February 28, 2012

TO: Mayor and City Council

FROM: Bob Deis, City Manager

SUBJECT: **FISCAL CONDITION UPDATE FOR FISCAL YEARS 2010-11, 2011-12 AND 2012-13**

RECOMMENDATION

It is recommended that the City Council adopt a resolution that:

1) authorizes prior period adjustments, amends the Fiscal Year 2011-12 budget, and approves various inter-fund transfers to help ensure a balanced budget for the rest of the fiscal year;
2) accepts the Management Partners Financial Assessment Report;
3) authorizes a confidential neutral evaluation process pursuant to Government Code Sections 53760-53760.7 (AB506) and directs staff to develop plans for long term fiscal sustainability to be discussed with interested parties before a neutral evaluator;
4) adopts findings and authorizes a contractual agreement with Management Partners, Inc. for project management and technical assistance for the AB506 mediation process for the City of Stockton in the amount of $175,000.
5) suspends certain debt payments from unrestricted resources for the remainder of fiscal year 2011-12;
6) adopts findings and ratifies the suspension of leave payoffs at employee separation;
7) authorizes the City Manager and the City Attorney to conduct an investigation into persons or entities that may have contributed to the causes of the City's current financial situation; and
8) authorizes continuation of the fiscal emergency as adopted by Council Resolution #11-0114 on May 17, 2011.

Summary

This report provides an update on the City's fiscal condition and discusses changes since the August 23rd and October 18, 2011 Fiscal Year 2010-11 and 2011-12 updates.

Recommended fund transfers and other actions of $15 million are also proposed to address the $15 million in unrestricted fund deficits now projected through June 2012. Approval of the recommended resolution will authorize a variety of 2009-10 and 2010-11 clean up actions and provides approval for a 2011-12 budget amendment which includes the inter-fund transfers necessary to balance the projected deficit. Approval of these actions will allow staff to complete the June 30, 2011 year-end close process,

resume the external audit and continue to operate on a balanced budget basis through this fiscal year, absent any new developments.

As we began to look at our budget for the upcoming fiscal year and prepare for the new state imposed "fact finding" process, a four-year projection has been prepared and 2012-13 balancing alternatives have been developed to help understand the magnitude of the projected deficit. The forecast shows deficits ranging from $20 (best case) to $38 million (worse case) in Fiscal Year 2012-13 and increasing in subsequent years. The "best case" assumes we continue to declare an emergency and continue to impose labor concessions. The $38 million assumes we lose in court with unions concerning the effects of prior fiscal emergency declarations and we must "turnoff" past concessions.

The independent financial condition assessment report has been received and confirms the City's dire fiscal situation. Commencement of a State AB506 confidential neutral evaluation process is recommended by staff and consultants. To avoid insolvency this fiscal year and into the future, staff recommends that debt payments from unrestricted funds be suspended. The City Manager has imposed temporary restrictions on leave pay offs effective February 16, 2012 to ensure we don't tip into insolvency this year. Your Council is being asked to ratify this policy.

It is apparent that past financial practices of former City staff and possibly contractors, that were not disclosed to the Council, have contributed to the City's current financial situation. Given the grave consequences now being faced by the City, the City Manager and City Attorney wish to investigate these practices for possible recourse.

This report and its discussion of revised budget projections support the continuation of the state of fiscal emergency as adopted by Council Resolution #11-0114 on May 17, 2011.

DISCUSSION

Background

It is no secret that the "Great Recession" has had an enormous impact on the City's finances. As I mentioned in my Fiscal Year 2011-12 Budget Message, the City of Stockton has been and continues to be near insolvency. Reserves in the General Fund were exhausted long ago, reserves in internal service funds were also depleted long ago and the City has leveraged itself with debt that puts the General Fund at risk for backfilling deficits in other funds. The City Council has declared two emergencies based on fiscal circumstances and negotiated or imposed concessions of $25 million and service reductions of $12 million this fiscal year alone.

Once you started getting complete information from your staff in early 2010, your Council immediately began making courageous decisions and focused on the area that you could influence, labor costs. You formulated a comprehensive Ten Point Action Plan for Fiscal Sustainability that was copied by other cities in the state. This Plan provided the direction for the last year's negotiations. Unfortunately, due to our dire financial situation, what would typically take three to five years to accomplish, we had to implement in six months. Needless to say, this plan was the source of conflict.

Your Council also adopted four aggressive goals, one being "Fiscal Sustainability – Getting our Fiscal House in Order." You also adopted various Strategic Initiatives around those four goals, including one that asked staff to analyze all of our funds and financial management practices and one to improve budget monitoring. The results of these initiatives have uncovered alarming facts. We uncovered substandard bookkeeping, fiscal mismanagement and a general lack of oversight over City-wide finances.

We now have to correct various bookkeeping errors, adjust for various over drafts and generally clean up the books for review by the independent auditors. We also need to backfill for a large amount of debt that was issued during the last decade of this century. Finally, we need to adjust for the "hangover" of past state raids on our finances.

Two budget updates presented to City Council on October 18, 2011 and August 23, 2011 reported several significant events impacting the 2010-11 and 2011-12 General Fund budgets. The City's financial condition has deteriorated. Budget estimates for fiscal year 2012-13 have been developed that identify a best case deficit of $20 million.

Our comprehensive review of our funds and fiscal practices is nearly complete. The following discussion describes the changes since the previous budget updates, and the adjustments and transfers proposed to balance the City's General Fund, to preserve and maintain solvency for this fiscal year and to begin to restructure the City's financial obligations to provide lasting fiscal sustainability. It is time to deal with our precarious financial situation, once and for all, and restructure our finances to allow the City to focus on and address the other challenges and opportunities of our community.

In the private sector there are numerous examples of financial restructuring that resulted in sustainable and healthy enterprises going forward, such as in the auto industry, airlines and the hi-tech industry. We plan to do the same. Our employees and the citizens of Stockton who receive city services have borne the entire brunt of our restructuring efforts so far and <u>now its time for others to do the same</u>.

The alternatives to this proposed approach include more radical service reductions in public safety; which we think would be dangerous to our citizenry. Another option would be to ask for tax increases. Even if the voters would approve such a proposal, we just don't think they should be asked to fix this problem, at least until we explore other alternatives, address our liquidation exposure and get our house in order. Even more importantly, the problems we face are so severe that neither of these options, even implemented aggressively, would be enough to correct the situation and make Stockton financially sustainable. In addition, focusing only on current revenues and expenditures avoids a large source of the problems, the debt and other contractual liabilities that so far have note been significantly addressed.

One may ask, "how did we get here?" It is clear, after spending the last year going through our finances and commitments, that an accumulation of poor decisions and practices contributed greatly, and that the "knock out punch," the long and protracted recession that still exists in the Valley, is the final "blow" that got us to this point.

The 1990's included a greatly expanding retiree health insurance commitment that, although appears legal, it was unsound and eerily similar to a "Ponzi scheme." We are now at the back end of this "scheme" and are having to pay for it. Next year, we expect to pay more for retiree health insurance than for our current employees. This coupled with enhanced retirement benefits, accelerated the problem. We now have roughly 1.7 retirees for every employee.

The City issued huge amounts of debt in the last decade with the assumption that the hyper growth that was occurring would last forever. The bond market was not willing to take the risk of continued growth, so the City was required to obligate the General Fund to act as backup security to get decent interest rates. The General Fund is now backfilling for some of this debt.

It is well documented and publicized the City also approved generous labor contracts that were not transparent nor sustainable. Since certain labor groups, such as the Stockton Police Officers' Association (SPOA), were not willing to re-open contracts, your Council had to declare two fiscal emergencies and impose concessions. These are being challenged by SPOA and Stockton City Employees' Association (SCEA) via the courts and the Public Employment Relations Board (PERB). The ultimate decisions in these venues have not been determined. In other words, there is more financial risk out there.

The Valley recession and its impacts have been well documented. The foreclosure crisis and property value reduction continues and has hit the General Fund and Redevelopment (RDA) hard. The RDA alone experienced a 60 percent reduction in tax increment.

Finally, the State's actions of raiding our funds have accumulated and impacted our General Fund.

Not one of these factors is the cause of our current problem. However, the interplay of all these factors has created a situation where we can't "grow our way" out of the problem and no amount of forward looking financial planning will properly fix it.

Present Situation

June 2010 Prior Period Adjustments

The list of bookkeeping changes to the City's fiscal condition starts in the years prior to June 2010. We have discovered serious issues with the accuracy of the June 2010 audited balances and have reviewed beginning and end of year balances of that year as part of the process of closing the books for June 30, 2011. In their internal control report to City Council, the City's 2009-10 external auditors publicly identified reconciliation issues for the City's cash, library, and property owner loan receivable programs. I don't think it was clear just how problematic these areas were to the underlying financial condition of the City. Through the Council's strategic initiative designed to "get our fiscal house in order," staff has identified a number of unsupportable balances in the June 2010 financial statements. Ordinary and customary reconciliations between supporting third party or subsidiary data bases and the City's financial books have simply not been performed by staff for many years. As a result, systems are out of balance and some balances reported in the City's financial statements are unsupportable.

Our research indicates a material overstatement of reported City assets and available balances in the General fund for the year ending in June 2010. Following is a list of necessary restatements.

- Cash - $500,000 was double counted for General Fund parking ticket revenues and their corresponding cash receipts through June 2010. For 2 ½ years, two different Police Department employees faithfully recorded the same set of cash receipts, one on a daily basis and one on a monthly basis. Administrative Services staff posted the daily receipt batches to the City's general ledger based upon deposits to the third party parking administrator's bank account in addition to the monthly cash receipt when program revenues were transferred by the administrator to the City. Daily and monthly bank reconciliations should have identified and protected against this type of misstatement.

- Accounts Receivable - A careful "aging" review has indicated that the net realizable value of General Fund accounts receivable at June 2010 was overstated by an estimated $2.8 million. Where possible, collection efforts will continue, but we believe the net value of the assets needs to be written down through an "allowance for doubtful accounts" to reflect the likely net realizable value of the asset to avoid overstatement of current, spendable resources. If and when the accounts are collected, they can be written back up to their original value and be available for programming in a future year. However, some of these receivables are four years old, ten years old or even older. This had the affect of overstating our financial position when developing budgets.

Accounting standards require that recognized revenues be realized within 90 days of year end to be available to finance the operating costs attributable to the year, or, in the alternative, to be "deferred" until the year that they are converted to cash. The City has not followed this accounting standard and as a result has overstated its available balance. The objectives for accounts receivable "allowances" and "deferrals" are to measure and report the underlying liquidity of funds available to finance current operations on June 30th.

The largest component of the proposed write-down is a million dollar aged balance carried over several years that is due from the independent Fire Districts in the County that are serviced by the City's Fire Department. This subject was the topic of a Council staff report in December 2011. A settlement with the districts has been developed that will permanently write-off the uncollectible portion of this balance. Since this revenue was not available to finance 2010-11 operations, the impact of the write-off should be pushed back to the June 2010 fund balance.

The next most significant receivable adjustment is for parking ticket collections. Police and Finance Department staff have worked with their contractors to update their collection methods and assessment of aged parking tickets. Estimated realization has eroded during the past year. A total of $649,000 is proposed for adjustment in this category based upon the contractor's assessment that 50% - 60% of delinquent balances that are under one year old will be collected. Older balances have been estimated with a sliding scale down to a 0% collection estimate for balances over three years old. The City contracts for both parking ticket administration and collection services to manage its parking ticket revenues.

The following is a recap of the receivable balances at risk for collection that are now judged to have not been available to finance operations at June 2010:

Fire Districts	$1.0 million
Parking Tickets	0.6 million
Garbage collections (pre-2002)	0.3 million
Fire mutual aid (5 years old)	0.2 million
Other programs (net)	0.7 million
	$2.8 million

These proposed June 2010 restatements will next be reviewed by the City's new outside auditor who will test and validate the proposed presentation. In some cases, less significant items might be consolidated with current year activity in the City's published financial statements while significant adjustments will be displayed as prior period adjustments to the beginning fund balance. Restatement and isolation of prior year impacts helps "right size" the reported current year operating results to best use as a base for out year comparison and projection.

- Wages Payable Liability - An error in the amount of $315,305 in the wages payable liability account was inadvertently posted in March of 2005. This is an account that should clear to zero after each pay period. The City-wide wages payable liability account had not been reconciled by accounting staff from 2005 through 2011. Reconciliation of subsidiary ledgers to the general ledger is a normal and customary accounting function that provides a safety net to identify posting errors on a timely basis. This is another example of failures in accounting and auditing controls.

- Expenditures – Adjustments to expenditures including a write off of $181,236 due to a cash variance, clean up of misstated expenditures in the amount of $68,798 related to inventory and payables, and a correction of $96,286 to align a deposit liability with a subsidiary ledger.

Below is a schedule of the General Fund Available Fund Balance at June 2010 as originally posted, with recommended adjustments. Staff recommends transfers from unrestricted funds be made to balance the General Fund at June 2011. The specific adjustments are described later in this staff report.

The net impact to the General Fund "available" fund balance at June 30, 2010 is a reduction of approximately $3.8 million. The following table provides a summary of the recommended adjustments:

General Fund
Available Fund Balance
June 2010 - Restated

June 2010 Available Balance, as previously reported in 2010 CAFR (General Fund only)	$ 1,101,075
Adjustments	
Cash and Investments:	
Parking Citations - double counted revenue	(496,528)
Accounts Receivable:	
Accounts receivable/deferred revenue	(2,774,919)
Expenditures:	
Cash - write off variance	(181,236)
Expenditures misstated (inventory, payables)	68,798
Deposit liability out of sync with subsidiary ledger	(96,286)
Correction of 2005 Wages Payable Liability	(315,305)
	(3,795,476)
June 2010 Available Balance, as restated	$ (2,694,401)

2010-11 Results Update

The ending available balance of the City's General Fund at June 2011 has eroded significantly from the $722,000 surplus estimate that was last provided to the City Council in the August 23, 2011 budget report. The estimated General Fund ending available balance is now a deficit of $6.6 million. The two primary factors in this change are the impact of the change to the beginning balance described above, and a necessary Redevelopment Agency subsidy. The recommended adjustments to the June, 2010 available fund balance, for example, correspondingly reduces the 2010-11 ending available balance by $3.8 million. A more comprehensive description of changes, is provided below. Some of this is typical for year end accruals to close out the year. Some are atypical due to poor fiscal management. For example, revenues sometimes do not come in until long after the year the revenue was earned in is closed.

