retiree medical costs are high and rising. Annual pay-as-you-go costs are projected to increase from the current $15 million ($9 million General Fund) to $30 million ($16.8 million General fund) over the next 10 years. Between FY 2009-10 and FY 2011-2012 citywide retiree medical costs have increased by $1.5 million despite benefit restructuring that reduced the unfunded liability by over $100 million compared to FY 2009-10. Between FY 2011-12 year and FY 2021-22 the City's actuary predicts the General Fund share of retiree medical costs will increase by 87%.

Service Delivery Solvency

The City can be considered insolvent from a service delivery perspective. Service delivery solvency is defined as a municipality's ability to pay for all the costs of providing services at the level and quality that are required for the health, safety and welfare of the community. While many cities might regard themselves as providing less than their community needs or desires, when a city cannot pay for (or does not have a reasonable plan to fund) basic services, including preventive and regular maintenance of assets or employee benefit costs, then that city is insolvent from a service delivery standpoint. The City of Stockton meets this definition on several levels.

While every community is different and there is no specific minimum level of service required of cities, the level of reductions made in Stockton's services are significant relative to the need within the community. Management Partners' analysis shows that serious reductions have been made in all areas and that adequate financial support for the full costs of delivering services including associated equipment and supplies does not exist. Available revenues are barely sufficient to support current service levels and costs, without considering

debt and retiree medical obligations. Future budgets will have to reduce debt costs, retiree benefit costs and service costs.

Table 1 below helps illustrate this point. This table shows that the operating costs to support City services take virtually all available revenues. This table *excludes* all payments to debt service (Public Facility Bonds, marina debt, new City Hall bonds, and pension obligation bonds) and health care premiums for retired employees. Note that even with these exclusions, the General Fund barely covers its costs in FY 2012-13 (with a surplus of $1.1 million), and resumes deficit spending in FY 2013-14 and FY 2014-15 at a rate of -$3.3 million and -$3.8 million, respectively.

The City has a legal obligation to repay its debt and retiree medical obligations unless it negotiates reductions. Nevertheless, the information in Table 1 shows the severity of the problem and underscores the point that while service reductions and labor cost reductions must be a part of the solution to balance the General Fund budget, the issue of creditors also needs to be addressed. Without the impact of debt service and retiree medical costs (creditors) the City's financial position would still be tenuous, but much less dire and more time would be available to find solutions.

Table 1. Pro Forma General Fund Budget Without Debt Service and Retiree Medical

	Optimistic Forecast (Baseline 1)		
	FY 2012-13	FY 2013-14	FY 2014-15
Revenue	$154,113,094	$153,593,332	$155,438,162
Expense[1]	171,385,033	176,421,939[2]	179,785,590[2]
Difference (Revenue/Expense)	(17,271,939)	(22,828,607)	(24,347,428)
Eliminate Debt Service and Retiree Medical Costs			
Public Facility Bonds	1,082,190	1,081,640	1,224,558
Marina Debt	732,000	732,000	732,000
New City Hall Bonds	1,866,794	1,866,794	1,866,794
Pension Obligation Bonds	5,644,217	6,072,694	6,170,124
Retiree Medical Costs	9,051,809	9,775,953	10,558,029
Pro Forma General Fund projected results	$ 1,105,071	$(3,299,526)	$(3,795,923)

[1] The "expense" line includes $3.5 million annually to cover administrative and debt service payments due to project area deficits in the Redevelopment Agency. With the recent California Supreme Court decision on AB 26/27, the City is in the process of revising its budgetary assumptions for the Redevelopment Agency.

[2] Expense figures are forecasted using the City's optimistic projection for labor costs, Baseline 1. The City's pessimistic projection for labor costs, Baseline 2, estimates total expenditures at $184,918,023 in FY 2013-14 and $189,600,044 in FY 2014-15. The optimistic projection includes the following labor cost assumptions.

- Furloughs continue for all bargaining groups.
- No cost of living adjustments.
- All concessions and imposed reductions continue.
- The increasing number of retirees will cause costs to rise by 8%.

- Current (active) employees absorb an 8% increase in their health costs.

It should be noted that this forecast is still service insolvent for current service levels. Internal service funds are underfunded, the retiree medical actuarial liability is unfunded, reserve balances are too low or nonexistent, while the City faces significant risks, and CalPERS rates may well increase.

Table 1 also shows the impacts that previous borrowing and promises regarding retiree health coverage will add to costs. When these decisions were made, staff and the City Council believed that strong economic and population growth would provide the resources needed to pay for these obligations. The Great Recession and the financial crisis of 2008 and 2009 changed that.

Even without the costs of these debts and commitments, the City would still face a difficult but less dire financial situation at its current reduced service levels because it has lost so much revenue. The combination of service, debt and benefit costs are such that there is not enough time to grow out of the problem. This downturn is unlike the 10-year boom and bust cycles that have characterized the California economy.

It also should be mentioned that the actions available to the City to reduce its costs have fallen most heavily on active employees through pay and benefit reductions and residents and businesses through service reductions. The retiree medical plan has been restructured to reduce costs and the eligibility for new hires has been limited but even with these changes the liability remains very high at almost $450 million. Bond investors that are supported by the financially distressed General Fund or Redevelopment Agency have not been affected.

Following are examples of service delivery insolvency pertaining to law enforcement, fire services, public works and the new City Hall.

1. **Staffing Levels for Law Enforcement and Fire Services.** Since 2009, in direct response to fiscal stress on the City, the number of police officers has declined from approximately 441 to 343. While it is difficult to identify a direct link between police staffing and the crime rate, the crime rate in Stockton also rose to the point that violent crimes per 1,000 residents increased to 13.81 in 2010, the second highest rate among California cities and the tenth highest in the country. Meanwhile, in the other cities included in the

Federal Bureau of Investigation survey with a population of over 100,000 violent crime fell by 5.5%.
Staffing levels in the Fire Department have also fallen from approximately 276 in 2009 to approximately 169 in FY 2011-12. Clearly both the Police and Fire Departments have significantly reduced service level reductions due to these staffing reductions. Those reductions have been mirrored in other City departments as well. Current service levels are far below what was provided by the City just three years ago.

2. **Funding for Law Enforcement Services.** The City of Stockton has been forced to reduce General Fund expenditures for its Police Department because of budgetary issues. Expenditures have gone from $93 million in FY 2008-09 to $85 million in the current fiscal year (FY 2011-12). In addition, while the City has been successful in acquiring federal Community Oriented Policing (COPS) grants and COPS Hiring Recovery Program (CHRP) grants, these funds come with maintenance of effort requirements that call for the City to continue funding the positions added through the grants after the grants expire. In the coming fiscal year, Stockton projects that it will need to cover $3 million in maintenance of effort for expiring COPS grants. For a city that is already spending more money than it brings in, locating an additional $3 million to fund maintenance of effort requirements for expiring grants is a significant challenge.

3. **Public Works.** The City has been unable to dedicate sufficient General Fund dollars to regular and periodic maintenance for public infrastructure, and as a result, the backlog of deferred maintenance is increasing with no end in sight. Staff estimates that annual contributions from the General Fund to support capital assets should be $15 to $20 million annually. However, the projected General Fund spending level for capital maintenance over the current and the next four fiscal years (FY 2011-12 to FY 2015-16) totals $2,832,000.