Revenue

When compared to what was estimated in the August report to the City Council, additional revenues in the amount of $1.9 million were received in 2010-11. Below is a description of these increases:

- Actual Sales Tax revenue came in $500,000 higher than projected at that time, with sales for the quarter ending June 2011 up 10% compared to the same quarter in

2010. Higher fuel prices and strong sales by new motor vehicle dealers were primarily responsible.

- An unexpected catch up payment of State Motor Vehicle License fees was received, adding $145,000.
- In the Taxes and Other General Sources category, Property Taxes, Business License Tax, and Interest were also slightly higher than previously projected.
- Revenue associated with the Police Department's supplemental contracted police services offered to local businesses and organizations accounts for $620,000 of the revenue increase. This revenue was offset by an increase in Police Department expenses associated with this program of $500,000.
- The August 23, 2011 revenue estimate included adjustments for the Fire District contracts and Parking Ticket uncollectible balances. After further research, it was determined that these uncollectible balances belonged in prior fiscal years. The 2010-11 revenues were adjusted upward to reflect only 2010-11 activity.

Expenses

Expenses have increased $5.2 million from the amount estimated in the August 23, 2011 budget update. The largest contributor to this increase is a $3.9 million subsidy for the Redevelopment Agency. The other major adjustments include a $500,000 subsidy to the Development Services fund, a $650,000 payroll tax liability accrual, the $500,000 added for Police Department contract expenses discussed above and a $300,000 correction related to the COPS Hiring Recovery Program. More detailed information is provided below:

- Since the August 23rd, 2010-11 budget update report, the State Supreme Court has ruled to uphold ABX1 26 and as a result, the Stockton Redevelopment Agency, along with all other Redevelopment Agencies in the State, was dissolved as of January 31, 2012. At June 30, 2011 the Redevelopment Agency had a deficit of $3.9 million. This deficit is due to overspending and ongoing revenue declines in prior years. The General Fund is forced to provide funding to offset the deficit issues described further below:

    - The Redevelopment Agency has overspent its available revenues. This condition has built up over a period of years. The Agency's cash overdrafts during this time have been papered-over with unauthorized working capital loans within the Redevelopment Agency and loans with the City that were not specifically called out nor understood. The North Stockton and Waterfront Project areas have a combined overdraft of approximately $9 million. Other Redevelopment Agency funds, including Midtown, South Stockton and the Affordable Housing programs have cash surplus balances of approximately $6 million. The Agency's total cash position at June 30, 2011 is an overdraft of $2.7 million.

  - The Redevelopment Agency funded a project (the Edward C. Merlo Institute of Environmental Technology Gymnasium on the William Brotherhood Park site) through a mix of Strong Neighborhood Initiative bond proceeds and a reimbursement agreement from the school district. Unfortunately, the same set of costs were reimbursed from both bond proceeds and by the schools, creating an ineligible "double dip" recovery not allowable from tax exempt bond proceeds. This issue was undetected from 2009 through 2011 due to incomplete reconciliation of available bond proceeds, project commitments, and bond trustee account balances. $1.2 million of Redevelopment Agency cash at June 2011 must now be set aside for replenishment of the trustee's fiscal agent bank balance to restore compliance with bond covenants.
- A subsidy to the Development Services Fund has been added to cover receivable allowances, unanticipated leave buy-out and cost allocation plan impacts. The Development Services Fund is expected to collect the receivable in 2011-12 and has already made progress on this collection.
- Payroll Tax Liability Accrual – Some employee retirement and retiree medical trust contributions were incorrectly treated as pre-tax in the calculation of employee payroll tax withholdings. The City is working with employees, their unions, and the IRS to correct the payroll tax deductions. It is estimated that the City might be required to pay $650,000 to correct and settle this matter. This amount is being accrued to the 2010-11 fiscal year.
- In 2009 the City of Stockton accepted a COPS Hiring Recovery Program Grant in the amount of $7,932,160 that funded 20 Police Officers for three years. The grant only funded the cost of entry level Police Officers and not all employee benefits were eligible under the grant. Actual Police Officer salaries and benefits exceeded the grant funding in both 2009-10 and 2010-11. A transfer of $107,000 was budgeted to pay for the cost above the authorized grant funding. A reconciliation of CHRP expenses showed that the City needed to fund an additional $135,000 in 2009-10 and a total of $164,000 in 2010-11. Expenses totaling $300,000 have therefore been moved to the General Fund. This expense is offset by the $107,000 originally budgeted.
- There are other minor expenditure adjustments that require increases in the General Fund transfers to the Recreation Fund ($20,000), Housing Grant Funds ($87,568), and Debt Service Fund ($6,000).
- These additional expenses were partially offset by approximately $486,000 in savings in the Peacekeeper Program and other programs.

The balance at June 30, 2011 is estimated to be a deficit of approximately $6.6 million. It should be noted, however, that these are still preliminary estimates, since the City has not officially closed its books, nor has the City's outside auditor reviewed the City's 2010-11 financial statements. The following chart provides a summary of changes to the 2010-11 General Fund Available Fund Balance made since the August 23, 2011 City Council budget update:

FISCAL CONDITION UPDATE FOR FISCAL YEARS 2010-11, 2011-12 AND 2012-13

General Fund
2010-11 Year End
Changes since August 23, 2011

	Major Taxes	Program Activity	Police Contracts	Other Support	Current Projection
June 2011 Available Balance, as reported in open session Aug. 23, 2011					722,257
June 2010 Available Fund Balance update		(3,795,476)			(3,795,476)
Revenue					
Taxes and other general sources	875,647				875,647
Program sources		164,495	620,889		785,384
Fire District Contracts		241,920			241,920
Other items					-
					1,902,951
Expenditures					
Programs					
Police Department		(34,397)	(832,639)		(867,036)
Department Updates (PW, ED, Fire)		(150,744)			(150,744)
					-
Program Support for Other Funds					
Redevelopment backfill				(3,875,976)	(3,875,976)
Recreation/Golf				(70,063)	(70,063)
Grant Match			34,397	(87,568)	(53,171)
Development Services				(526,069)	(526,069)
Other Funds				105,334	105,334
Compensated Absences				302,083	302,083
Administration					
Administration Dept. Updates		40,923			40,923
External Auditor		(62,360)			(62,360)
Peacekeeper/Other Program Savings		486,243			486,243
Payroll Tax Accrual		(650,000)			(650,000)
Labor/Legal		54,002			54,002
Debt Service		(2,496)			(2,496)
					(5,269,330)
Reserves		(113,558)			(113,558)
Net Change since Aug. 23, 2011	875,647	(3,821,448)	(177,353)	(4,152,259)	(7,275,413)
					-
June 2011 Available Balance, as restated					(6,553,156)
					-

2011-12 Budget Update

During the budget update on October 18, 2011, the City Council took a number of actions to address $4 million in 2011-12 budget issues that had developed during the first quarter of the 2011-12 fiscal year. The largest causes of the projected shortfall were an unexpected erosion of property tax and the state redirecting vehicle license fee revenue collections. These impacts were largely offset through the availability of unbudgeted one-time grant sources, vacancy savings, and a draw of $1 million of the $2 million budgeted contingency. Since October additional 2011-12 problems have been identified. Staff currently estimates that the General Fund is now facing an operating shortfall of approximately $8.7 million.

The changes from the previous estimate are a combination of an estimated decline in revenue of $825,000, and an increase in projected expenditures of $7.8 million. Major Tax revenues are actually up by $1.4 million, but these gains have been more than offset by a shortfall in Police Department program revenues. Expenditures have increased $7.8 million primarily due to Redevelopment backfill, Pension Obligation Bond shortfall, Public Facility Fee debt shortfall, and increased estimates for labor negotiations and legal costs. Both revenue and expenditure projection changes are described in more detail below.

- Major Taxes
  - Property Tax – Projections are slightly lower ($100,000), based on an updated estimate from the County Auditor-Controller's Office provided November 30, 2011.
  - Sales Tax – The revised sales tax estimate has increased by $530,000 based on recent information from HdL Corporation, the City's sales tax consultant. This increase is primarily driven by rising fuel prices and improved sales in the auto and transportation industry.
  - Franchise Tax – The City will benefit from a one time true up of $700,000 in 2011-12 as Comcast moves from a local franchise agreement to the state franchise agreement. Currently Comcast remits on a calendar year basis but this will change to a fiscal year basis when their local franchise agreement expires in April 2012. A portion of this increase has been offset by a decrease in franchise revenue from the waste haulers. A 2% increase in franchise revenue from the waste haulers was anticipated in the adopted budget. Year to date revenues indicate a 1% reduction compared to fiscal year 2010-11 actual revenue. The revenue loss is primarily due to declines in commercial and industrial waste collection. The 2011-12 revenue projection has been reduced $234,000.
  - Business License – The business license revenue estimate has been revised based on actual revenue received in 2010-11. The revised business license revenue estimate remains at 1% below the amount received in 2010-11.
  - Investment Income – The estimate of interest earnings has been adjusted to reflect the true General Fund negative cash position and interest cost.

- Other Revenue Updates
  - Fire Districts – The City now anticipates collecting $1 million of unbudgeted, prior year Fire District contract revenues based on the amended agreement with the Fire Districts approved by Council in December 2011.
  - The Redevelopment Pass Through revenue estimate has been reduced $105,000 to reflect the expected decline in Redevelopment Agency tax increment.
  - Police Department Revenues – The Police Department now anticipates a $1.9 million program revenue shortfall concentrated in three major areas: parking fines, code enforcement, and vehicle impound fees. The department cites staffing shortages and vacancies as the primary cause for all three of these shortfalls, and has proposed a plan to backfill some current vacancies with part time help to try to recapture some of these revenues prior to year-end. This projection does not rely on recaptured revenues at this time, but an opportunity might exist to recapture some of these revenues. The current projection does, however, include the department's updated vacancy savings estimate which adds $300,000 in savings to partially offset these revenue losses.
  - Prison Grant – A State grant to mitigate Prison construction impacts had been added to the General Fund budget during the October 18, 2011 budget report. Further dialogue with the state indicates this will be restricted for related capital projects and is not available for general City use. This $347,000 grant has been removed from the projection.
  - Indirect Cost – Estimated $500,000 decrease in indirect cost revenue paid to the General Fund by other City funds. This is a placeholder value pending a revision to the City's Cost Allocation Plan.

- 400 E. Main Street Move

  The City Hall move to 400 E. Main has been postponed at this time. City hall space allocations to non-general fund programs, such as housing and utilities, have been restored as current year General Fund revenue (+$294,000). In addition, General Fund department rental charges for 400 E. Main occupancy have also been reversed from General Fund expenditure budgets (+$512,000). However, due to loss of anticipated City occupancy non General Fund budgeted rental payments, the 400 E. Main fund is now expected to need a General Fund back fill of approximately $800,000 to cover its debt and operating costs. The 400 E. Main fund has experienced high variable interest costs during the year due to market reaction to credit risk in the City's bond liquidity provider, Dexia, a troubled European bank. Interest rates on these bonds were budgeted at 3%, actual weekly rates had exceeded 4% but have now drifted back just below 4%. The net 2011-12 General Fund impact of the delayed 400 E. Main move approximately breaks even, with higher revenues and higher net expenditures, with nominal net change.

- Pension Obligation Bonds (POBs)
  The City issued POBs in 2007 with an objective to reduce the interest cost on its unfunded pension liability with CalPERS. Unfortunately due to the poor timing of this issuance, CalPERS lost an estimated 24 to 30 percent of the principal due to investment losses. The POBs were intended to reduce the City's long-term CalPERS contribution rates and substitute with a lower bond payment. The bonds were structured with deferred principal retirement in the first few years and an increasing annual debt service cost. In past years, the City accumulated the resources to make the bond payments with a pension benefit rate surcharge through its labor budget. While estimated 2011-12 workforce reductions were included in the 2011-12 pension rate development, the ultimate number of position reductions and further vacancies have generated an estimated $1.2 million shortfall in this contribution, of which the General Fund share is approximately $876,000. Prospectively, to avoid unexpected impacts from workforce fluctuations, in future years these bond payments will be budgeted as a fixed cost.

- Redevelopment Update
  The General Fund is at risk for an estimated 2011-12 Redevelopment Agency operating deficit. First, because the City has pooled Agency cash to reduce it's unauthorized working capital loans at June 30, 2011, the Redevelopment project areas are not expected to have sufficient cash flow for operations in 2011-12. Second, Redevelopment revenue projections (due to revised estimates from the County Assessor) have eroded the Agency's revenue projection by $1 million from budget. The result of recent redevelopment actions is a projected 2011-12 General Fund backfill for Redevelopment activities of $3.1 million. The chart below reflects the $2.1 million update since the October 18th briefing.

- Other Operating Costs
  Other expenditure updates include new County election cost estimates from the County, recent contract awards for Federal/State advocates that no longer have an RDA subsidy, property tax administration charges recently received from the County, external audit costs, and negotiated labor costs. A placeholder estimate of $100,000 has been added for additional external audit costs due to the significance of restatements to prior audited balances and for risks related to the City's solvency. We will look to the City Auditor to obtain and evaluate a revised fee proposal from the external auditor for consideration by the City Council. On October 18, 2011 the Council approved a Memorandum of Agreement with the Fire union that extended the eligibility for some Longevity pay to July 1, 2012. This expense was part of a resolution of the Fire union's arbitration claims that would have avoided $4 million in general fund costs. The implementation of this extension for the Fire union members and all other employees will result in an additional cost of $128,000 to the General Fund.

- Labor/Legal Costs
  Estimated costs of $3.5 million have been added as a placeholder for an extensive confidential neutral mediation process (AB506) and contingency planning costs, increasing by $3.5 million labor/litigation/debt/actuarial analysis appropriation in the adopted budget. The proposed actions in this report will require significant assistance from bond counsel, labor counsel, labor consultants, debt consultants and project management. This will also pay for the Management Partners, Inc. firm to assist the City through the AB506 process, actuarial work to address retiree health options, etc. We also may be contractually required to pay for some debt holder's expenses due to participating in this confidential process. AB506 reflects new law and has not been utilized by any local government in the state. The process is a new state mandate, which if successful, will produce $20 million or more in savings for next fiscal year. It may resolve litigation exposure for this year and previous years as well.

It is important to note that the current year projections are based on imposed reductions to Stockton Police Officers Association and Stockton City Employees Association of over $11 million in the General Fund. These reductions to Add Pays and benefits were similar to reductions agreed to by other labor units. Unfortunately, these impositions are the subject of current litigation and pose a risk to the General Fund. The City does not have the resources to pay for these concessions should their litigation be successful.

General Fund
Midyear Update of Known Budget Impacts
2011-12
Changes since Oct. 18, 2011

	Major Taxes	Program Activity	400 E. Main Move	Other Support	Current Projection
Net Annual Activity, as reported Oct. 18, 2011					-
Revenue					
Property Tax	(100,200)				(100,200)
Sales Tax	530,000				530,000
Utility User Tax	95,000				95,000
Franchise Tax	451,000				451,000
Other - Business License/Document Tax	440,000				440,000
Interest				(528,000)	(528,000)
Redevelopment Pass Through		(105,000)			(105,000)
Fire District Contracts		925,000			925,000
Police Department program revenues		(1,953,000)			(1,953,000)
Restricted prison grant not available for general use		(347,000)			(347,000)
Indirect Cost Plan				(500,000)	(500,000)
Rent from Non-General Fund Dept			294,000		294,000
Other items				(27,599)	(27,599)
					(825,799)
Expenditures					
Pension obligation bonds - insufficient rate for current staffing				(876,000)	(876,000)
Public Facilities Fee Bonds				(680,839)	(680,839)
Redevelopment backfill - net savings from bond conversion				(2,100,000)	(2,100,000)
Other Cost updates					
Police Department Vacancy Savings		300,000			300,000
Longevity Cost - Fire MOU		(128,500)			(128,500)
Federal/State advocates (loss of RDA subsidy)		(144,000)			(144,000)
Election Costs		(240,000)			(240,000)
Property Tax Administration		(70,000)			(70,000)
External Audit Costs		(100,000)			(100,000)
400 E. Main Building - no rent payment			512,370		512,370
400 E. Main Subsidy			(800,000)		(800,000)
Labor/Legal/Actuary/Project Management					
AB506/contingency plan		(3,500,000)			(3,500,000)
					(7,826,969)
Net Change since Oct. 18, 2011	1,415,800	(5,362,500)	6,370	(4,712,438)	(8,652,768)
					-
Revised Ending Available Fund Balance					(8,652,768)
					-

Present Situation

Solutions

The combined 2010-11 deficit of $6.6 million and projected 2011-12 deficit of $8.7 million have created a $15.2 million shortfall in the General Fund at June 30, 2012. To address this shortfall, staff recommends multiple transfers of available funds from unrestricted sources and the suspension of debt payments from unrestricted funds for the balance of this fiscal year.

General Fund
Status of Unrestricted Funds
Projected at June 30, 2012

	Current Projection
Requirements	
General Fund at June 30, 2011	(6,553,156)
General Fund at June 30, 2012	(8,652,768)
Subtotal, Requirements at June 30, 2012	(15,205,924)
Solutions/Options	
Special Revenue Funds	
Library	720,995
Measure W	1,232,000
400 E. Main Operating Fund	589,025
Entertainment Venues	570,000
Capital Funds	
General Capital Fund	798,309
ESB & 400 E. Main Capital Fund	1,929,706
Internal Service Funds	
Fleet	2,286,061
Retirement	3,731,170
Trust Funds	
Arts Endowment	1,300,000
City March to June 2012 Debt Service	2,048,658
Total Solutions	15,205,924
Net Unrestricted Funds, June 2012	$ 0

The "solutions" strategy listed above proposes transfers of unrestricted resources from programs outside of the General Fund. As mentioned previously, many of the fund balance amounts listed above are preliminary and unaudited numbers subject to change. The final ending balances less 2011-12 operating deficits and some capital commitments will be the amount actually available to transfer. Almost all of these transfers are reserves which were accumulated by these programs for strategic reasons, such as equipment replacement, and are only recommended to be utilized given the severity of this fiscal deficit. We still have four months left in the fiscal year with no reserves. As a result, we feel we need to take these actions to avoid an uncontrolled insolvency or default. We still have four months left in the fiscal year with no reserves. This provides the time to show good faith in complying with the new state mandated process found in AB506. The following list reprises the proposed transfers and program impacts:

- Sweep Library fund balance and cancel selected capital projects
  - Two large and much needed roof, HVAC, and building repair projects for the Angelou and Chavez facilities would be retained.
  - Impact: The Chavez repair and renovation will be canceled and the library minor repairs account will be closed. The General Fund would become the default contingency for unexpected operational shortfalls or facility repairs, similar to other programs with direct General Fund support.

- Draw Measure W reserves through additional staff allocations
  - Impact: The General Fund would become the default contingency if the Measure W sales tax revenues aren't realized at the budgeted rate.
  - This is a particular risk since sales tax receipts are reported to the City by the State Board of Equalization up to three months in arrears. Without reserves, the budgeted expenditures are spent and service provided before the revenues for the year are confirmed.
  - Further, this draw on reserves moves us even further away from being in compliance with the Measure W policy for a reserve that is 25% of budgeted revenues.

- Sweep the 400 E. Main operating fund balance
  - Impact: Sweeping the 400 E. Main reserve will also push the operating risk contingency back to the General Fund.
  - Operating revenue risk for this program is the continued leasing and collection of commercial tenant revenues.
  - Operating expenditure risk includes building maintenance but also the variable interest rate on the bonds used to purchase the building. The fund also bears the acceleration risk of principal payments on the bonds if the current bank bonds, held by the City's liquidity provider, Dexia, if they are unable to be resold to the market.

- Sweep Entertainment Venues fund balance
  - Impact: 2010-11 results, including the wrap up of IFG/SMG transition, have resulted in a surplus that could be swept back to the General Fund. The Entertainment Venues Fund has additional cash available due to correction of the balances reported in the 2010 CAFR for this program.

This is yet another restatement of previously audited 2010 balances, this time in a positive direction. The contract with the new SMG Entertainment Venue operator includes a requirement for a third party audit. Their audit has been submitted and supports the ending balance available to reduce the General Fund subsidy on a one-time basis at June 2011.

- The Arena business model does not include an operating fund balance reserve, further exposing the General Fund for unexpected operating and facilities maintenance requirements.

- Sweep unencumbered General Capital Projects fund balance and cancel most if not all projects not yet in progress
  - Impact: The most significant impact of this sweep would be the continued erosion of contingency reserves and appropriations for major maintenance projects of City facilities and buildings.
  - Up to $1.3 million in projects have been appropriated, but contractual obligations have not yet been committed.
  - Impacted projects will cross City programs and buildings.
  - Separately, the local match appropriation for a large federal grant program would be retained, as well as some small contingency repair funds.
  - Over $250,000 of the uncommitted funds considered for cancellation relates to Arena projects anticipated by the City's new operator, SMG, which could impair their business plan. Other appropriations evaluated for cancellation include asbestos removal, ADA projects, an electrical power upgrade, a HVAC upgrade to the animal shelter, and roofing projects.

- Sweep cash that had been appropriated for City Hall moving costs to 400 E. Main
  - Impact: Relocation of City Hall operations would be deferred until a replacement funding source could be available to fund the move.

- Sweep Internal Service Fund balances for Vehicles, Pension, Unemployment, and LTD/Life Insurance. These funds had accumulated prudent reserves to buffer unexpected cost impacts.
  - Impact: Without reserves, the business risk for these programs would now fall back to the General and other operating funds. We have huge investments in vehicles for Police and Fire that are core to delivering on their mission. We are behind in setting aside adequate replacement funds.
  - Fleet: The vehicle fund has a cash balance of $4 million at June 2011. However, replacements in recent years have been severely held back due to the limitations of the cash flowing into the fund from budgeted program contributions. The current year replacement budget of $2 million has increased from prior levels, but current department charges are still insufficient to fund a normal ongoing replacement schedule. Sweeping

this cash will diminish the program's ability to address its aging fleet and it will no longer be accessible to catch up replacements from years of underfunding. Fleet is saying they can sustain their known replacement schedules after this sweep, but they will have no reserves for the unexpected and they will likely have to increase rates in future years.

- Retirement: The retirement fund also holds a significant $5 million cash balance at June 2011. This cash is accumulated throughout the year to provide cash flow to fund the annual $7 million debt service payment each August. Sweeping this cash will result in the fund's draw on pooled cash from the time of the debt payment, with replenishment during the course of the fiscal year. The ultimate impact will reduce the City's overall liquidity and increase the program's interest costs during the year.
- Reserves in these Internal Service Funds have accumulated through contributions from all City programs, both restricted and unrestricted. Transfers of surplus back to the contributing funds would be proposed in the same proportion as the source contributions.

- Cancel and take back $1.3 million endowment from the Arts Commission
  - This endowment was established by the City Council and could, as a matter of policy, be liquidated and transferred for other use. Income from the trust currently typically funds $50,000 annually in community arts grants. As an alternative, if the trust were to be liquidated, the General Fund could directly contribute $50,000 per year in grant appropriations from its annual tax revenues to make the program whole.

- Debt service payments of approximately $2 million are due to be paid from unrestricted funds between now and June 30, 2012. $1.5 million is due collectively on the 2004 Parking Bonds and the 2009 Public Facility Fee bonds. An additional $500,000, paid through monthly installments, is due on the variable rate 400 E. Main bond obligation. As discussed below, suspension of debt payments for the balance of this year will ensure we continue operations within available resources this fiscal year.

Fiscal Year 2012-13 Projection and Beyond

The Budget Office has developed a Four-Year General Fund Forecast model that projects revenue and expenses for fiscal years 2011-12, 2012-13, 2013-14, and 2014-15. Attachment A provides the detail of the 2012-13 projection from this forecast. The City's annual projected General Fund deficits in this forecast range from $20 to $28 million over the next three years under the "best case" scenario.

The chart below summarizes the deficits projected in the Four-Year Financial Forecast assuming nothing is done to address the problems (the chart includes the Baseline 1, "best case", assumptions described below):

General Fund
Four-year Financial Projection

	2011-12	2012-13 Baseline #1		2013-14		2014-15	
Revenues							
Marjor Taxes	135,826,195	134,841,919	-1%	134,558,652	0%	136,197,953	1%
Other Revenues	22,176,319	20,067,647	-10%	19,853,792	-1%	19,664,632	-1%
	158,002,514	154,909,566	-2%	154,412,444	0%	155,862,585	1%
Expenditures							
Salaries & Benefits	115,082,008	121,585,664	6%	125,976,771	4%	128,544,213	2%
Services & Supplies	33,146,646	32,233,077	-3%	32,790,546	2%	33,286,321	2%
Other Program Support	17,576,628	19,298,365	10%	19,590,919	2%	19,900,652	2%
Contingency	850,000	2,000,000	135%	2,000,000	0%	2,000,000	0%
	166,655,282	175,117,106	5%	180,358,236	3%	183,731,186	2%
Net Annual Activity (Best)	(8,652,768)	(20,207,540)		(25,945,792)		(27,868,601)	
Net Annual Activity (Worst)	-	(38,182,873)		-		-	

Two 2012-13 scenarios were developed to present a range of potential fiscal outcomes. Baseline #1 represents a more "optimistic" projection, with slightly more positive revenue projections, and a presumption that most or all of the labor cost reduction measures imposed this fiscal year will continue on in fiscal year 2012-13 and that we will prevail in all of our lawsuits. Baseline #2 includes less optimistic revenue projections, especially relating to the prospect of stabilized property tax revenues and a presentation of the costs if some of the key labor reduction measures are not upheld, essentially we "turn off" all emergency imposed concessions.

When looking at Attachment A, the 2012-13 Baseline #1 projection shows a deficit of $20 million and a $38 million deficit with 2012-13 "Baseline #2" assumptions.

These deficit projections are driven by a series of factors, the most significant of which were anticipated further property tax revenue declines, potential migration of the Code Enforcement program off the County Teeter distribution plan, expiring Federal police grants, increasing pension, pension bond, and retiree health costs, and the impact of a base 2011-12 budget balanced with one-time grants, transfers, and vacancy savings.

The section below discusses the assumptions behind Baseline #1, the best case scenario. In Baseline #1 an overall 2% decrease in General Fund revenues is projected due to property tax declines, potential migration of the Code Enforcement Teeter Plan impacts, and the discontinuation of one time revenues received in 2011-12.

- Property Taxes are expected to decline 5% or $2.2 million in Fiscal Year 2012-13 based on discussions with both the San Joaquin County Assessor and the City's property tax consultant, HdL Companies. Property values are expected to continue to decline because of declining home prices and Prop. 8 reductions.

- The Code Enforcement revenue estimate presumes a discontinuation of the application of the County's "Teeter Plan", where the County covers the cost of delinquent City Code Enforcement liens. County staff has proposed this change to the Board of Supervisors to begin next fiscal year. The impact of that change has been estimated to be a loss of approximately $500,000 or more to the City.

- Franchise Tax and Fire District Contract revenues were higher in 2011-12 due to receipts of one time funds. Projected 2% growth in Franchise revenue is offset by the $700,000 one time Comcast revenue received in 2011-12 for a net decline of $535,000. The Fire District revenue has been decreased by the $1 million one-time prior year payment received in 2011-12.

- Sales Tax revenue is estimated to increase $1.7 million based on trends from the last two quarters and a more optimistic projection received from the City's Sales Tax consultant, the HdL Companies. HdL also projects a higher County ERAF sales tax backfill payment of about 13% in 2012-13 due to a $440,000 true up of 2011-12 sales tax revenue. Without the above adjustments, HdL's baseline sales tax projection is up 3% for 2012-13.

The 2012-13 Baseline #1 projection assumes employee compensation is the same as in 2011-12. Overall labor costs, however, are projected to increase 6% over 2011-12 costs due to: expiring Federal police grants, increasing pension, pension bond, and retiree health costs, and a base 2011-12 budget balanced mid-year with one-time grants, transfers, and vacancy savings which cannot be repeated in future years.

- The three year Federal COPS Hiring Recovery Program (CHRP) grant ends at June 30, 2012 and requires that the City keep the 20 Police Officers for a minimum of one year after the grant expiration. This is an increase of $2.8 million to the general fund. The 2012-13 projection also includes $100,000 to provide a local match of salary and benefit costs for the new federal Community Oriented Policing Services Hiring Program Grant recently accepted by the Department. This $7.8 million grant will fund 17 police officers for three years.

- CalPERS provided rates for Fiscal Year 2012-13 in October 2011. The Safety rate increased from 29.099% to 31.79%, a 9% increase. The Miscellaneous rate actually dropped slightly from 16.941% to 16.881%, a decrease of 0.4%. Combined this is an additional cost of $730,000 to the General Fund in 2012-13. After these projections, CalPERS has recently recommended a reduction in their actuarially assumed interest rate (from 7.75% to 7.5%) effective July 1, 2013 which, if approved, will increase our safety rates from 32.5% to 40% and miscellaneous from 17.4% to 22%. This would create an approximate increase of $6.7 million in all City funds, and of this approximately $4.4 million would be paid by the General Fund. This is not factored in our projection.

- Retiree health pay-as-you-go cost will increase in the General Fund by over $1 million due to an increase in the number of retirees and a projected 10% increase in health care costs. As you know, most retirees pay nothing towards health insurance.

Significant adjustments to the 2012-13 services and supplies budgets include legal costs, general liability insurance and equipment internal service fund updates.