4. **New City Hall.** The City has acquired a new facility to house its administrative offices through a $40 million variable rate bond issuance. In addition, the City allocated $1.8 million for relocation costs that may be diverted to address immediate cash solvency issues. These items leave the City without a viable plan to occupy the new City Hall or to reduce the costs of holding the asset.

Unfortunately, it appears that funding of any significant amount to support moving to the new City Hall or improving the existing facility will not be available in the foreseeable future. The City will likely remain in the existing facility without improvements needed to make it safe and functional. Further, the City will likely not be able to make payments on the new building if its financial structure cannot be changed or if the variable rate debt accelerates.

Budget Solvency

The City can be considered insolvent from a budget perspective. "Budget solvency," refers to the ability of an agency to create a balanced budget that provides sufficient revenues to pay for its expenses that occur within the budgeted period. Since unforeseen events occur, an organization that is truly solvent from a budget perspective must have adequate reserves, as well as reliably accurate projected income and expenses. It does not mean that every annual budget needs to be balanced in terms of revenues and expenses but, over time, this must be the case.

Despite adopting balanced budgets at the beginning of each fiscal year the General Fund has operated at a deficit for the last three years. Though reductions in revenue sources have been anticipated and built into the budget fairly accurately, the last two budget years have been severely affected by corrections to accounting records to address errors that were discovered by the new City Manager and Chief Financial Officer. Based on current service levels, accounting corrections and known budget variances revenues will not match expenditures in the current fiscal year, or for the next three fiscal years. With major expenditure reductions already in place, further financial restructuring must occur to prevent budget and cash insolvency. The next section shows how that is the case.

Structural Imbalance Since FY 2008-09

Table 2 presents a seven-year perspective of General Fund revenues and expenses. It shows that the budget has been in structural imbalance since FY 2008-09. In FY 2008-09 and FY 2009-10, the City was able to use reserves and available cash (i.e., fund balance) to cover its costs. Such deficit spending cannot continue. The City has limited available unrestricted funds. The City expects that it will use all available unrestricted fund balance to cover General Fund expenses in FY 2011-12 and to implement accounting corrections from prior years.

However, using available unrestricted fund balance to cover costs and correct errors increases risk for the City. Since those funds are non-recurring, once they are exhausted, they cannot be used to absorb unexpected events and unfavorable budget variances.

Table 2. Seven-Year Perspective of General Fund Revenues and Expenses[1]

	Actuals		Estimated Actuals	Projected as of 12/20/11	Optimistic Forecast (Baseline 1)		
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Beginning Fund Balance	$9,628,221	$8,607,048	$1,101,075	n/a	n/a	n/a	n/a
Revenue	203,101,529	166,907,289	173,039,201	158,471,672	154,113,094	153,593,332	155,438,162
Expense	203,444,922	173,638,841	177,278,301	163,675,139	171,385,033	176,421,939[2]	179,785,590[2]
Difference (Revenue/ Expenditure)	(343,393)	(6,731,552)	(4,239,100)	(5,203,467)	(17,271,939)	(22,828,607)	(24,347,428)
Resources Used to Balance the Budget							
Use of Fund Balance	1,021,173	7,505,973	n/a	n/a	n/a	n/a	n/a
Ending Fund Balance	**$8,607,048**	**$1,101,075**	**$(6,180,602)[3,4]**	**n/a[5]**	**n/a[5]**	**n/a[5]**	**n/a[5]**

[1] Based on City's November 9, 2011 Midyear Budget Review for FY 2010-11 and the City's four-year forecast as of January 18, 2012.
[2] Expense figures are forecasted using the City's optimistic projection for labor costs, Baseline 1. The City's pessimistic projection for labor costs, Baseline 2, estimates total expenditures at $184,918,023 in FY 2013-14 and $189,600,044 in FY 2014-15.
[3] Based on information available on December 31, 2011.
[4] Fund balance also changed as a result of proposed prior period adjustments not reflected in the budget basis schedule.
[5] Hypothetical negative fund balances are not displayed because the City must take action to address budget insolvency and cannot adopt a budget that is out of balance.

The analyses show that the City of Stockton has not met the definition of budgetary solvency in any of the prior three fiscal years, and the problem is only projected to get worse. Over the next three years, there is a gap of $17 million to $24 million between projected resources and anticipated expenditures in the General Fund. Thus, the City will not be able to generate a balanced budget in the coming years, unless significant changes are made.

Not reflected in Table 2 is that restatements and corrections of accounting errors in prior periods reduced the available General Fund balance at July 1, 2010 from $11.4 million to a $3.5 million deficit. That deficit grew to $6.2 million by the end of FY 2010-11 and General Fund cash, excluding payroll trust cash, dropped to an $11.7 million deficit. Collections of accrued revenues and receivables were expected to cover deficit cash as this fiscal year began.

Accounting corrections affecting fund balances have not been included in this schedule so year-to-year comparisons are not distorted. The City has not projected cumulative deficits because staff plans to take action before these deficits would occur. There are no reserves to absorb deficits. Annual deficits shown in the out years in this table illustrate a large and growing problem and indicate the size of the gap in the forecast period.

City of Stockton Debt

As of June 2011, the City of Stockton owed $977 million in debt on bonds, notes, and long-term leases. The majority of the debt is secured by restricted revenues ($659 million) and is not affected by the reduced resources level of the General Fund. The remaining $319 million is secured by the General Fund. It should be noted that general purpose revenues are not the only funding for debt that is secured by the General Fund. In a number of cases, the General Fund was needed as a guarantor to improve the underlying credit rating then debt was issued. Nearly all of the current debt secured by Stockton's General Fund was issued during the real estate boom that preceded the recent recession.

Below is a list of the outstanding debt that is secured by the General Fund, as of June 2011.

Bonds

- 2003 Housing Projects - $13,300,000
- 2004 Events Center / Arena Project - $45,985,000
- 2004 Parking and Capital Projects - $31,945,000
- 2006 Essential Services Building - $12,470,000
- 2007 New City Hall - $40,500,000
- 2007 Pension Obligation Bonds - $124,660,000
- 2009 Public Facility Fees - $35,080,000

Notes

- 2011 Marina Capital Improvements - $11,061,093

Equipment Leases

- 2007 Fire Trucks - $815,142
- 2007 Telephone System - $1,162,820
- 2011 Civic Auditorium HVAC Equipment - $1,777,734

Direct General Fund Debt

The City is at risk of defaulting on its direct General Fund and cross-collateralized debt. The City is directly obligated for $169 million of debt issues primarily benefiting General Fund operations. Debt service is

included in the City's four-year forecast and the cost is allocated among all funds benefitting from the proceeds of the debt. The primary sources of this debt are pension obligation bonds (POB) and variable rate bonds for the new City Hall.

Both the Pension Obligation Bonds and the variable rate bonds have complex risks associated with them. The City did not retain reserves to serve as a cushion against cost increases associated with POBs and variable rate bonds. As a result, service levels could be materially affected by unbudgeted cost increases.

In addition, the City drew down what reserves it had because it could not change the budget and cost structure quickly enough to respond to reduced revenues, due to contractual and legal obligations. The City's financial condition is much weaker because, without reserves, it cannot absorb unexpected costs.