- The legal and miscellaneous services budget was reduced by $3 million to reflect the City's legal cost in a more typical year. This will be largely impacted by the AB506 process.
- Based on new actuarial reports, the General Liability Insurance charges have been increased to cover costs based on actuarial cash flow projections and are designed to break even on a cash basis. The General Fund impact is an increase of $660,000.
- An additional $1 million increase came from the updated internal service rates for equipment programs. In prior years and originally expected in the near future, these internal service funds have operated at deficits and drawn down their fund balances. Available balances have been proposed for sweep at June 2012 and are no longer available to cover ongoing program deficits.
- Other projected costs increases include election costs, property tax administrative costs, state and federal advocacy contracts that can no longer be charged to Redevelopment, external auditor costs, fuel costs, and Police and Fire recruitment costs. New cost information received from the County on property tax administration and election costs have been added to the General Fund projections. Polygraph and psychology test costs for Police and Fire recruitments have been absorbed by department vacancy savings in 2011-12 but are now added back as new baseline costs in 2012-13. The Public Works Department reviewed fuel usage and pricing and proposed three scenarios. The fuel cost increase of $241,000 is based on the mid-range of the proposed scenarios.

The Other Program Support section includes operating subsidies for Library, Recreation, Golf, and Entertainment Venues; grant match funds, general capital expense funding; and debt supported by the General Fund. City staff has revisited all funds with operating deficits in the 2011-12 adopted budget and identified additional funds at risk for General Fund support. These funds have been drawing from their fund balance reserves through June 2012:

- A $350,000 subsidy for the Golf Course Fund has been added to projected General Fund costs. In prior years, annual deficits in the Golf Program have been absorbed the Recreation Fund, which is now out of reserves and no longer available to support the Golf operation.
- Library and Recreation Fund subsidies have been increased by $100,000 and $85,000, respectively, to cover projected increases in salary and benefit costs.
- The General Fund subsidy for the Entertainment Venues Fund has been reduced by $200,000 based on the business plan proved by SMG.
- Grant match funds have been reduced from $300,000 to $50,000 due to the expiration of the CHRP grant.
- Capital improvement support has been returned to the original 2011-12 budget level of $575,000. Since City staff will not be moving to the 400 E. Main Building additional repairs may be needed in City Hall.
- The 2012-13 projection reflects the net impact of the delayed move of City staff into 400 E. Main St. ($600,000), and the fact that interest payments on the variable rate bond for this building have increased ($400,000). Staff is working with the Real Property manager to identify operational savings that may be generated from the now vacant "future" City Hall space. The deficit in the adopted 2011-12 budget for this fund will continue into the next few years without rent from City departments. The General Fund forecast now includes a net $1 million subsidy for the only partially occupied 400 E. Main St. building. We are working on reducing this number.
- The General Fund will be called upon to backfill development revenues that are insufficient to cover Public Facility Fee Debt bond payments which are backed by the General Fund. The General Fund subsidy is projected to increase from $620,000 to $1 million.
- Debt payments for the MUD/Howard Jarvis settlement and General Fund assistance for Redevelopment activities, the Downtown Marina, and Debt administration remain level in 2012-13.

The General Fund Contingency account in 2012-13 has been restored to the $2 million level.

As we contemplate a strategy to extricate the City from this situation it is important to note that financial projections for the next several years continue to show that the City's current fiscal condition is not temporary, and we cannot expect to simply wait to grow out of this problem. Furthermore, your Council has to adopt a balanced budget by June 30th of each year.

Ongoing Issues

The projections discussed above include the quantifiable and known budget impacts to the General Fund. However, the General Fund remains at risk for a number of other serious but un-quantified and unresolved issues.

County Teeter Program – As discussed above, in response to high delinquency rates on district assessments, County staff have proposed a change to its "Teeter" method of tax distribution. Under the current plan, the City receives 100% of all taxes and assessments levied, including substantially all Code Enforcement liens. The County covers the delinquent taxes in exchange for penalties and interest earned in the period in which the delinquent taxes are collected.

Proposed changes to the Teeter Plan will have particular impact on the City's General Fund Code Enforcement revenues. The City levied approximately $2.4 million in code enforcement fees, fines, abatement charges, interest, and penalties on the County tax roll for 2011-12. Changes to the County's Teeter Plan began in 2009 when the County imposed restrictions on lien payments by comparing the lien amount on each property to the assessed land value of the property. If the amount owed exceeded the assessed land value, the County reduced the Teeter payment down to or slightly below the assessed value. The Neighborhood Services Section of the Police Department accounted for this restriction in its 2011-12 revenue estimate.

The County recently notified the City that it has proposed removing all direct assessments from the Teeter Plan in fiscal year 2012-13. The Teeter Plan changes do not mean that this revenue will be lost, only that the County will not pay the City up front for all delinquent fees and fines. On Tuesday, September 23, 2011, the County Board of Supervisors returned this agenda to staff, requesting additional analysis of alternatives.

The risk to the City is for 2012-13. At that time, the City might need to absorb the cash flow, carrying cost and risk of unpaid property assessments. This forecast carries an assumption that the adoption of the changes to the Teeter plan would cost the City approximately $500,000 or more. There have been estimates however that this change could add as much as $2 million to our operating deficit in FY 2012-13. We will continue to monitor County action on this proposal.

Labor Contracts and Related Litigation – Modified labor agreements with cost reductions have been ratified with all groups for 2011-12 except the Stockton Police Officers' Association (SPOA) and Stockton City Employee's Association (SCEA). On June 21, 2011, the City imposed salary and benefit reductions for SPOA and SCEA employees under its May 17, 2011 emergency declaration. These impositions are the subject of litigation and present a risk of more than $11 million.

Recap of Ongoing Issues – The recommended fund transfers and other actions of $15 million address the $15 million in unrestricted fund deficits now projected through June 2012. The Four Year Forecast projects a deficit range from $20 million to $38 million in fiscal year 2012-13 and ongoing deficits ranging from $25 to $28 million in fiscal year 2013-14 and 2014-15. The ongoing issues discussed above create challenges for the General Fund as initiates its budget development process for 2012-13.

Options for Closing Gap

Revenue - To close the gap and balance the budget we must either raise revenue or decrease expenses. The City has limited options for new tax revenues. The California Constitution limits the ability of cities to increase tax revenues without voter approval. City residents already contribute supplemental sales tax revenues to Measure W (Public Safety) and Measure K (Transportation) programs. With an unemployment rate of just under 20%, residents are unlikely to have the economic footing to approve ballot measures for additional tax revenue support, either through additional sales or parcel tax options. Given our public disagreement on labor costs and well documented generous retiree health benefits, the voters will likely hesitate funding more revenues now. Furthermore, any additional revenues are at risk by various litigants with the City. However, if the voters were to approve an additional quarter (1/4) percent sales tax, for example, it could generate $9 million of new revenues per year. In any case, this hypothetical relief would only provide $4.5 million in the 2012-13 fiscal year if approved by voters in November 2012. It would be far more beneficial to seek additional revenues to support a restructured, sustainable organization.

Service Reductions - Seventy-one percent of the General Fund expenses are dedicated to labor. Another way to look at the General Fund expenses is by function and 77% of the functions in the General Fund are related to public safety (police and fire). In order to cut $20 million from the General Fund, more layoffs of staff and more reductions in public safety would be necessary. Over the past few years the City has taken the steps to cut costs. The budget gap closed last year was $37 million, before that it was $23 million, and before that $28 million. Staffing has been cut from a high of 1,886 positions in 2008-09 to 1,424 currently authorized positions. Authorized sworn positions in the Police Department have gone from 441 in 2008-09 fiscal year to 343 currently authorized. Staffing is critically low and service to the citizens of Stockton is suffering. In 2011 almost 50 firefighter positions were also eliminated.

Although Management and Council agree that programs have been cut enough and in many cases too much, this is the area where the City had the most ability to cut cost. General Fund program departments were asked to submit reduction plans to demonstrate the service level impact of the reductions necessary to balance the budget. The scope of necessary service reductions would severely redefine the City's service capacity and eliminate essential community services. Their submissions are presented in Attachment B. It is important to note that the department heads do not recommend these reductions, indeed, just the opposite. Below are some of the components of the reductions:

- An average of 15% in department service reductions would be required to achieve $20 million in expenditure savings.
- Since the most significant expenses in the General Fund are invested in public safety services (Police and Fire), reductions of this magnitude would have particularly serious consequences for services provided by those departments. For example a 15% reduction to the Police Department budget would total just over $12.7 million, and a 15% reduction to the Fire Department budget would total just under $6.0 million.
- A 15% reduction to the Police Department would require the elimination of all 30 Community Services Officers, 64 sworn officers, and a variety of other support services staff.
- Achieving a 15% reduction to the Fire Department would result in the elimination of three fire engines and 1 fire truck and the reduction to firefighter staffing on one fire truck. This would mean the elimination of 41 sworn fire positions.
- In total, department proposals would reduce the General Fund work force by up to 190 full-time positions and 6 part-time positions, in the following expenditure reduction scenarios:

5%	76
10%	136
15%	190

These kind of cuts simply pose too much of a safety risk to our citizens.

Labor negotiations - Employee compensation in the General Fund is part of a negotiated agreement. In the past the City has imposed changes to labor contracts due to the Fiscal Emergency, however, these impositions are temporary and the problem is not. Additionally, litigation is pending with labor related to the emergency impositions. In fiscal year 2012-13, it is estimated that $13 million must be renegotiated or imposed to maintain current compensation levels. This represents the $11 million of imposed reductions for the Stockton Police Officers Association and Stockton City Employees Association and furloughs for all other units. Significant compensation restructuring was accomplished last year bringing compensation for most units closer to our labor market. As we consider a plan to close the gap and look at additional changes to compensation, we must balance that with our ability to attract and retain quality employees. I highly recommend that we do not go too far below the labor market "average" for compensation. Whatever services we do continue to provide, we must provide them in a quality way. Substandard compensation will erode our capacity to do this.

Other options - Our options for raising revenue are limited. Our service levels are already critically low. Our employee compensation would fall below market if reduced by $20 million. Employees have already seen a 12-23% reduction in compensations in 2011. The City cannot continue to balance budgets without dealing with other issues driving our unsustainable fiscal environment. The City's debt, retiree health programs, and other burdensome contractual commitments must be dealt with to put the City on stable financial footing. The City must take a comprehensive approach to restructuring its obligations.

The 2012-13 General Fund projection for retiree health costs is $9 million. Retiree health costs are estimated to nearly double in ten years if left unchanged. Our retiree health insurance program is one of the most generous in the state. The irony is that we anticipate spending more for the retiree health insurance than for our employees. The near term problem from this program is due to a poor funding strategy when these commitments were made (1990's). We now have the "tail end" of a legal but mis-managed program that feels similar to a "Ponzi scheme" that has ballooned to a $434.8 million unfunded liability that would require 31.58% of the payroll to adequately fund it. I might add, due to your quick but difficult decisions last year, you reduced the reitree health unfunded liability by over $120 million. This mismanaged program, coupled with retirement benefit enhancements has put our retiree to employee ratio upside down (2400 retirees to 1424 employees).

The City is scheduled to make $13.6 million in General Fund-backed debt service payments from unrestricted resources in 2012-13. Some of these payments are administratively budgeted in other funds, such as the Parking Fund, but are ultimately paid from unrestricted fee revenues that could be redirected for other purposes if not used to pay debt. The following chart describes these unrestricted debt service payments. The significance of the projected deficit prompts a review of these obligations for restructuring options.

Debt Service Payments Backed by General Fund

	FY 2011/12 Remaining Payments		FY 2012/13 Annual Payments	
	Scheduled Amount Spring 2012	Paid from Unrestricted Funds	Scheduled Spring/Fall FY 2012/13	Paid from Unrestricted Funds
2007 Pension Obligation Bonds Paid by Pension Internal Service Fund Source of funds: Labor budget contributions	-	-	7,712,550	5,644,216
2004 Lease Revenue Bond (Parking) Paid by Parking Fund from unrestricted fees	803,658	803,658	1,960,116	1,960,116
2006 SPFA Lease Rev Bonds - (1999 ESB Refinance) Budgeted in Gen Fund with offsetting Transfer In from unrestricted Parking Fund fees	-	-	907,494	907,494
2003 COPS (Housing Projects) Obligation of Redevelopment Housing Fund	-	-	990,170	
Paid from Bond conversion through Sept 2012 Projected General Fund backfill March 2013				326,372
2009 Lease Revenue Bonds (Public Facilities Fees)	1,207,919		2,415,838	
Paid from PFF funds; backfilled by General Fund		680,000		1,082,190
2007 Variable Rate Bonds (City Hall) at 4% Budgeted in 400 Main Fund, backfilled by Gen Fund	565,000	565,000	1,866,794	1,866,794
Department of Boating & Waterways Budgeted in Marina Fund; Backfilled by Gen Fund			719,677	719,677
Jarvis/MUD Settlement Paid by General Fund	-	-	1,112,998	1,112,998
Rev Bond Events Center-Arena Project 2004 Pledge of Waterfront Tax Increment	-	-	2,570,687	-
	2,576,577	**2,048,658**	**20,256,322**	**13,619,857**

We also need to assess other "burdensome contracts" to consider cost reductions on other more favorable terms to the City.

Additional legal costs - The balancing scenarios discussed here may include departures from contractual obligations that are likely to require significant legal defense. In the case of bond holders, agreements may require the City to cover not only its own bills but also creditor collection costs.

Summary of Options for Closing the Gap

This staff report has discussed a list of balancing alternatives for City Council consideration. It is important to remind the reader that if we are able to close the gap for Fiscal Year 12-13, we will still have no fund balance to cushion against further deterioration of finances and the deficits continue to grow in subsequent years. A sustainable solution must be developed now. It is recommended that Council immediately direct staff to develop plans for long term fiscal sustainability to be discussed with interested parties before a neutral evaluator.

Management Partners Financial Assessment

On December 13, 2011 your Council authorized Management Partners (MP) to conduct an independent assessment of the City's finances. Their final report is attached (Attachment C). They are opining that we are insolvent, depending on what we do now. Their report validates what you've been told by staff. They concur with staff that poor fiscal management in the past and the Great Recession have combined to put the City in an extremely weak fiscal condition. They believe the four year forecasts prepared by staff may even be a bit optimistic. Their financial findings confirm our sense of urgency and they affirm the recommendation that we proceed with the mediation process outlined in AB506 immediately.

Management Partners key observations include:

- The City faces significant risks and increasing costs that weaken its financial position and continue to erode its ability to provide fundamental services.
- The City can be considered insolvent from a service delivery and a budget perspective.
- The City is nearly cash insolvent and is likely to run out of unrestricted available fund balance before the end of the fiscal year unless immediate action is taken.
- The weakness of the City's financial condition as represented in documents prepared by the City management for FY 2011-12 and FY 2012-13 is not overly conservative.

They recommend cash be conserved to avoid insolvency and uncontrolled default, that we immediately prepare for AB506 proceedings to restructure our finances, and that we develop plans to lower serviced levels or alternate service delivery approaches to further reduce costs.

Recommended Commencement of AB 506 Mediation Process

The City is in an immediate and severe fiscal crisis and it is or likely will become unable to meet its financial obligations as and when those obligations are due or become due and owing. Absent some negotiated adjustments to the City's financial obligations, the City will be insolvent and will have no alternative than to seek bankruptcy protection under chapter 9 of the United States Bankruptcy Code. A recently adopted California law known as AB 506 (Government Code Sections 53760-53670.7) provides for a confidential neutral evaluation process as a precondition to or in lieu of (if successful) filing a chapter 9 petition. The goal of this process is to achieve a negotiated solution to the City's financial challenges. Immediate commencement of a confidential neutral evaluation process under AB 506 with the City's creditors is recommended to attempt in good faith to resolve the City's financial crisis. However our timing or room for maneuvering is very tight.

As previously mentioned, the AB506 confidential and independent mediation process is an intense and complex process that has not been tried by any agency in California. It will include a long list of creditors or interested parties that will try to forge a successful restructuring process in a compressed time frame. This will require a huge amount of coordination of staff and outside parties. This can only be done by contracting for additional resources. As a result, we propose a contract in the amount of $175,000 with Management Partners. Additional information is provided in the next section of this document.

Management Partners Project Management

The City Manager's Office recently approached Management Partners to request a proposal to provide project management and technical assistance support for the AB 506 mediation process (see Attachment D's Exhibit A). Management Partners has the resources to immediately begin the planning and project preparation including preparing a work plan for executing the AB 506 process. The work plan will identify the key steps, schedule and individuals or consultants who will have responsibility for each element of the work plan. Management Partners will also prepare a communications plan and assist in preparing materials to communicate the City's financial condition to interested parties in the AB 506 process. Management Partners will then identify the relevant interested parties or creditors and notify them of the City's intent to initiate the AB 506 mediation process. Management Partners' in depth knowledge of the City's finances will also allow them to quickly develop plans for long term fiscal sustainability to be discussed with creditors. This is known as the "ask" to interested parties, and consists of the relief being sought by the City with respect to existing debt and contractual obligations which are no longer consistent with fiscally sustainable operations. Management Partners will also work with the City Attorney and outside counsel to facilitate the selection of the neutral evaluator, create and coordinate a mediation schedule and assist the City in preparing materials for presentation and discussions in the mediation sessions. Finally, Management Partners will also assist the City in identifying any additional tasks that must be completed following the mediation process.

To accomplish these tasks, Management Partners has proposed the dedication of outstanding resources with exceptional experience in project management and municipal finance, including their Regional Vice President and a Partner of the firm. Management Partners will coordinate the efforts of their team along with City staff, legal counsel and other experts to assist the City through the AB 506 process. Management Partners will serve as the City's project manager for the AB 506 process, doing what is necessary to move what is sure to be a new and challenging process forward to a satisfactory conclusion.

Staff recommends that the City avoid delay in initiating the AB 506 mediation process by executing a new contract with Management Partners for project management and technical assistance in the AB 506 mediation process in the amount of $175,000 (Attachment D).

Findings

Stockton Municipal Code Section 3.68.070 provides an exception to the competitive bidding process in cases where the City Council has approved findings that support and justify the purchase.

The following findings support the exception as follows:

- There is an immediate need to initiate the AB 506 mediation and neutral evaluation process.
- The fiscal sustainability of the City is the top priority of the City Council.
- The City does not have the resources or staff time to support the AB 506 process while managing the City.
- There would be a significant delay in engaging in a formal Request for Proposals (RFP) process for AB 506 support services.
- Management Partners is uniquely familiar with the financial condition of the City based on their work conducting the financial condition assessment.
- Management Partners has working knowledge of the City and its staff that will expedite the process.
- Management Partners has the expertise and staff available to begin the preparation for the AB 506 process immediately.
- Management Partners has demonstrated the expertise and capability to manage time sensitive, high profile projects with outstanding performance and attention to detail.
- The proposed fees are reasonable and comparable to the costs for similar project management engagements.

Suspension of Debt Service Payments

As a necessity, to preserve cash liquidity in the general fund for the remainder of Fiscal Year 2011-12, we are recommending that the Council authorize suspension of payments on certain general fund lease obligations (for detail see page 29) in the amount of approximately $2,048,658. Failing to make these payments will constitute an Event of Default on the part of the City, although all of the obligations have cash reserve funds or surety policies so that investors in the City's obligations will not immediately suffer a missed payment. However, this is a serious step and will very likely result in the withdrawal or downgrade of the ratings on these publicly traded obligations and will negatively impact their market value. A portion of the 2009 Lease Revenue Bonds (Public Facilities Fees) will be paid with Public Facilities Fees (PFF). Where fee revenue is insufficient, unrestricted funds will not be used to backfill the remaining amount of the payment. As shown on page 29, the total payment on this issue is expected to be $1,207,919. The shortfall of PFF revenue will create a default of approximately $680,000 of this payment. With respect to the variable rate Series 2007A and Series 2007B Bonds issued to finance the acquisition of 400 E. Main St., the failure to make payment on March 1, 2012 could result in those bonds being tendered to Dexia, the liquidity provider, which would result in a significant increase in the interest rate on those bonds; however, holders of the bonds would be paid in full for their tendered bonds, and Assured Guaranty, the bond insurer, would make payment to the holders (or Dexia to the extent they purchase the bonds).

The providers of bond insurance for the City's general fund obligations (National Public Finance Guarantee, Assured Guaranty and Ambac), and the trustee (Wells Fargo), will be invited to participate in the AB 506 confidential neutral evaluation process described above. It is likely that they will be asked to make significant concessions as a part of any negotiated solution to the City's financial crises in the AB 506 process.

Ratification of Leave Payoff Suspension

On May 17, 2011 the City Council adopted Resolution #11-0114 declaring that the City of Stockton was experiencing an ongoing fiscal emergency. That declaration is still in effect and continues today. That emergency declaration resolution gave the City Manager authority to take further emergency actions to preserve the City's ability to provide essential service to the citizens of Stockton to safeguard public health and safety.

Effective February 16, 2012, under this authority the City Manager took the following actions to stabilize and preserve the finances and available cash of the City in order to continue to provide services. It is recommended that your Council adopt findings regarding the suspension of vacation sell back and leave pay off. These findings are below.

1. On May 17, 2011, this Council approved Resolution #11-0114, declaring a state of emergency based on fiscal circumstances and directed the City Manager to take appropriate and lawful measures to achieve a balanced budget including any change to existing labor agreements determined necessary by the City Manager, limited to the duration of the fiscal emergency. The financial information provided in this report supports the continuation of the state of emergency. The measures implemented under this emergency are necessary to generate the cost savings needed to maintain solvency of the General Fund during fiscal year 2011-12.

2. The City is dangerously low on available cash resources necessary for current operations, including the operation of the City's police and fire departments, which are funded almost entirely from unrestricted general fund revenues.

3. The ability of the City to continue funding basic public safety services during the pendency of this condition of fiscal emergency is of paramount importance to the citizens of Stockton.

4. City employees have, through valued and continuous service, accumulated leave balances in the form of both sick leave and vacation and these balances represent a significant unfunded general fund obligation.

5. It is anticipated that due to the current financial position of the City certain employees, some with very large leave balances that they will seek to convert to cash upon separation, will chose to immediately separate from City service and that these employee separations will cause extreme pressure on the City's greatly depleted unrestricted cash resources.

6. The City currently does not have sufficient unrestricted cash resources available to both maintain necessary levels of public safety related services and immediately pay separating employees for 100% of its liability for accumulated leave balances without an unacceptable risk of depleting available cash resources to the point that public safety services may be put in jeopardy.

7. While any risk to the City's ongoing ability to provide necessary public safety services to it's citizens is a grave concern, the current level of crime in Stockton makes this risk one that this Council is unwilling to incur. To place at greater risk the safety of the community in this time of greatest need would be an unconscionable dereliction of this Council's most basic obligation to it's citizens.

8. It is necessary at this time to immediately, but temporarily, delay the further payment of all leave balances to separating employees until such time as there are sufficient unrestricted cash resources available to the City to allow for the payment of such leave balances while ensuring the City will have adequate resources remaining to fund basic services.

Along with these findings, the City manager is also directed to develop alternatives to this complete suspension of leave buyouts and report back to the City Council as soon as practical. The alternative should strike a balance between our ability to pay and what is rightfully owed to our employees.

It is further recommended that your Council ratify these emergency actions by the City Manager. These actions proposed for ratification are:

1. Annual Vacation Sell back or Cash Payoffs of Vacation. Effective the pay period starting February 16, 2012, the City Manager has ordered that whatever annual vacation sell backs or pay offs as provided for in various Memorandums of Understanding/resolutions are hereby temporarily suspended. This applies to all bargaining units and employees, including those units where the annual sellbacks or cash outs have already been suspended during the furloughs.

2. Vacation Hours paid at separation. Effective the pay period starting February 16, 2012, the City Manager has ordered that all pay offs of unused vacation hours that would otherwise be made to an employee upon separation from City employment, and as provided for in various Memorandums of Understanding/resolutions, are hereby temporarily suspended. This applies to all bargaining units and all employees. This suspension of pay offs of unused vacation shall also apply to Fire and Fire Management Longevity Vacation. This provision shall not apply to employees who are involuntarily separated from City Service.

3. Sick Leave Hours paid at separation. Effective the pay period starting February 16, 2012, the City Manager has ordered that all payments of unused sick leave that would otherwise be made to an employee upon separation from city employment for any reason, and as provided for in various Memorandums of Understanding/resolutions, are hereby temporarily suspended. This applies to all bargaining units and all employees.

4. Holidays leave hours paid at separation. Effective the pay period starting February 16, 2012, the City Manager has ordered that all payments of unused holiday leave hours that would otherwise be made to an employee upon separation from city employment for any reason, and as provided for in various Memorandums of Understanding/resolutions, are hereby temporarily suspended. This provision shall not apply to employees who are involuntarily separated from City Service.

5. Other leave balance pay offs at separation including payments of unused compensatory time in lieu of overtime or furlough hour banks shall not be impacted by these suspensions.

The City Manager and staff will make it a top priority to provide options to this suspension, that provide a better balance between the 100% suspension, versus the financial exposure of potentially large payoffs.

Investigation

Over the years the City has relied on the services of various professionals in the areas of finance and fiscal management. Through the hard work that staff has undertaken in the near term it has become apparent that the true financial condition of the City was not communicated in certain prior fiscal years to the Council at a time when measures might have been available to avoid, at least in some measure, the current difficulties now being confronted.

It is also now apparent that there may have existed in certain past fiscal years non-standard financial practices engaged in, either intentionally or negligently, by City administrators and/or contractors that were not disclosed to the Council and that have also contributed to the City's current financial situation.

Given the grave consequences now being faced by the City, it is important that staff engage in an investigation aimed at determining if the City has the ability at this time to pursue remedies against persons or entities that may have contributed to the City's current financial situation by failing, either by their intentional or negligent actions, to properly serve the City.

It is staff's intention, if so directed by your Council, to engage in an investigation and return to Council (in open or closed session as appropriate) for direction regarding any further actions that may be appropriate.

FINANCIAL SUMMARY

A General Fund action plan has been identified to offset $15 million in 2010-11 and 2011-12 losses that have materialized since the previous budget updates. The proposed plan and budget amendment addresses known and quantifiable impacts to the budget. As discussed above, a series of additional and significant contingent risks to the General Fund remain outstanding.

The following are prior period and current year transfers and appropriations that must be made in order to balance the General Fund at June 30, 2010, June 30, 2011 and to maintain a balanced budget in Fiscal Year 2011-12. The amounts below are approximate unaudited available fund balances; actual available funds will be transferred.

FISCAL CONDITION UPDATE FOR FISCAL YEARS 2010-11, 2011-12 AND 2012-13

At June 30, 2011 authorize the following appropriations and transfers of unappropriated fund balance:

	Account	Amount	Page Reference
Transfer To:			
Redevelopment Waterfront #343	330-0000-492	3,876,000	pg. 9
Recreation Fund #044	044-0000-492	20,000	pg. 10
HUD Grant Funds	052-0000-492	88,000	pg. 10
Development Services Fund #048	048-0000-492	526,000	pg. 9
City Debt Service Fund #201	201-0000-492	6,000	pg. 10
	Total	4,516,000	
Transfer From:			
General Fund	010-0000-992	(4,516,000)	
Transfer From:			
Library Fund	041-0000-992	(721,000)	pg. 18
400 E. Main Operating	085-0000-992	(590,000)	pg. 18
Entertainment Venues	086-0000-992	(570,000)	pg. 18
General Capital Fund	301-0000-992	(798,000)	pg. 19
ESB & 400 Main Capital	305-0000-992	(1,930,000)	pg. 19
Fleet ISF	501-0000-992	(2,286,000)	pg. 19
Retirement ISF	561-0000-992	(3,731,000)	pg. 20
Arts Endowment Trust	613-0000-992	(1,300,000)	pg. 20
Total		(11,926,000)	
Transfer To:			
General Fund	010-0000-492	11,926,000	
Increase 2010-11 Expenditure Appropriation:			
General Fund #010 - Payroll Accrual		650,000	pg. 9
Measure W Fund #081		1,232,000	pg. 18

Amend the 2011-12 General Fund Budget as follows:

	Oct. 18, 2011 Amended Budget	Increase/ (Decrease)	**Feb. 28, 2012** Amended Budget	Page Reference
Revenues	158,828,313	(825,799)	158,002,514	pg. 12
			-	
Expenditures				
Police	83,172,036	(223,500)	82,948,536	pg. 13
Fire	39,812,835	47,000	39,859,835	pg. 14
Redevelopment	1,000,000	2,100,000	3,100,000	pg. 14
City Manager	735,926	1,800	737,726	pg. 14
City Auditor	405,801	100,000	505,801	pg. 14
Admin Services	3,201,627	1,500	3,203,127	pg. 14
Human Resources	1,272,332	1,700	1,274,032	pg. 14
Tax Collection and Election	2,310,000	310,000	2,620,000	pg. 14
Other Admin / PIO	1,363,178	(368,370)	994,808	pg. 13, 14
Labor Litigation/Negotiation/AB506	1,500,000	3,500,000	5,000,000	pg. 15
Debt Service	2,137,468	2,357,000	4,494,468	pg. 13, 14
March to June 2012 Debt	-	(1,245,000)	(1,245,000)	pg. 20
Transfer In Parking Debt	-	(804,000)	(804,000)	pg. 20
Subtotal, Expenditures	158,828,313	5,778,130	164,606,443	

The financial information provided in this report supports the continuance of the state of emergency adopted by City Council Resolution #11-0114 on May 17, 2011. The measures implemented under this emergency are necessary to generate the cost savings needed to maintain a balanced budget and maintain solvency of the General Fund through the end of fiscal year 2011-12. The City continues to closely monitor its 2011-12 budget and will report to you as conditions change.