Table 3 provides a summary of direct General Fund debt as well as a settlement obligation from a lawsuit brought by the Howard Jarvis Taxpayers Foundation. As a part of the court-approved settlement agreement, the City's General Fund must repay money to the Water and Wastewater Funds in the amount of $19.4 million. We treat the $19.4 million settlement as a debt for the purposes of this analysis. This brings the total direct General Fund debt and settlement obligation total to $189 million.

Table 3. Direct General Fund Debt and Settlement Obligation

Issue	Issuer	Principal	General Fund Impact FY 2011-12	General Fund Impact FY 2012-13
2007 Pension Obligation Bonds	City	$124,660,000	$5,615,200	$5,644,217
2007 Variable Rate Bonds (City Hall) Series A&B	Stockton Public Financing Authority	40,500,000	857,544[1]	1,866,794 [1]
Equipment leases	City	3,755,696	250,000[2]	250,000[2]
Sub-total, Direct GF Debt Obligations		**$168,915,696**	**$6,722,744**	**$7,761,011**
Jarvis Settlement	City	19,378,000[3]	1,112,998	1,112,998
Total		**$188,293,696**	**$7,835,742**	**$8,874,009**

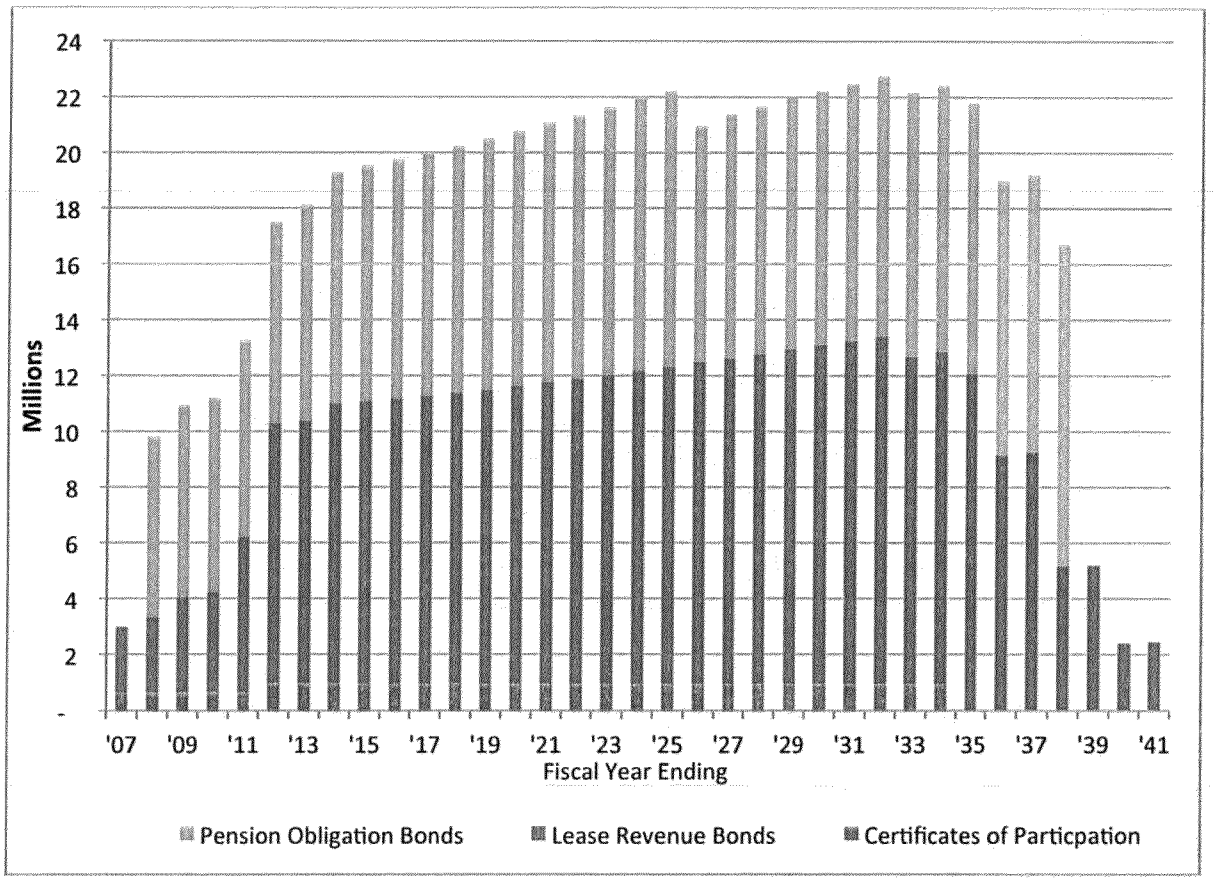
[1] Other funds contribute their allocated share of the costs associated with space in a new City Hall and the Pension Obligation Bonds.
[2] Estimated at $250,000, however, actual lease amounts may range from $250,000-350,000.
[3] Court approved settlement of lawsuit relating to repayment of transfers from Water and Wastewater Enterprise Funds.

Table 3 also shows that the impact on the General Fund will increase from $7.8 million in FY 2011-12 to nearly $8.9 million the following year. If the City cannot move into the new City Hall, the General Fund may have to bear the full cost of debt service for that building.

Figure 1 shows the dramatic increase of debt service payments by the General Fund for pension obligation bonds, lease revenue bonds, and certificates of participation between FY 2006-07 and FY 2040-41. The data show that in FY 2006-07, debt service payments were $3 million. The next year the figure jumped to $9.8 million due to the start of payments on pension obligation bonds that were issued in 2007.

In the current fiscal year, total General Fund debt service payments will be $17.5 million. The payments are projected to peak in FY 2031-32 at $22.7 million, and decline significantly in FY 2038-39 when the pension obligation bonds are scheduled to be paid off.

Figure 1. Forecast of General Fund Debt Service Payments



Source: Figure prepared by Management Partners based on data from Stockton's Comprehensive Financial Audit Reports and the Summary of Outstanding Debt Presentation by Public Financial Management, November 2010

The debt issues included in Figure 1 are as follows:

- Pension Obligation Bonds
  - Series 2007 A and B
- Lease Revenue Bonds
  - Series 2004 (Arena Project)
  - Series 2004 (Central Parking District)
  - Series 2006 A (Refunding)
  - Series 2007 A and B (Building Acquisition Projects)
  - Series 2009 A (Capital Improvements)
- Certificates of Participation (COP)
  - Series 2003 A and B (Redevelopment Housing)

General Fund Risk for Public Facility Fee Fund Debt

Stockton's financial problems extend beyond the General Fund. Instability due to deficit spending and large negative fund balances have been identified by staff and confirmed by Management Partners in interfund transfers and special funds. For example, the General Fund may be obligated to support deficit balances in the Redevelopment Agency and Public Facility Fee funds. Table 4 shows the projected required General Fund contribution to cover debt service that should be paid through Public Facility Fee accounts.

Table 4. Estimated General Fund Risk for Public Facility Fee Fund Debt Service

	Actual	Estimated Actuals	Projected as of 12/20/11	Forecast		
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Total Debt Service (a)						
Streets	$1,395,930	$808,138	$822,589	$822,589	$995,317	$996,411
Fire	200,498	412,300	419,646	419,646	507,764	508,322
Police	507,167	293,672	298,905	298,904	361,669	362,066
Parks	417,911	859,376	874,698	874,698	1,058,368	1,059,531
Total Debt Service	$2,521,506	$2,373,486	$2,415,838	$2,415,837	$2,923,118	$2,926,330
PFF Ability to Pay (b)						
Streets	1,395,930	808,138	822,589	822,589	995,317	996,411
Fire	200,498	412,300	95,570	150,774	251,359	189,641
Police	507,167	293,672	-	-	94,740	18,824
Parks	417,911	859,376	874,698	360,284	500,062	496,896
Total Ability to Pay	$2,521,506	$ 2,373,486	$1,792,857	$ 1,333,647	$ 1,841,478	$1,701,772
General Fund Risk (a-b)	**$0**	**$0**	**$622,981**	**$1,082,190**	**$1,081,640**	**$1,224,558**

The City accumulates funds for its Pension Obligation Bond payment throughout the year. This year, due to shrinking payrolls, the City estimates that it will not accumulate sufficient funds through interfund payroll charges, and will be almost $1 million short of making a full August 2012 payment. This will be an adjustment of a budget estimation error in FY 2011-12.

General Fund Supported Debt (On Behalf of Other Funds)

The City issued the following debt on behalf of other funds and guaranteed the payment of debt issued by other funds to address investor concerns about the strength of the primary sources of repayment. This means that the City's General Fund may be liable for shortfalls if the primary revenue sources cannot cover the required debt service payments. These debt issues are the:

- 2003 Lease COPs A & B Housing (asset transfer)
- 2004 Revenue Bonds – Event Center/ Arena
- 2004 Lease Revenue Bonds Parking/ Capital
- 2006 Lease Revenue Refunding Parking/ Building
- 2009 Lease Revenue Bond Refunding/ Capital Improvement Projects (Public Facility Bonds)
- Marina Enterprise State Note Payable

The principal amount of the above debt issues is $150 million. Table 5 provides a summary of these General Fund supported debts on behalf of other funds. The data show that the impact on the General Fund will jump from $1.7 million in FY 2011-12 to 2.8 million the following year.

Table 5. General Fund Supported Debt (on behalf of other funds)

Issue	Issuer	Principal Amount	Total Payment *New FY 2011-12 GF Impact*	Total Payment *New FY 2012-13 GF Impact*
2003 Lease COPs A & B Housing (asset transfer)	City	$13,300,000	$326,372	$990,170
			$326,372	***$990,170***
2004 Revenue Bonds – Event Center/ Arena	Stockton Redevelopment Agency	45,985,000	1,061,114	2,570,687
			0	***0***
2004 Lease Revenue Bonds Parking/ Capital	Stockton Public Financing Authority	31,945,000	803,658	1,960,116
			0	***0***
2006 Lease Revenue Refunding Parking/ Building	Stockton Public Financing Authority	12,470,000	257,747	907,494
			57,858	***18,097***
2009 Lease Revenue Bond Refunding/Capital Improvement Projects	Stockton Public Financing Authority	35,080,000	1,207,919	2,415,838
			622,981	***1,090,000***
Marina Enterprise State Note Payable	Stockton Redevelopment Agency	11,061,093	732,000	732,000
			732,000	***732,000***
Totals		$149,841,093	$4,388,810	$9,576,305
			$1,739,211	***$2,830,267***

Optimistic Assumptions

The City had planned for tax increment, impact fees, and other non-general purpose revenues to cover debt payments on the Stockton Arena, the marina and other public facilities that were needed to support new and anticipated private sector activities (e.g., new housing developments and business growth). Severe weakness in these revenues, lack of management control over Stockton Redevelopment Agency expenditures, overly optimistic estimates of marina revenues and interfund lending and borrowing now impose costs on the General Fund. These costs will continue for years and could grow, absent a booming recovery in real estate values and business activity, or restructuring of the debt.

Risk of Increased Debt Interest

The City could experience acceleration of variable rate interest debt or higher interest rates, resulting in higher costs. Investor concerns about the

issuer's financial condition, or that of the Stand by Purchase Agreement provider[1] or of the bond insurer, will either result in higher rates and increased costs or will cause investors to refuse to purchase the debt at any interest rate. Information about insolvency, default or bankruptcy of the issuer or credit support providers will often prompt investors to return all bonds. If bonds are returned the interest rate increases to 0.5% over prime and if the bonds are not remarketed the rate increases again to 1% over prime. Bonds held over 180 days can be accelerated to a seven-year amortization schedule. Bond insurers may not invoke this provision to avoid having to guarantee the cash flow to the letter of credit bank.

Risk of Defaulting on Debt

As noted above, the City is at risk of defaulting on its direct General Fund and cross-collateralized debt. The City is directly obligated for $169 million of debt issues primarily benefiting the General Fund operations and is obligated to reimburse over $19 million to its utility funds as a result of a court-approved legal settlement. Debt service is included in the City's four-year forecast and the cost is allocated among all funds benefitting from the proceeds of the debt. The primary sources of this debt are pension obligation bonds (POB) and variable rate bonds for the new City Hall.

Where agreements have not been worked out for all contracts and debt, "hard default" after bond reserves are consumed could lead to an uncontrolled default. Many of the City's creditors would pursue separate legal actions to enforce their contractual rights. Some creditors could trigger cross default provisions if the City defaults on obligations over $5 million. Few creditors will make agreements outside of bankruptcy's structured process unless all other creditors are on board and there is a provision for unknown liabilities that have not surfaced.

Reaching agreements with investors outside a structured process or even within bankruptcy is difficult and expensive. Creditors and trustees are also subject to investor or shareholder lawsuits if they do not aggressively protect bondholders, thus being proactive and avoiding contests in court is most advantageous for the City.

---

[1] In terms of variable rate debt a Stand By Purchase Agreement (SBPA) provides liquidity during the weekly remarketing effort if needed. Stockton's SPBA provider on the new City Hall debt is Dexia, a company that has suffered a credit downgrade. This will likely affect investor interest in purchasing the debt.

Therefore, the City must avoid an uncontrolled default at all costs. It is better to plan for bankruptcy, but be able to avoid it, than to have it essentially imposed upon the City in a chaotic situation. While such a decision is politically difficult, it is the only financially and managerially prudent approach to take, given the existing situation and risks.

Retiree Medical Benefit Costs

Retiree medical costs are high and rising. Annual pay-as-you-go costs are projected to increase from the current $15 million ($9 million General Fund) to $30 million ($16.8 million General fund) over the next 10 years. Between FY 2009-10 and FY 2011-2012 citywide retiree medical costs have increased by $1.5 million despite benefit restructuring that reduced the unfunded liability by over $100 million compared to FY 2009-10. Between FY 2011-12 year and FY 2021-22 the City's actuary predicts the General Fund share of retiree medical costs will increase by 87%.

Staff noted that during the last 20 years, the City enhanced its retiree medical benefits and offered plans that required limited financial contributions from plan participants and their dependents. Until 2011, most retirees participated in the Modified Plan established in 1993 that paid 100% of almost all medical claims with a deductible of $50. In 2011, the City negotiated changes that provided for higher deductibles, 80% in-network benefit and 60% out-of-network benefit. This is the first major cost containment measure implemented since the Modified Plan was established.

As of January 1, 2012, the City had almost 1,100 retirees receiving retiree medical benefits. This was an increase of about 10% from the year before. One third of these retirees are over 65 and two thirds are under 65; the over-65 lifetime retiree benefit was only available after 1995 for most employees. Much of the City's workforce consists of safety employees who retire at younger ages.