Respectfully submitted,

Laurie Moore

for BOB DEIS
CITY MANAGER

Attachment A: Detailed Fiscal Year 2012-13 Forecast
Attachment B: Service Level Reductions
Attachment C: Management Partners Financial Assessment Report
Attachment D: Consultant Services Contract

General Fund Projection

	2008-09	2011-12 Current Projection at 1/31/12	% vs PY	2012-13 Baseline #1 Optimistic	2012-13 Change from 2011-12	% vs PY	2012-13 Baseline #2 Pessimistic	2012-13 Change from Baseline #1	% vs PY
Beginning Available Balance	9,628,221	-		-	-		-	-	
Revenues									
Property Tax	55,499,968	44,512,970	-5%	42,319,722	(2,193,249)	-5%	41,842,191	(477,531)	-6%
Sales Tax	37,344,891	36,180,001	4%	37,965,021	1,785,020	5%	37,932,319	(32,702)	5%
Utility Users Tax	30,853,668	31,236,736		31,386,600	149,864		31,008,000	(378,600)	
Other General Revenues	46,524,091	33,379,991		32,153,247	(1,226,744)		31,260,244	(893,003)	
Program Revenues	32,878,911	12,692,816		11,084,977	(1,607,839)		10,719,095	(365,882)	
	203,101,529	158,002,514		154,909,567	(3,092,948)	-2%	152,761,848	(2,147,718)	-3%
Expenditures									
Salaries and Benefits									
Salaries - Safety	44,727,294	37,232,821		37,677,139	444,318	1%	38,806,558	1,129,419	3%
Salaries - Non-Safety	22,893,333	16,955,006		17,157,338	202,332	1%	18,514,798	1,357,460	8%
Salaries-Part time, Temporary	1,351,167	605,194		605,194	-	0%	605,194	-	0%
Pension - CalPERS	26,313,359	16,075,185		*16,806,002*	730,817	5%	*21,148,500*	4,342,498	26%
Pension - Bonds	-	5,615,200		5,644,217	29,017	1%	5,644,217	-	0%
Health, Dental, Vision - Employee	19,034,883	9,403,915		8,982,969	(420,946)	-4%	11,853,249	2,870,280	32%
Health - Retirees	-	*8,010,742*		*9,051,809*	1,041,066	13%	*9,051,809*	-	0%
Workers Compensation	3,120,880	5,660,652		5,627,821	(32,831)	-1%	5,930,754	302,933	5%
Other Pay and Benefits	11,544,889	7,091,431		*6,605,792*	(485,639)	-7%	*9,704,772*	3,098,980	47%
Overtime & Standby/Callback	8,497,730	6,842,859		6,842,859	-	0%	6,842,859	-	0%
Compensated Absences	3,470,937	4,347,003		4,277,674	(69,329)	-2%	4,881,682	604,007	14%
Salaries - Safety - Expiring Grants	-	-		2,954,850	2,954,850		3,175,470	220,620	7%
Reductions/reorganizations	-	(2,758,000)		(648,000)	2,110,000	-77%	(648,000)	-	0%
	140,954,472	115,082,008		121,585,664	6,503,656	6%	135,511,861	13,926,198	11%
Services and Supplies									
Internal Services-Equip	12,302,619	12,182,833		*13,299,313*	1,116,480		*13,299,313*	-	
General Liability Insurance	2,053,914	2,283,248		*2,947,771*	664,523		*3,142,284*	194,513	
Utilities	4,388,811	2,437,740		2,486,495	48,755		2,486,495	-	
Maintenance & Repair Services	1,599,774	2,444,155		2,444,155	-		2,480,817	36,662	
Labor/Legal Services	2,350,467	5,122,803		2,122,803	(3,000,000)		2,222,803	100,000	
General Expenses	7,295,143	5,871,867		6,113,390	241,523		6,237,114	123,724	
Tax Collection & Election	3,140,830	2,804,000		2,819,151	15,151		2,861,828	42,677	
	33,131,557	33,146,646		32,233,077	(913,569)		32,730,653	497,576	
Other Program Support									
Library, Recreation, and Golf Funds	12,254,613	6,735,022		7,269,349	534,327		8,335,734	1,066,385	
Entertainment Venues Fund	-	2,441,299		2,232,732	(208,567)		2,358,188	125,456	
Other Program Support	119,355	950,000		625,000	(325,000)		625,000	-	
Redevelopment	-	3,100,000		3,100,000	-		3,100,000	-	
Debt - Other	16,984,925	4,350,307		6,071,285	1,720,978		6,283,285	212,000	
	29,358,893	17,576,628		19,298,365	1,721,738		20,702,207	1,403,841	
Contingency	-	850,000		2,000,000	1,150,000		2,000,000	-	
Total Expenditures	203,444,923	166,655,282		175,117,106	8,461,825		190,944,721	15,827,615	
Reserves	(677,780)	8,652,768			(8,652,768)				
Net Annual Activity	(1,021,173)	-		(20,207,540)	(20,207,540)		(38,182,873)	(17,975,333)	
% of Expenditures		0%		-12%			-20%		
Ending Available Balance	8,607,048	-		(20,207,540)	(20,207,540)		(38,182,873)	(17,975,333)	

General Fund
Department Reduction Summary
2012-2013

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Programs										
Police										
Eliminate all Community Service Officer positions. Reduce revenue from $1.2 mil to $600,000. Net reduction is $2,012,133	All current CSO and Sr. CSO activities would be reassigned to Police Officers. VIPS being considered for parking tickets.	2,012,133	2,012,133	2,012,133	30		30		30	
Reduce the number of Police Records staffing for filled and vacant civilian positions	This overall reduction in the Records Division would increase the amount of time related to all functions of the Records Division. This would include access to documented reports and provision of reports to the public and government agencies, including the Court system.	220,573	220,573	220,573	3		3		3	
Reduced staffing in the Telecommunications Division. 3 Telecommunications Specialist	Decrease level of Telecommunications support for Police Dispatch. Longer wait for 911 calls.	296,402	296,402	296,402	3		3		3	
Reduced civilian support staffing in the Traffic Division	Clerical duties would be assigned to Police Officers as time permits. This would greatly reduce the level of customer service related to towed vehicles and citation disputes.	167,483	167,483	167,483	2		2		2	
Eliminate Investigations Division Police Records Assistant	Case work for CSO's & PRA would be absorbed by Police Officers.	75,216	75,216	75,216	1		1		1	
Eliminate Special Investigations Records Assistant vacancy	Nominal effect on current Special Investigations operations	74,544	74,544	74,544	1		1		1	
Reduce staffing in Animal Services & Animal Control	Reduced hours at Shelter and reduced coverage for animal control	371,077	371,077	371,077	5		5		5	
Eliminate Graffiti Abatement Program salary and costs	Dramatic increase in graffiti throughout Stockton	577,190	577,190	577,190	5		5		5	
Sworn salary savings		448,484	448,484	448,484						

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Police (Continued)										
Eliminate 9 Police Officers, 2 Sergeant's and 1 Lieutenant from the Traffic Division	No separate Traffic Section. Only 8 Police Motor Officers assigned to regular Patrol shifts to handle essential traffic support and manage fatal traffic accidents		1,519,573	1,519,573			12		12	
Eliminate 18 Special Investigation Section (SIS) Police Officer Positions, 2 SIS Sergeant's & 1 SIS Lieutenant. Transfer remaining 2Sergeant's and 6 Police Officer Investigators into the Investigations Section. Restructure Investigations Section.	Remaining 2 GSET Sgts reassigned; only 6 Police Officers remain in Special Investigations. Either GSET or Task Force operations eliminated		2,825,022	2,825,022			21		21	
Decline the 17 positions funded by the 2011 COPS CHP Grant	Few Police Officers to handle calls for service.		100,000	100,000						
Eliminate 26 Police Officer Positions, 4 Sergeants & 1 Lieutenants from Patrol duties. Restructure entire Patrol and Investigative Operations	Reduction in staff available to respond to 911 calls.			4,141,608					31	
	Sub Total	**4,243,102**	**8,687,697**	**12,829,305**	**50**		**83**		**114**	
Fire										
Close Engine No. 11	Increased response time	1,500,697	1,500,697	1,500,697	9		9		9	
Reduce Truck No. 3 by 1 Fire Fighter (1 for each shift = 3)	Increased fire loss, reduced staff safety, increased incident loss, morbidity and mortality	450,445	450,445	450,445	3		3		3	
Fire District Contracts - Revenue reduction estimate		(397,873)	(586,984)	(776,095)						
Reduce Truck No. 2 by 1 Fire Fighter (1 for each shift = 3)	Increased fire loss, reduced staff safety, increased incident loss, morbidity and mortality	450,445	450,445	450,445	3		3		3	
Close Engine No. 6	Increased response time		1,500,697	1,500,697			9		9	
Reduce Truck No. 7 by 1 Fire Fighter (1 for each shift = 3)	Reduced staff safety		450,445	450,445			3		3	

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Fire (Continued)										
Reduce Truck No. 7 by 1 Fire Fighter (1 for each shift = 1)	Increased fire loss, reduced staff safety, increased incident loss, morbidity and mortality		150,148	150,148			1		1	
Savings from other expenditures			65,390	65,390						
Close Engine No. 14	Increased response time			1,500,697					9	
Close Truck No. 3	Increased fire loss and reduce staff safety			1,500,697					9	
Keep 1 Fire Fighter in Truck No. 2 (Reduce by 1 shift)	Increased incident loss and increased morbidity and mortality			(150,148)					-1	
Keep 4 Fire Fighters in Truck No. 7				(665,983)					-4	
	Sub Total	**2,003,714**	**3,981,284**	**5,977,435**	**15**		**28**		**41**	
Public Works										
Reduce contract budget for Trees	Reduced ability to respond to emergencies	100,000	100,000	100,000						
Reduce contract budget for Parks	Delayed repairs to playgrounds and irrigation systems	135,000	135,000	135,000						
Reduce contract budget for HVAC	Probable service delays as more work shifted to staff	60,000	60,000	60,000						
Shift portion of Street Trees non-payroll costs to Gas Tax	Less Gas Tax for Street maintenance	60,000	60,000	60,000						
Shift portion of Pixie Woods maintenance to Pixie Woods Board	Depends on ability of Board to make alternative arrangements		110,000	110,000			1		1	
Eliminate vacant but funded Parks Inspector	Maintains reduced Parks oversight		100,000	100,000			1		1	
Shift additional Street Trees non-payroll costs to Gas Tax for total shift equaling 50%	Less Gas Tax for Street maintenance		65,000	65,000						
Shift Facilities Electrician to Streets and Gas Tax	Probable delays for Facilities electrical issues; improved Traffic electrical		85,000	85,000						
Reduce Parks maintenance to minimum levels	Higher grass and more trash			185,000						
Reduce Parks water usage by 50%	Brown grass and stressed landscaping			165,000						
	Sub Total	**355,000**	**715,000**	**1,065,000**			**2**		**2**	

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Economic Development										
Elimination of Deputy Economic Development Director position and redistribution of staff allocations.	Reduced resources for business outreach, attraction, and retention	24,260	48,520	72,780	1		1		1	
	Sub Total	**24,260**	**48,520**	**72,780**	**1**		**1**		**1**	
Peacekeeper										
Eliminate Phones budget	Staff will not have City Hall numbers; will use cell phones	8,596	8,596	8,596						
Reduce Consultant budget	Reduce services for clients: tattoo removal, conflict management, counseling classes	622								
Eliminate Printing budget	No outreach materials for community fairs, etc.	2,000	2,000	1,657						
Eliminate Travel budget	No training and travel for award programs or training staff	1,200	2,000							
Eliminate Training budget	No training and travel for award programs or training staff	2,000	1,200							
Eliminate Equipment budget	No purchase of radios, scanners, etc	1,000	1,000							
Eliminate Supplies budget	No purchases for the fiscal year	1,000	1,000							
Reduce Full Time Position to Part Time	Reduce current caseload by 200; turn away additional 200 referrals		14,000				1		1	
Reduce Pooled Vehicle budget	Reduce car rental for field trips- fewer field trips		1,000							
Reduce Fuel budget	Reduce fuel budget to match reduction of YOW hours in car (from full time to part time)		2,039							
Eliminate one Youth Outreach Worker Position	Reduce the current caseload by 400, turn away an additional 400 referrals			39,000					1	
	Sub Total	**16,418**	**32,835**	**49,253**			**1**		**2**	
Arts Commission										
Supplies reduced		1,837	3,674	5,511						
	Sub Total	**1,837**	**3,674**	**5,511**						

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Programs Support for Other Funds										
Community Services - Library										
Hold Librarian II Vacant	Delays completion of project to transition to 100% "shelf-ready" new materials. No donations/local history added to catalog and eliminates 5 hours per week of public service desk support lost	53,934	53,934	53,934	1		1		1	
Eliminate Library Asst II (PPJ)	20% of Chavez Library Reference Desk staffing lost (Chavez averages 48,000 reference interactions per year), Longer customer wait times for reference service, Collection maintenance work delayed – customers may not find desired materials on the shelves	85,228	85,228	85,228	1		1		1	
Parity of all late fees		47,000	47,000	47,000						
Reduce PT staff funding by 21%	Less PT and FT staff leads to longer lines at customer service desks, reduced capacity to fill leave time/vacancies, and less skilled tasks performed by higher-paid employees	11,000	11,000	11,000		1		1		1
Reduce Tech Services Supplies by 30%	Reduced capacity to recover books with damaged covers and to replace damaged media cases (audiobooks/music, DVDs) so that serviceable materials can still circulate and virtually eliminates capacity to accept not-shelf-ready donations from customers	4,000	4,000	4,000						

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Community Services - Library (Continued)										
Eliminate Librarian I (PS)	25% of Chavez Library Reference Desk staffing lost beyond that lost at 5% reduction target (total 45% lost), troke Library Reference Desk staffing reduced by 25% and Significantly increased customer wait times at both Chavez and Troke libraries		93,736	93,736			1		1	
Eliminate Librarian I (AC)			98,054	98,054			1		1	
Reduce City branch landscaping by 50%			10,000	10,000						
Eliminate Circulation Asst (LT)	Eliminate Library Assistant from Chavez Library and necessitates operating hours reduction of 31% (from 36 to 25 hours weekly maintains 5-day/week service)			62,812					1	
Eliminate Library Aide (SN)	Eliminate Circulation Assistant and Library Aide from Troke Library. Necessitates operating hours reduction of 31% (from 36 to 25 hours weekly maintains 5-day/week service)			61,771					1	
Eliminate Library Asst II (KBT)	Less skilled tasks performed by higher-paid employees			76,934					1	
	Sub Total	**201,162**	**402,952**	**604,469**	**2**	**1**	**4**	**1**	**7**	**1**