The history of retiree medical benefits is summarized below, as provided by City staff:

- Prior to 1980 the City did not provide any contribution towards the cost of retiree medical benefits and did not allow retirees to buy coverage under the City's plan.
- Between 1980 and 1983, retiree medical benefits were extended to all employees. Public safety employees were granted a time limited benefit for the retiree and 1 dependent for 7 years or until age 62. The intent was to provide a bridge until the employee was

Medicare eligible, as to not create a lifetime obligation to the City. Other employees were offered limited medical benefits based on the number of months of paid premium for their cash out of sick leave hours (dependent coverage was not available).

- The initial benefit plans had no minimum years of service to Stockton. An employee only had to retire while employed by Stockton. In theory, a person would only have to work one month and then retire from CalPERS to receive the medical benefit.
- By 1986, the City allowed retirees to buy coverage for extra dependents and themselves if their City pay insurance would expire before they reached the Medicare eligible age of 65. While the original intent was that retirees would pay the full costs for coverage, the City consistently undercharged retirees in these circumstances by not increasing charges in most years. By January 2011 the City was undercharging 103 retirees, at a cost of $900,000 a year. This was resolved in July 2011 but past undercharges were not corrected.
- Starting in 1985 through 1998, the City expanded its medical benefit coverage for all employees to cover the retiree and one dependent beyond the age of 65. Thus, the City-paid coverage no longer stopped when the participant was eligible for Medicare. No specific years of service were required to receive this expanded lifetime medical benefit.
- In 2005 the City negotiated changes in retiree benefits for new hires and current employees for Stockton Police Officers Association (SPOA) members and police management. New hires in these areas would not receive City-paid retiree medical. The City would pay 2+% of salary into the retiree medical trust instead. Current employees would get City trust payments and would get the City retiree medical benefit frozen at the City's contribution level in 2012.
- Between 2008 and 2010, operations and maintenance employees and the operating engineers bargaining group negotiated to get retiree medical benefits for the retiree and their spouse after 15 years of City service.
- In 2009, the City negotiated with Stockton City Employee Association (SCEA) members as well as the mid-management, supervisors, and operating engineers bargaining groups to change the benefit so that new hires would not get the City retiree medical benefit but would get 2% of their salary into retiree medical trust.

- In 2011, for all employees except SPOA and SCEA members, the City negotiated that new hires as of July 2011 would not receive any retiree medical benefits.

While the City's recent efforts to change retiree medical benefits are steps in the right direction to contain benefit cost for future retirees, they do not significantly address the costs for employees who have already retired.

Accounting Errors

Specific to the General Fund, Management Partners was informed of accounting issues affecting last year's budget that include uncollectible receivables, prior period accounting errors and unfavorable budget variances affecting the current FY 2011-12 budget. Such accounting issues have overstated the amount of available unrestricted balances or increased risks associated with underlying assets. Updated projections for the next three years will, according to City staff, pose significant risks and threaten the solvency of the fund. Administrative actions identified by Management Partners can mitigate the impact of some of these issues. Unfortunately the amounts involved are one time only and are small in the context of the severe budget and liquidity issues facing the City. Ongoing detailed analysis of the City's accounting records continues to reveal problems that are being addressed as they are encountered.

Restatements and corrections of accounting errors in prior periods reduced the available General Fund balance at July 1, 2010 from $11.4 million to a $3.5 million deficit. That deficit grew to $6.2 million by the end of FY 2010-11 and General Fund cash, excluding payroll trust cash, dropped to an $11.7 million deficit. Collections of accrued revenues and receivables were expected to cover deficit cash as this fiscal year began.

At the time of this report, the Finance Department was in the process of closing the books on FY 2010-11 to prepare for the comprehensive annual financial report, which will be conducted by the City's new independent audit firm, Maze and Associates. Changes to cash and budget projections and accounting records continue as more information is developed. Given the number of problems encountered in the City's accounting records the level of change and uncertainty surrounding operating results and forecasts is not unusual. It does, however, introduce solvency risk that is normally managed with reserves as problems are identified, analyzed and as solutions are implemented.

Public Facility Fee Interfund Loans

As staff analyzed accounts, they noted that certain Public Facility Fee interfund loans could not be repaid because of declines in Public Facility Fee revenue and, in the foreseeable future, debt service payments will consume all available revenue in the funds with debt that received the loans. Uncollectible interfund loans will be reclassified as transfers reducing the PFF fund balances. The Community Center Fund owes $2.8 million, the Fire Station Fund owes $2.4 million and the Police Station Fund owes $1.2 million, for a total of $6.4 million.

Management Partners believes there are alternatives to an immediate repayment of the PFFs, such as a phasing schedule. We communicated our thoughts on this to the City Manager and advised that legal advice should be sought to ascertain whether an immediate remedy for all Public Facility Fee and interest allocation compliance issues is required or whether a phased-in approach, an administrative action, or fixing the problem on a go-forward basis could be used to provide more time for the City to restructure its finances. The City Attorney is working with special counsel and will advise the City Council on a recommended course of action. The recommended solution for these issues will not result in risks more serious than the risks it would face if it consumed available unrestricted fund balances immediately.

Cash Insolvency

"Cash solvency" is defined as an organization's ability to generate and maintain cash balances to pay all its expenditures as they come due. The City of Stockton is nearly cash insolvent and is likely to run out of unrestricted available fund balances (UAFB) by the end of the fiscal year. Estimates of collections of receivables, liquidity of other fund assets, legal and contractual restrictions and future revenues attributable to the current period affect the timing of insolvency.

We base this conclusion on our review of the City's UAFBs at the beginning of FY 2010-11, restatements and revised deficits figures for FY 2010-11 as well as year-to-date expenses in the current 2011-12 fiscal year and other known issues, itemized below. We have also had several discussions with the Chief Financial Officer and have reviewed the City's four-year forecast and the scorecard dated November 11, 2011, which contains potential issues affecting cash solvency in FY 2010-11, FY 2011-12 and future budgets.

We believe the City should take action now, if possible, to address impending insolvency before it runs out of unrestricted cash (see Recommendation section). This will make sure that lack of unrestricted cash does not result in an uncontrolled default or breach of contract obligations. A forecast of insolvency is adequate reason to convene the AB 506 process or a Chapter 9 filing if other requirements have been met.

The City started the year with a cash deficit that will likely worsen because of further material accounting corrections, unfavorable budget variances and legal issues affecting the valuation of interfund transactions in the Redevelopment Agency and PFF funds. Optimistic budget forecasts show that the City faces large deficits in future years and is unlikely to win support for new revenues because of public concern about the problems discovered by the staff and City Council since July 1, 2010. The deficits continue in future years even if the City could eliminate all debt payments and all payments for retiree medical benefits due to major revenue losses and costs resulting from the financial crisis, the Great Recession, and the growing costs of debt. The current pessimistic scenario does not include all possible negative outcomes, primarily those related to possible bond default or adverse legal rulings.

Because the City did not have an updated cash projection for the General Fund at the time of this report, we cannot precisely predict when the City will run out of unrestricted cash to pay its employees, retirees and investors. However, the factors above make it very likely that the City could face uncontrolled debt default or contract breach due to a lack of unrestricted available cash within 12 months if immediate action is not taken.