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Community Services - Recreation										
Fewer Civic supplies/repairs & maintenance after remodel	No impacts	20,000	20,000	20,000						
Reduce utilities in Civic Auditorium	No impacts	10,000	10,000	10,000						
Reduce gas utility	Efficiency from upgrade and no impact	80,000	80,000	80,000						
Reduce PT Comm Ctrs & Sports	Contracted field maintenance and no decrease in service	20,000	20,000	20,000		3		3		
Sr AA to PM savings	No impacts	11,500	11,500	11,500						
Rec Asst II separation not filled	Transactions performed by higher paid staff, less time for contract monitoring, program mgmt/development, slightly slower customer service at centers		79,005	79,005			1		1	
Rec Asst II remains vacant			79,146	79,146			1		1	
Layoff Office Asst II	Admin transactions, scheduling performed by higher paid staff, less time for committees, commission participation and support. Full time staff will assist in after school program, no impacts to after school, but other community center customers may incur slower service			61,708					1	
Recreation staff pick up Public Art duties of lay off OA funded by Public Art Fund				11,287						
After school program reduction				48,443						5
	Sub Total	**141,500**	**299,651**	**421,089**		**3**	**2**	**3**	**3**	**5**

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Entertainment Venues										
Reduction of maintenance, repairs, and supplies	Barebones maintenance, repair, contracted services budget. Deferred maintenance issues may create risks to facilities	122,065								
Reduction of maintenance, repairs, and supplies; and reduction of any further line items	Barebones maintenance, repair, contracted services budget. Deferred maintenance issues may create risks to facilities. Deferral of critical maintenance items may create risks. Staff will need to meet and confer with SMG to determine if facilities can safely operate with lower budget.		244,130							
Closure of Baseball Stadium	Further reduction will create risk. Staff will need to meet and confer with SMG. It is estimated that this level or above in service reductions will require the Baseball Stadium closure. Stadium generate lowest level of revenue of all four facilities.			366,195						
	Sub Total	**122,065**	**244,130**	**366,195**						

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Administration										
Non-Departmental, City Manager and City Council	Inability to launch Social Media efforts. Significant impacts to Website, Ask Stockton, and media relations support. Severe impacts to the ability to be responsive to Public Disclosure Requests. Impacts the already strained ability to support City Executives.	131,045	131,045	131,045	2		2		2	
	Inability to broadcast Council Meetings on Channel 97. Severe impacts to Channel 97 programming and maintenance. Severe impacts to media relations and community access to City business.		131,045	131,045			2		2	
	Reduce citizen support, public outreach, and strategic planning.			131,045					1	
	Sub Total	**131,045**	**262,090**	**393,135**	**2**		**4**	**-**	**5**	**-**
Administrative Services										
Reduce 3 Administrative Services Positions	Reduce administrative support to the City wide programs and increase risks to the accounting and financial activities	160,081	160,081	160,081	3		3		3	
Reduce 3 Administrative Support Positions	Reduce administrative support to the City wide programs. Increase risks to the accounting and financial activities, delay in accounting transactions' reconciliation, and delay in payroll and disbursement processing		160,081	160,081			3		3	

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Administration (Continued)										
Reduce 3 Administrative Support Positions	Reduce administrative support to the City wide programs. Increase risks to the accounting and financial activities, delay in accounting transactions' reconciliation, and delay in payroll and disbursement processing			160,081					3	
	Sub Total	**160,081**	**320,162**	**480,243**	**3**		**6**	**-**	**9**	**-**
Human Resources										
Reduction in Training Budget	Eliminate a portion of City-Wide training program which provides the courses for the various certificate programs. The City has class specs requiring these various certifications, there would be meet and confer obligations over elimination/suspension of the programs and corresponding job requirements. Contrary to Council strategic initiative on increasing organizational capacity.	63,617								
Reduction in Training Budget	Eliminate an additional amount of funding for City-Wide training program which provides the courses for the various certificate programs. The City has class specs requiring these various certifications, there would be meet and confer obligations over elimination/suspension of the programs and corresponding job requirements. Contrary to Council strategic initiative on increasing organizational capacity.		38,452							

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Administration (Continued)										
Eliminate HR Specialist	Eliminate last remaining support personnel to Civil Service Commission and the City's Air Quality liaison. The majority of CSC agenda preparation and other support activities would fall to analyst staff, significantly reducing their capacity to perform analytical level work.		88,781				1		1	
Reduction in Training Budget	Eliminate the remaining funding for City-Wide training program which provides the courses for the various certificate programs. The City has class specs requiring these various certifications, there would be meet and confer obligations over elimination/suspension of the programs and corresponding job requirements. This would also eliminate all training for HR staff, significantly impairing ability to develop employee/labor relations expertise in house. Contrary to multiple City Council strategic initiatives.			80,000						
Eliminate HR Specialist	Eliminate last remaining support personnel to Civil Service Commission and the City's Air Quality liaison. The majority of CSC agenda preparation and other support activities would fall to analyst staff, significantly reducing their capacity to perform analytical level work.			88,781			1		1	

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Administration (Continued)										
Eliminate HR Assistant II	Eliminate all reception and mail services. Potential reduction in hours lobby would be open to public. Reduces customer service, incoming calls would potentially receive voicemail. Mail services and other low level clerical tasks would be reassigned to remaining higher level employees, thereby reducing efficiency.			22,679					1	
	Sub Total	**63,617**	**127,233**	**191,460**			**2**		**3**	
City Clerk										
Eliminate Office Specialist Position	Statement of Economic Interest tracking; Tracking of Ethics Training; Document Research; Customer Service; meeting support; bid openings; Agenda prep & distribution; staff training & development; filing; records mgmt.	88,281	85,633	85,633	1		1		1	
Reclass Supervising Deputy City Clerk to Senior Deputy City Clerk		7,000								
Reduce Senior Deputy City Clerk to 3/4 hrs.	High possibility of non-compliance with State mandates re: Legal Noticing, Public Hearings, Boards & Commissions recruitment and roster maintenance eliminated/meeting support, i.e. preparation of meeting record, filing of documents, meeting action followup decreased by 45%/processing of official documents (mandated), i.e. recordation of documents will be missed			23,593						
	Sub Total	**95,281**	**85,633**	**109,226**	**1**		**1**		**1**	

Service Reductions	Service Level Impacts	Savings @5%	Savings @10%	Savings @15%	FTE's Eliminate @5%	Part-time Eliminate @5%	FTE's Eliminate @10%	Part-time Eliminate @10%	FTE's Eliminate @15%	Part-time Eliminate @15%
Administration (Continued)										
City Attorney										
Loss of one advisory attorney	Serious delay in delivery of advisory advice/projects due to lack of staff and increased cost for consultation with outside counsel.	45,656	91,312	136,967	1		1		1	
	Sub Total	**45,656**	**91,312**	**136,967**	**1**		**1**		**1**	
City Auditor										
Vacancy Savings (3/4 position - 1 FTE)		20,290	20,290	20,290						
Reduce staff by 1 full time position			64,800	64,800	1		1		1	
Increase Contractual Services			(24,220)	(24,220)						
Vacancy savings reversed			(20,290)	(20,290)						
Reduce Contractual Services				20,290						
	Sub Total	**20,290**	**40,580**	**60,870**	**1**		**1**		**1**	
	Grand Total	**7,625,028**	**15,342,753**	**22,762,938**	**76**	**4**	**136**	**4**	**190**	**6**

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.

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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

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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**

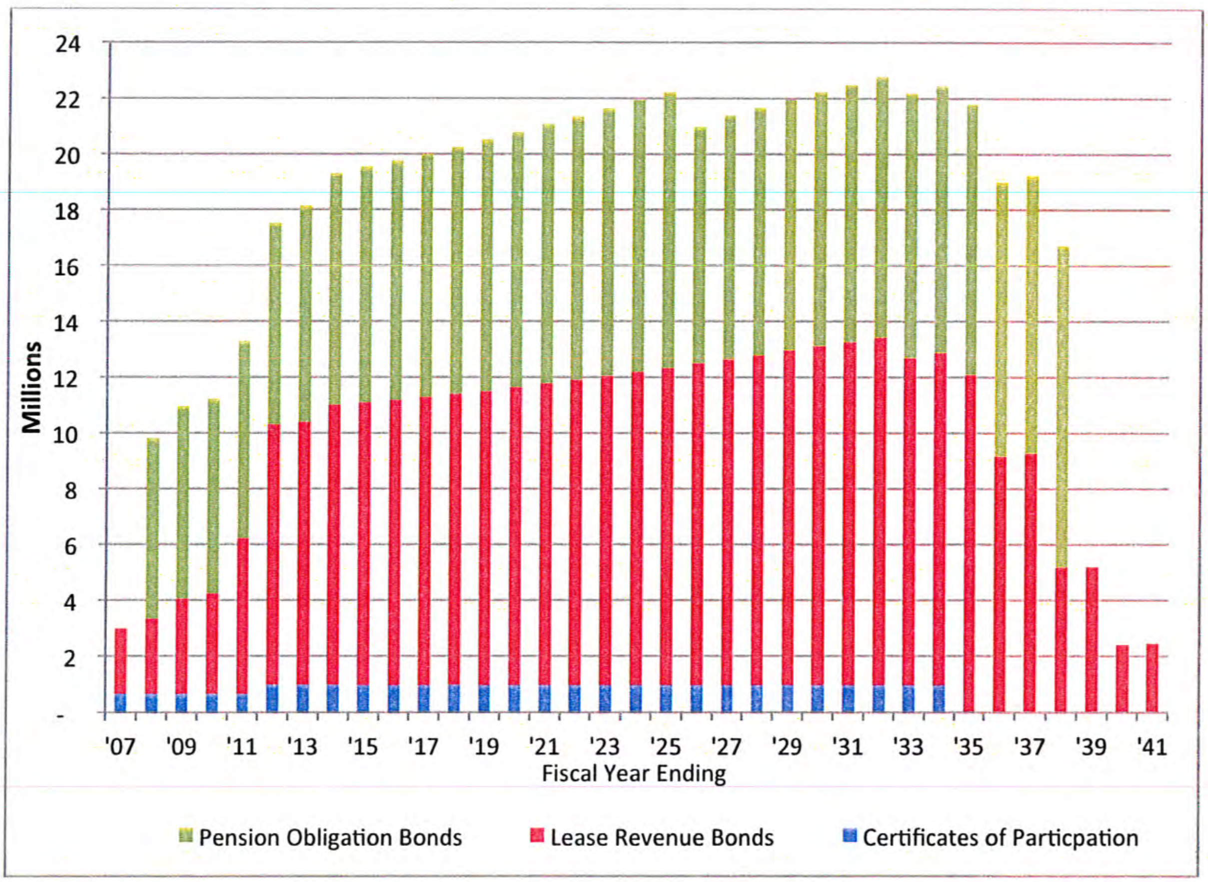
[1] Other funds contribute their allocated share of the costs associated with space in a new City Hall and the Pension Obligation Bonds.
[2] Estimated at $250,000, however, actual lease amounts may range from $250,000-350,000.
[3] Court approved settlement of lawsuit relating to repayment of transfers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

251.85

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.

THE CITY OF STOCKTON
PROFESSIONAL SERVICES AGREEMENT

THIS AGREEMENT is by and between the CITY OF STOCKTON, a municipal corporation (hereinafter "CITY"), and MANAGEMENT PARTNERS, INC. (hereinafter "Consultant"). City and Consultant may be collectively referred to as the "Parties."

In consideration of the mutual covenants and conditions set forth herein, this agreement is made between the Parties:

1. EFFECTIVE DATE AND TERM

This agreement shall commence on the date that it is fully executed by the Parties, and shall remain in effect through project completion or until terminated pursuant to the provisions of this Agreement.

2. SERVICES

Contractor shall perform for the City services ("Services") set forth in the Scope of Work, attached hereto and incorporated herein as "Exhibit A."

3. COMPENSATION

The City of Stockton agrees to pay Consultant for said services in the amounts set forth in "Exhibit "A" based upon actual hours incurred, not to exceed $175,000, with such payments advanced in increments of $25,000. Consultant will invoice the City in such increments in advance of anticipated use.

4. CITY MANAGEMENT

The City's Manager shall represent City in all matters pertaining to the administration of this Agreement and shall be authorized to act on the City's behalf.

5. CHANGES

This Agreement, including but not limited to the scope of Services and Compensation, may be amended in whole or part only by an agreement in writing signed by both City and Contractor.

6. SUSPENSION OR TERMINATION OF AGREEMENT

Either party shall have the right to terminate this Contract at any time upon giving the other party written notice of its intention to terminate twenty (20) days prior to the effective date of said termination. Upon termination, Consultant shall turn over to the City all documents, records, plans, and instruments of services produced by Consultant in connection with its performance of services pursuant to this Contract. City shall pay Consultant for all services satisfactorily performed pursuant to this Contract up to the date of termination.

7. DEFAULT OF CONSULTANT

The Consultant's failure to comply with the provisions of this Agreement shall constitute a default. In the event that Consultant is in default for cause under the terms of this Agreement, City can terminate this Agreement immediately by written notice to the Consultant.

8. INDEMNIFICATION

Insurance shall be provided as set forth in "Exhibit B."

To the fullest extent permitted by law, Consultant shall indemnify, protect, defend and hold harmless City and any and all of its officials, employees and agents from and against any an all losses, liabilities, damages, costs and expenses, including attorney's fees and costs which arise out of, pertain to, or relate to the gross negligence, recklessness, or willful misconduct of the Consultant.

City shall indemnify, protect, defend and hold harmless Consultant from and against any and all losses, liabilities, damages, costs and expenses, including but not limited to attorney's fees and costs which arise out of Consultant's performance of this Agreement within the scope of his duties as a consultant providing an updated strategy and pathway for moving the City leadership team toward the City Council's aggressive list of goals.

9. INDEPENDENT CONTRACTOR

Consultant is, and shall at all times remain, as to the City, a wholly independent contractor. Neither City nor any of its officers, employees, or agents shall have control over the conduct of Consultant, except as set forth in this Agreement. Consultant shall not at any time or in any manner represent that he is in any manner an officer or employee of the City. Contractor shall not incur or have the power to incur any debt, obligation, or liability whatever against City, or bind City in any manner.

No employee benefits shall be available to Consultant in connection with the performance of this Agreement. Except for the fees paid to Consultant as provided in the Agreement, City shall not pay salaries, wages or other compensation to Contractor for performing services hereunder for City. City shall not be liable for compensation or indemnification to Consultant for injury or sickness arising out of performing Services hereunder.

10. LEGAL RESPONSIBILITIES

The Consultant shall keep itself informed of State and Federal laws and regulations which in any manner affect the performance of his or her Service pursuant to this Agreement. The Consultant shall at all times observe and comply with all such laws and regulations. The City, and its officers and employees, shall not be liable at law or in equity occasioned by failure of the Consultant to comply with this Section.

The Consultant represents and warrants that prior to commencing any work under this Agreement, it shall obtain and maintain at its own expense during the life of this Agreement any other licenses, permits, qualifications, and approval required to practice its profession and perform the contract services.

In performing the services under this Agreement, the Consultant shall not discriminate in the employment of its employees and the engagement of any subcontractors on the basis of race, color, national origin, ancestry, sex or any other criteria prohibited by law.