A legal review to determine whether unrestricted cash must be allocated immediately to address legal compliance issues or whether a deferred approach would be appropriate is essential. Without the temporary cushion provided by the last of the City's available unrestricted cash balances, the City may not have time to complete the processes that will afford it protection while it restructures its financial situation. The City's decision on this matter has implications for restructuring, debt disclosure and legal liability and must be supported by expert legal advice.

Though the exact timing of the point when the General Fund runs out of cash is uncertain, we think there is little doubt that it will face cash insolvency in FY 2012-13. Only an extraordinary economic recovery in the next several months could close the budget gap forecasted in the General Fund. Negative financial information developed after the documents we reviewed were prepared could accelerate insolvency into FY 2011-12.

Other Financial Risks

As noted above, the weakness of the City's financial condition as represented in documents prepared by the Chief Financial Officer for FY 2011-12 and FY 2012-13 is not overly conservative. Indeed, Management Partners believes it is likely too optimistic, as a number of contingent liabilities related to legal, budget and financial risks have not been factored into this year's cash forecast or the four-year budget forecast.

Management Partners believes that these additional risks may further contribute to the City's longer-term fiscal challenges or, in the worst case, may create immediate cash insolvency in the General Fund.

Insufficient Contingency

The General Fund is about to exhaust its unrestricted available fund balances and has an insufficient contingency reserve given the risks that must be covered. The City's current General Fund reserve policy calls for a minimum of 10%, which is divided into a 5% reserve for catastrophic events and 5% for economic contingency/budget uncertainty. Neither of these reserves is currently funded. The dollars representing the total 10% reserve policy, on a FY 2011-12 General Fund budget of $167 million, would be approximately $16.7 million. At present, the City could exhaust the fund balance in the General Fund and has recently only budgeted a contingency of $2 million annually. This year $1 million of that contingency has been used to deal with unfavorable budget variances and correction of past period accounting errors.

The Government Finance Officers Association (GFOA) Best Practice on "Appropriate Level of Unrestricted Fund Balance in the General Fund" recommends a reserve of at least two months of regular General Fund operating revenues or regular General Fund operating expenses. Such a reserve amount for the City's FY 2011-12 General Fund budget would be $28 million. At mid-year the projected unrestricted available fund balance for the General Fund is negative by a manageable amount. But only $1 million remains to absorb unexpected budget changes in the second half of the year. The GFOA Best Practice also recommends that the reserve be set to reflect an individual city's financial circumstances and risk environment.

Lower reserve levels are most often seen in larger agencies with stable revenue sources. Standard and Poor's noted last year that their 2006 downgrade of the City's bond rating, which reduced the City's financial practices from strong to good, was related to the fact that the City dropped below its 5% reserve target for economic contingencies and its

5% reserve target for catastrophes. In addition to dealing with unstable revenues that have dropped since the beginning of the Great Recession, the City of Stockton now faces a number of financial challenges and risks as noted above.

Management Partners believes that, given the risk environment of the City, neither the current level nor the adopted target level of reserves is adequate. Ideally, the City of Stockton would have reserves significantly higher than industry guidelines given the high risks it faces. Such reserves would then allow the City to absorb and adjust to impacts without significant immediate reductions in critical services. Because the identified risks will continue into the future, a sustainable financial plan should include a plan to build City reserves to a level appropriate to risks or the plan should detail how to restructure the risks to eliminate their negative impacts.

The conflict among competing cash demands is not unheard of in a complex fiscal environment with many specialized funds, and underlies recommendations for reserve balances of 10% to 15%.

Litigation Risks

The City has significant litigation risks that could result in additional expenditures not currently budgeted. Management Partners was provided information about pending litigation in order to have a framework for understanding risks. We also reviewed legal claim disclosure issues related to the upcoming 2011 Comprehensive Annual Financial Report.

Based on interviews with staff and material prepared by the City Attorney in connection with the FY 2010-11 CAFR, Management Partners understands that legal risks have not been quantified either because the risk of loss is remote or the amounts cannot be estimated. Sufficient information was not available to enable Management Partners to reasonably estimate the potential risk to the General Fund (or other City funds) from a negative result of litigation.

The City's lack of reserves makes impact from legal liabilities more problematic than usual. It should be mentioned, however, that the City carries excess liability coverage for insurable liabilities over $1,000,000 that may apply to several of the open cases. Nevertheless, for a city with inadequate reserves and limited available cash, even settlements within Stockton's self-insured retention level can pose a significant cash flow problem.

One uninsurable case that could have material impact where probabilities and amounts cannot be estimated for financial disclosure is the lawsuit by the Stockton Police Officers' Association (SPOA) filed on July 14, 2010. The lawsuit challenges the City's right to reduce compensation to employees represented by the SPOA after it declared a fiscal emergency in both 2010 and 2011. The financial impact of losing the SPOA lawsuit is not factored into the City's optimistic financial projections but would be significant. This would worsen its cash position and negatively impact the budget for FY 2012-13 which, according to the City's forecast, is already structurally imbalanced for that year.

Such a court decision could immediately invalidate budget assumptions for the current fiscal year and FY 2012-13 and make cash and budget insolvency imminent. If our recommendations as described in the following section are followed, the City will begin restructuring efforts before May 2012 when a court decision on this case is expected.

Further, we note that an adverse decision in the SPOA case could trigger another bargaining group to petition for retroactive re-instatement of compensation to their members. The annual amount of the reductions that were imposed on other bargaining group is estimated at $6.7 million in total, of which $3.7 million would be needed from the General Fund.

Property Tax Revenues

The City may experience further declines in property tax revenues. The recent economic downturn has had a severe impact on the housing market and on property values in Stockton and the immediate area. Property tax revenues for the City have fallen from $55.5 million in FY 2008-09 to a projected $44.4 million in FY 2011-12, and are expected to fall farther due to declining market values and a high level of foreclosure activity. The City's four-year forecast assumes further reductions of 5% in FY 2012-13 and 4% in FY 2013-14 before stabilizing in FY 2014-15. The City's estimate is based on its analysis of information from various sources, including the County Assessor and HdL Companies, which is the City's property and sales tax consultant.

Management Partners understands the basis for the City's property tax revenue forecast but believes there is a risk that the current forecast may be too optimistic, given economic conditions and the high level of foreclosures being experienced.

CalPERS Rates

The City could see higher CalPERS rates than currently forecast after FY 2012-13. The four-year forecast includes retirement costs to be paid to CalPERS based on information provided by CalPERS in the most recent actuarial valuation received in October 2011. The rates for FY 2012-13 are fixed, while the rates for FY 2013-14 and FY 2014-15 are preliminary.

The CalPERS rates consist of two components: the *normal cost* and payment on the *unfunded accrued liability (UAL)*. The rate for the second element, the UAL, is derived by taking the dollar amount needed for the year and dividing it by the total payroll base. Unfortunately, the calculations are based on payroll information for the City as of June 30, 2010 and since that time, the City's payroll base has reduced substantially due to reductions in positions. There is a high likelihood that this portion of the rate, when recalculated to reflect the current lower payroll base, will rise substantially. Because the decline in payroll occurred in FY 2011-12, the impact will be felt in the rates beginning in FY 2013-14. If the recalculation occurs, CalPERS will provide the City with a new rate to use for its budget estimates, and the new rate for FY 2013-14 and subsequently years will need to be included in the salary and benefit cost projections in the four-year forecast.

Additionally, the CalPERS payment amount could increase if actuarial assumptions are changed in the future. Currently, the economic assumptions underlying the valuations are being reviewed by the CalPERS actuarial staff, with a recommendation to the CalPERS Board due in March 2012. The economic assumptions include portfolio yield, cost of living, and salary increase projections. Any adjustment in these assumptions could impact the CalPERS employer rates going forward.

Wind-Down of Redevelopment Agency

The City could have unexpected costs associated with winding down its Redevelopment Agency following the California Supreme Court's decisions regarding Propositions 26 and 27. Changes to Stockton's Redevelopment Agency (SRDA) may create unbudgeted expenditures and ongoing risk. The City has no reserves to cover such expenditures and risk. The Court's decision may also mean that the City will no longer be able to support the economic development programs essential to rebuilding the local economy.

The SRDA's current status weakens the City's financial position in several ways: 1) by being a long-term cash commitment if the City administers

the successor agency phase-out, 2) as a source of liability because of the General Fund's role as guarantor, and 3) as a source of contingent liabilities from either the oversight board's decisions or from actions of the legislature. Restructuring the risk exposure to its debt obligations by renegotiating debt terms is the best course of action for the City.

Unfunded Actuarial Liabilities

The City has unfunded actuarial liabilities for employee benefits in its internal service funds and has unfunded actuarial liabilities in both its CalPERS pension plans and its Enhancement Plan. The City has no structured funding plan for retiree health care long-term actuarial liabilities. Only CalPERS requires a consistent funding program for unfunded liabilities.

The funding available in the City's self insurance program provides working capital for annual operations. The primary assets in those funds are amounts receivable from other City funds to cover annual pay-as-you-go costs. There is no structured program to accumulate funds for future payments on incurred liabilities. This transfers the costs of past operations to future taxpayers, depriving them of the service levels their taxes could fund.

Table 6 shows the unfunded amounts of actuarial benefit and claim liabilities at the most recent reporting date.

Table 6. City of Stockton Unfunded Actuarial Liabilities (UAL) and Long-Term Self-Insured Claim Liabilities (Most Recently Reported – January 2012)

Item	Unfunded Liability and Claims Liability	Estimated Annual Amortization Amount	Amortization Amount Funded
Pension UAL			
CalPERS Miscellaneous Employees	$54,700,000	$4,100,000[1]	$4,100,000
CalPERS Safety Employees	95,700,000	6,700,000[1]	6,700,000
Enhancement Plan	4,800,000	800,000	800,000
Pension Obligation Bond	124,700,000	7,700,000[1]	7,700,000
Sub-total Pension UAL	*279,900,000*	*19,300,000*	*19,300,000*
Retiree medical (FY 2009-10 CAFR)	543,700,000	27,100,000	0[2]
Total Retiree UAL	*$823,600,000*	*$46,400,000*	*$19,300,000*[4]
Long Term Claim Liabilities			
General Liability (FY 2009-10 CAFR)	3,900,000	800,000[3]	0[2]
Workers' Comp (FY 2009-10 CAFR)	42,200,000	8,400,000[3]	0[2]
Sub-total Claim Liabilities	***46,100,000***	***9,200,000***	***0***
Grand Total	**$869,700,000**	**$55,600,000**	**$19,300,000**

[1]Fiscal year 2009-10 amount was $2.2 million for Miscellaneous, $1.5 million for Safety and $0 for Pension Obligation Bond for a total of $3.7 million. The increase in unfunded pension liability cash requirements from FY 2010-11 to FY 2012-13 is 550%.
[2]Annual funding covers current operations and claim payment requirements only.
[3]Annual amortization required to fully fund the liability in five years. Actual cash demands may vary but claims develop over a shorter period than pension cash requirements.
[4]Subsequent benefit restructuring reduced this total.

The City is only funding actuarial claims and liabilities required by its contracts with CalPERS and its pension obligation bond indentures. Pension obligation bond payments will remain fixed but CalPERS pension contributions are expected to increase. A major contributing factor to the City's cash and budget crisis on the expenditure side is that its cost of amortizing CalPERS unfunded liabilities has increased by $6.2 million per year to $10.8 million per year between FY 2010-11 and FY 2012-13 (a 290% increase) according to CalPERS' most recent analysis. In addition the City pays $7.7 million per year on Pension Obligation Bond Debt issued in 2007 for a total of $18.5 million per year.

The current service cost (also called the normal cost) of the retirement plan remains fairly stable at about $19 million per year. When employee contributions, payments to CalPERS and payments on Pension Obligation Bonds are considered, the total cost of the City's pension plan is about 50% of eligible compensation for safety employees and 33% for other employees based on the City's FY 2010-11 payroll reported to CalPERS. As noted above, subsequent actions to reduce payroll will cause rates that amortize unfunded liabilities to increase after FY 2013-14.

Fees

This financial condition assessment did not focus on fees. However, during our interviews and analysis, we noted that the City does not have an ongoing aggressive fee management program that ensures that fees and fines cover the costs of service they are intended to cover. Without careful and consistent fee management, the City may be losing revenue that would otherwise be available to support services.

Fee analysis and overall fee management is important and should be done on an ongoing basis. Proper fee management requires an allocation of resources to ensure that revenues are produced as intended. Analytical resources are needed for setting fees and fines and staffing resources are needed to carry out the programs that will produce the revenue. From interviews with staff, it appears this has been a low priority. Once the City gets through its immediate crisis and completes its financial restructuring, fee management would be an important future action.

Recommended Actions

Management Partners has identified several actions to be taken by the City immediately to address its financial challenges and insolvency.

Recommendation 1. Preserve General Fund liquidity. All legally available cash will be needed by the General Fund to deal with the City's solvency risks and the costs of using restructuring tools as part of the City's financial recovery plan.

As part of maximizing liquidity, finalize legal analysis to determine the City's flexibility to address outstanding liabilities associated with the Public Facilities Fees (PFF) and interest allocation to ascertain alternatives to immediate use of available unrestricted resources. This is relevant to cleaning up liabilities from past financial errors when doing so would have a negative impact on the General Fund. While taking care of such mistakes as soon as they are found is normally the prudent thing to do, the City is not operating under normal circumstances and will need all possible resources to deal with future insolvency. When the City discusses this issue with its attorneys it should determine whether it has flexibility to address these liabilities with various alternatives to immediately correcting them with General Fund monies.

Maximizing liquidity will require the City to abandon plans previously approved for use of available unrestricted fund balances held in other funds, including eliminating library and recreation fund balances, abandoning the new City Hall project for the foreseeable future, using all accumulated Measure W funds and eliminating $1.2 million of general capital improvements.

Recommendation 2. Immediately prepare for AB 506 proceedings to restructure debt and benefit obligations. Such preparation will be prudent for the City even if bankruptcy can be avoided. Without adequate preparation, Stockton may find itself in a position of uncontrolled default with outcomes that are much more negative than if the City were to have a plan.

The City's goal in the AB 506 would be to negotiate a restructuring of its obligations to avoid bankruptcy. AB 506 requires public agencies to either engage in a process with interested parties or declare a fiscal emergency before filing for bankruptcy.

As has been discussed in this report, a significant component and perhaps a decisive part of the City's fiscal stress stems from what now appears to be ill-advised debt issuances and other promises made to City employees regarding paid medical coverage in retirement. These sources of fiscal stress have not yet been addressed in working out a financial recovery plan for the City, as all work has concentrated on reducing operational expenditures. Addressing these issues and meaningfully including creditors in a financial recovery plan can probably only occur in an AB 506 or, if necessary, a Chapter 9 setting. Expert legal advice on how to proceed with AB 506 and Chapter 9 will be essential, as Stockton may be the first public agency to undergo municipal bankruptcy since changes to the process took effect in January 2012.

Prior to the signing of AB 506, a public agency in California could file for protection under Chapter 9 of the United States Bankruptcy Code (dealing with municipal bankruptcy) without state approval or pre-conditions. Under AB 506, which was signed into law in late 2011 and became effective in early January 2012, public agencies may still resort to bankruptcy protection. Before a public agency may file for protection, it must either 1) engage in a neutral evaluation process with its creditors with the help of an expert neutral third party; or 2) declare a fiscal emergency before filing for bankruptcy.

The intent of this legislation is to provide a process prior to an actual Chapter 9 filing to allow an alternative resolution to be developed outside of bankruptcy. The alternative could result in a successful negotiation among all parties or a structured bankruptcy agreement that would shorten the Chapter 9 process. Because no municipality has availed itself of the AB 506 process, it remains to be seen if it can achieve superior results relative to an actual Chapter 9 proceeding. It should be noted, however, that several other states have such an intermediate step when it comes to providing for municipal access to Chapter 9 provisions.

The neutral evaluation process is aimed at providing a limited amount of time (60 to 90 days) to develop a settlement or adjustment plan among interested parties.[2] If the neutral evaluation process period concludes without an agreement and if the public agency believes that a bankruptcy filing is necessary, it may go ahead with a Chapter 9 filing.

An agency may bypass the neutral evaluation process by declaring a fiscal emergency. The declaration of fiscal emergency must include findings that the financial state of the public agency is such that the health, safety and well-being of residents will be jeopardized without the protections of Chapter 9. Perhaps more importantly, the resolution must include a finding that the public agency will be unable to pay its obligations within the next 60 days.

Recommendation 3. Develop plans for lower service level scenarios or alternative service delivery approaches to further reduce costs. Despite the significant and sustained cost reductions it has implemented, the City's revenues will not support existing service levels. Given other obligations that are currently legally required, the

[2] Interested parties include a trustee, a committee of creditors, an affected creditor, an indenture trustee, a pension fund, a bondholder, a union that, under its collective bargaining agreements, has standing to initiate contract or debt restricting negotiations with the municipality, or a representative selected by an association of retired employees of the public entity who receive income from the public entity convening the neutral evaluation. Contingent creditors may also be included.

City may need to further reduce services to reduce costs, despite being service insolvent. In some cases, there may be other service providers that could be contacted for proposals to maintain services at lower costs. Such alternatives should be explored.

Recommendation 4. Obtain legal advice regarding potential liabilities that may have been created as a result of past accounting errors and interfund transactions that are no longer feasible because supporting revenues are so reduced. This applies to all instances where funds spent or advanced in anticipation of future revenues create legal issues resulting from overdrawn pooled cash, fund deficits or stranded advances where expected revenues are inadequate for repayment.

Getting clear legal advice on this issue is essential and urgent. The City and its staff members' responsibilities regarding existing or anticipated unplanned cash deficits will define the point at which further cash expenditures would result in creation of unauthorized debt, causing insolvency to the point required cash disbursements cannot be made. This would be reached after the point the City is qualified to seek the protection of a bankruptcy court. The General Fund and funds with balances derived from the General Fund are the only funds with unrestricted resources that can cure legal compliance issues in other funds if this view is accurate.

Recommendation 5. Begin drafting a Fiscal Recovery or Stabilization Plan, which, if necessary, will provide a foundation for Chapter 9 Pendency and Work Out Plans, if creditors do not agree to restructure the City's obligations outside of bankruptcy. That plan should reflect the budget the City needs to adopt to make it through FY 2011-12 and FY 2012-13, including reductions in debt, services and personnel costs.

Recommendation 6. Revise four-year financial forecasts to include scenarios for possible higher CalPERS rate increases. CalPERS assumptions about the City's payroll include typical rates of growth in future payrolls, retirement ages and years of service at retirement. The

City's actual situation does not match those assumptions. As a result, the rates currently forecast by CalPERS are too low because costs are increasing while the payroll base is shrinking. In addition, CalPERS will revisit its assumed investment rate in spring 2012 and there is a very real possibility that the rate will be lowered. A half percent decrease in CalPERS investment income assumption could increase employer rates by up to 10% representing 2 to 3% of covered compensation.

Recommendation 7. Develop a multi-year forecast for all funds that are directly or indirectly guaranteed by the General Fund. This will provide the basis determining the service levels and obligations the General Fund can afford. Funds where the General Fund guarantees debt or faces shortfalls in special revenues intended for debt repayment are included in the current forecast. However the funds that will provide unrestricted available resources to close this year's budget gap are not included in the forecast. Those funds' operations have the potential to affect the General Fund in the future because they will have no reserves.

In addition to the above seven recommendations, Management Partners suggests that the City conduct a detailed analysis within the next two to three years of the cost of services and fees to determine whether fees can appropriately be increased to recover costs. Given the urgency of the immediate issues, this can and should be delayed, but at some point, it will be important for the City to know whether its fees are covering its costs. Meanwhile, as time permits, individual departments may be able to review cost recovery opportunities that might result in additional revenue to aid in the restoration of needed services.

Furthermore, Management Partners suggests that at some point the City consider conducting voter polling to gauge support for augmenting existing revenue sources. Voter polling may also be suggested for debt ratification to address unintended unauthorized debt as a result of interfund transfer and expenditure issues.

Conclusions

According to City management's own budget forecasts, the General Fund will likely reach cash insolvency by the end of this fiscal year (FY 2011-12). Management Partners has found no reason to doubt these forecasts. To the contrary, we have identified numerous issues that may deepen the City's fiscal crisis. This crisis has come about from activities and events occurring over past years and, despite very significant efforts to do so, could not be contained only by reducing operating expenses. Major factors are:

- The "Great Recession" reduced revenues significantly.
- Just prior to the recession, the City took on a large amount of debt, which it does not now apparently have the ability to repay.
- Compensation packages exceeded sustainable levels and the City assumed significant liability for retiree health coverage without secure funding.
- Prior fiscal management practices obscured financial problems.

It is clear that services dependent on the General Fund are insolvent from both a service delivery and budgetary perspective. With regard to immediate cash solvency, if the City is able to defer legal compliance issues, cash insolvency in the General Fund may be delayed, but only for the short term.

Solvency problems are found in the General Fund, in funds receiving direct support from the General Fund, and in funds that may require support from the General Fund in the future. However, Management Partners has not identified solvency problems in other funds that do not depend on the General Fund including the water and wastewater utilities.

The worst case for the City would be bankruptcy without a plan, or an uncontrolled default, because the City would lack the tools necessary for dealing with creditors in an organized fashion. If bankruptcy can be avoided, it will largely be dependent on the willingness of creditors, including debt holders and former employees, to agree to restructure outside of a Chapter 9 filing. Conversely, if bankruptcy cannot be

avoided, the City's Fiscal Recovery or Stabilization Plan for the AB 506 process will serve as a foundation to manage the organization and the community through the process.