11. UNDUE INFLUENCE

Consultant declares and warrants that no undue influence or pressure is used against or in concert with any officer or employee of the City in connection with the award, terms or implementation of this Agreement, including any method of coercion, confidential financial arrangement, or financial inducement, No officer or employee of the City will receive compensation, directly or indirectly, from the Consultant, in connection with the award of this Agreement or any work to be conducted as a result of this Agreement. Violation of this Section shall be a material breach of this Agreement entitling the City to any and all remedies at law or in equity.

12. RELEASE OF INFORMATION/CONFLICTS OF INTEREST

Consultant shall not, without written authorization from the City Manager or unless requested by the City Attorney, voluntarily provide declarations, letters of support, testimony at depositions, responses to interrogatories, or other information concerning the Services performed under this Agreement. Response to a subpoena or court order shall not be considered "voluntary" provided Contractor gives City notice of such court order or subpoena.

Consultant shall promptly notify City should Consultant be served with any summons, complaint, subpoena, notice of deposition, request for documents, interrogatories, or party regarding this Agreement and the work performed thereunder. Consultant agrees to cooperate fully with City and to provide the opportunity to review any response to discovery requests provided by Consultant. However, City's right to review any such response does not imply or mean the right by City to control, direct, or rewrite said response.

13. ASSIGNMENT

The Consultant shall not assign the performance of this Agreement, nor any part thereof, nor any monies due hereunder, without prior written consent of the City. The Consultant may hire at its own expense the services of independent contractors to perform a portion of its obligations under this Agreement with prior approval by the City. Independent contractors and subcontractors shall be provided with a copy of this

Agreement and shall agree to be bound by its terms. The Consultant shall be the responsible party with respect to all actions of its independent contractors and subcontractors, and shall obtain such insurance and indemnity provisions from its contractors and subcontractors, as the Consultant shall determine to be necessary.

14. OWNERSHIP OF DOCUMENTS AND DATA

All completed reports and other data or documents provided or prepared by the Consultant in accordance with this Agreement are the property of the City, and may be used by the City at its own risk.

15. AUDITING

The City reserves the right to periodically audit all charges made by the Consultant to the City for services under this Agreement. The Consultant agrees that City or its delegate will have the right to review, obtain and copy all records pertaining to the performance of this Agreement. The Consultant agrees to provide City or its delegate with any relevant information requested and shall permit City or its delegate access to its premises, upon reasonable notice, during normal business hours for the purpose of interviewing employees and inspection and copying such books, records, accounts, and other material that may be relevant to a matter under investigation for the purpose of determining compliance with this requirement. The Consultant further agrees to maintain such records for a period of three (3) years after final payment under this Agreement.

16. GOVERNING LAW

The City and Consultant understand and agree that the laws of the State of California shall govern the rights, obligations, duties, and liabilities of the Parties to this Agreement and also govern the interpretation of this Agreement. Any litigation concerning this Agreement shall take place in the County of San Joaquin.

17. ENTIRE AGREEMENT

This Agreement contains the entire understanding between the Parties relating to the obligations of the Parties described in this Agreement. All prior or contemporaneous agreements, understandings, representations, and statements, oral or written, are merged into this Agreement and shall be of no further force of effect. Each party is entering into this Agreement based solely upon the representations set forth herein and upon each party's own independent investigation of any and all facts such party deems material.

18. DISPUTE RESOLUTION

All claims, disputes, or any other matters in controversy between the Parties arising out of or in any way related to this Agreement shall first attempt to be resolved by informal telephonic or written communication between the Parties. In the event that informal techniques do not resolve a dispute, all Parties agree that any dispute will be submitted to mediation, prior to pursing any other remedies provided by law.

19. ATTORNEY'S FEES

In any action between the Parties arising out of or connected with this Agreement, including any arbitration proceeding, the prevailing party in such action shall be awarded, in addition to any damages, injunctions, or other relief, its costs and expenses, not limited to taxable costs, and reasonable attorney's fees.

20. INTERPREATION, SEVERABILITY

The headings used in this Agreement are used for the convenience only and shall not be construed in interpreting this Agreement. Whenever the context so requires, the masculine shall include the feminine and neuter, and the singular shall include the plural and conversely.

If any portion of this Agreement shall be held invalid or inoperative, then, so far as in reasonable and possible:

1. The remainder of this Agreement shall be considered valid and operative; and

2. Effect shall be given in the intent manifested by the portion held invalid or inoperative.

21. NOTICE

Any notices or other communications to be given to either party under this Agreement shall be in writing, shall be delivered to the addresses set forth below, and shall be effective as follows:

1) be personal delivery, effective upon receipt by the addressee; or
2) by certified US mail, return receipt requested, effective seventy-two (72) hours after deposit in the mail:

The City of Stockton
Deputy City Manager
Laurie Montes
425 N. El Dorado St
Stockton, CA 95202

Management Partners, Inc.
Jan Perkins
Partner
2107 North First Street
San Jose, CA 95131

IN WITNESS WHEREOF, the Parties hereto have caused this Agreement to be effective as of the date first above written.

ATTEST

BONNIE PAIGE
CITY CLERK

By____________________________

CITY OF STOCKTON, a municipal corporation

DATE:____________________________

By ____________________________
BOB DEIS, CITY MANAGER
"CITY"

APPROVED AS TO FORM

____
JOHN LUEBBERKE
CITY ATTORNEY

MANAGEMENT PARTNERS, INC.

DATE:____________________________

By ____________________________
GERALD E. NEWFARMER,
PRESIDENT
"CONSULTANT"

Management Partners

EXHIBIT A

February 8, 2012

Mr. Bob Deis
City Manager
City of Stockton
725 N. El Dorado Street
Stockton, CA 95202

Dear Mr. Deis:

This letter is sent in response to a request from the City for a proposal to provide project management for an AB 506 process which may be initiated by the City. We have outlined our approach to the engagement below. Management Partners is well qualified to provide these services to the City of Stockton. We are in the process of completing a financial condition assessment for the City which has provided us with a clear understanding of the financial challenges leading to this next phase. While our final report will not be completed until the end of February, we have provided preliminary observations and recommendations to the City Manager pertaining to the City's financial condition. We believe Stockton's financial position is such that it should initiate the AB 506 process now.

Understanding of the Engagement

The City of Stockton is facing a very serious financial crisis, brought on by a number of factors and decisions made during 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. As a result, the City must 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.

The City intends to initiate proceedings pursuant to AB 506 to restructure debt obligations, including unfunded liabilities. AB 506 is legislation that became effective on January 9, 2012. A public agency that believes it is or will be unable to meet its financial obligations when those obligations become due may initiate the neutral evaluation process provided for in AB 506. These proceedings will, if necessary, 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.

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

Under this legislation, a fiscally distressed public agency may resort to bankruptcy but before it files for protection it must either engage in a neutral evaluation process with its creditors with the help of a mediator or declare a fiscal emergency. The City of Stockton intends to pursue the first option, engaging in a neutral evaluation process. The process involves a variety of required steps and engaging outside experts.

The key elements of the process are to:

- Notify interested parties and creditors of the City's intent to pursue the AB 506 process,
- Select a neutral evaluator (also called a mediator), and
- Participate in a mediation process in good faith with interested parties.

Numerous specific tasks must be carried out to comply with AB 506 requirements. Additionally, the legislation dictates timelines and the City of Stockton is under its own urgent timelines because of its cash flow problems. Because the financial position is precarious the process must be engaged immediately and pursued expeditiously. The goal of the process is to restructure the City's obligations within its financial capacity.

Project Approach

Management Partners will create a work plan for executing the AB 506 process. The work plan will identify the key steps, schedule and individuals or consultants who will have responsibility for each element of the work plan. The team will include City executive staff, the City Attorney and outside legal counsel, labor relations consultants, financial advisors, Management Partners associates, and other experts as needed.

Management Partners will serve in two key roles: managing the overall AB 506 process and developing a proposal to creditors for relief. The latter will involve a variety of parameters with respect to existing debt and contractual obligations which are no longer consistent with fiscally sustainable operations by the City. We term this the development of an "ask" in keeping with the nomenclature of the securities market. Managing the 506 process as well as developing the ask proposition, which is at the heart of the procedure, will be essential, since the process will be on a short timeline and there are numerous components to the process.

As part of our project management, Management Partners will prepare materials, coordinate with the City's staff and consultants, identify other needed experts, prepare communications, and assist with timely completion of tasks. The City will provide staff for analytical assistance, access to information to assist with the AB 506 process, secretarial support for meeting scheduling, and other assistance as identified by the City and Management Partners as being in the best interest of expeditious decisions and actions.

We have outlined the key activities in this engagement below. This is subject to modification upon discussion with City management and legal counsel. Since AB 506 only took effect on January 9, 2012, no one has experience with the process. As a result, uncertainties and interpretations of the legislation may affect the implementation timeline.

As the process unfolds, there will be other tasks identified to be completed by City staff or consultants. Management Partners will maintain a flexible posture with respect to the needs of the City during this project. We have the expertise necessary both to manage the project and to identify and fill process or analysis gaps which may become apparent. We are also comfortable managing a team of other professionals all working towards the same goal and will seek to eliminate redundancy and develop the most efficient solutions possible. Our fundamental orientation is to be the City's manager for the AB 506 process, acting as a problem solver and doing what is necessary to move what is sure to be a new and challenging process forward to a satisfactory conclusion.

The activities we will undertake are described below. As indicated previously, they will be adapted to suit the needs of the City as the project progresses.

Activity 1: Start Project
At the initiation of this project, Management Partners will create an organization chart and work plan with a schedule and designation of responsibilities. These documents will outline the required deliverables and process steps and show how City staff and consultants working with the City will be integrated. Because the process will be conducted on a short timeline, clear designation of tasks and assignments will be essential. We will convene a project meeting with City staff and outside consultants to review the process components, roles and responsibilities, and schedule. The work plan will be revised following that meeting.

Management Partners also will coordinate with City staff to prepare a communications plan at the outset of the project to ensure appropriate information for team members, the Council and others. We will assist in preparing materials to communicate the City's financial condition and the AB 506 process to the Council, executive team, community and employees.

Activity 2: Define / Notify Interested Parties and Creditors
AB 506 requires that the City notify interested parties and creditors of its intent to pursue the process outlined in the legislation. The legislation contains specific definitions of interested parties and creditors, and also includes some discretion to the public agency as to parties which may be invited to participate. Therefore, an early task will be to determine who will be invited to be part of the process.

Once the parties have been identified, Management Partners will facilitate the preparation and distribution of appropriate notices. Interested parties are required to respond to the notification within 10 business days or they will have waived their right to participate in the neutral evaluation process.

Activity 3: Prepare the "Ask"
During this activity, Management Partners will coordinate and provide advice on preparation of the "ask" to interested parties. This will consist of the relief being sought by the City from the interested parties and creditors. Technical and analytical support will be provided to the City as needed on this component.

In order to begin this process Management Partners will coordinate an inventory of all obligations owed to creditors and interested parties. This will include conventional debt obligations as well as other long term contractual liabilities pursuant to the provisions in AB 506 and the definition of interested parties.

To generate appropriate relief, the City will need to consider a variety of factors including the ability to pay based on current and reasonably foreseeable revenues, potential adjustments to debt obligations such as the amortization period or interest rate, and obligations under existing contracts relative to the degradation of the City's fiscal position. In addition, the City will need to consider such strategic factors as developing some rough equity between concessions already obtained from current employees and operations, conventional debt creditors and retired employees. All this must be achieved while keeping in mind the need to continue to be a viable municipality, able to attract and retain employees and vendors, and able to provide services.

Activity 4: Select Neutral Evaluator and Conduct Mediation
Management Partners will manage the process of selecting a neutral evaluator and conducting the mediation. Both components will require significant coordination, communication, and preparation of materials.

Select Neutral Evaluator. AB 506 sets forth requirements for selecting a neutral evaluator. The legislation requires that the interested parties and public agency mutually select the neutral evaluator through a mutually agreed upon process. The legislation further provides that if the parties are unable to mutually select a neutral evaluator, the public agency shall furnish the names and background of five qualified neutral evaluators. A majority of interested parties shall then strike up to four names from the list and the remaining candidate shall serve as the neutral evaluator.

Management Partners will manage the neutral evaluator selection process. Tasks will include identifying potential criteria for considering neutral evaluators, seeking input from the participating parties about selection criteria and potential neutral evaluators and preparing materials to assist with a discussion about selecting the neutral evaluator. The process will continue until a neutral evaluator has been selected.

This process is fraught with uncertainty since this section of AB 506 is vague, particularly with respect to what constitutes a "majority of interested parties." With legal assistance we will attempt to fashion a solid approach that can gain consensus and avoid delay.

Create a Mediation Schedule. Following selection of the neutral evaluator, a mediation schedule will be created. AB 506 provides for a maximum 60 day mediation process with the ability for the public agency or a majority of interested parties to extend by another 30 days. The neutral evaluation process could end prior to 60 days based on circumstances outlined in the legislation.

Management Partners will assist with materials needed for presentation and discussions and coordinate the mediation process. As with the selection of the neutral evaluator, this process will need to be carefully planned and executed to avoid delay.

Activity 5: Outline Subsequent Steps
Once the mediation has been concluded, Management Partners will assist the City in identifying additional tasks that must be completed. As further project management is needed, Management Partners will provide it.

Project Team
The Management Partners team will be led by Andrew Belknap, Regional Vice President. He will be assisted by Jan Perkins, Dave Millican, Tom Gardner, Dianne Gershuny, Larry Lisenbee, Jovan Grogan and other members of Management Partners' team as needed. Qualifications for each person are attached to this letter proposal. Additionally, Management Partners will be coordinating with other members of the overall project team, including City staff, legal counsel, financial advisors and other experts engaged by the City to assist through the AB 506 process.

Fee Proposal
Management Partners suggests a contract in the amount of $175,000 for the assistance discussed above that we will provide to the City of Stockton. As noted, the AB 506 process is new and therefore the actual amount of time required is unknown. In our estimates of hours for each of the major activities, and given the uncertainties in the process, we believe the level of effort could easily require 800 to 1,500 hours (or more) of Management Partners' time, which would mean a cost range of $150,000 to $250,000.

The actual cost will depend on the amount of time devoted by Management Partners. We will track our hours against each activity outlined above and associated sub-tasks and provide a monthly report to the City. As noted earlier we will work with the City to adapt our activities to accomplish the work properly at the lowest cost possible.

The billing rates for our consultants are provided below.

Regional Vice President	$250
Partner	225
Special Advisor	195
Senior Manager	175
Senior Management Advisor	150
Management Analyst	100

Conclusion

We would be pleased to assist the City of Stockton with this important project. Please feel free to contact either Jan Perkins (949-202-8870) or me (805-320-1702) if you have any questions about this proposal.

Sincerely,

Andrew S. Belknap
Regional Vice President

Accepted for the City of Stockton by:

Name __________________________

Title: __________________________

Date: __________________________

Attachment – Project Team Resumes

ANDREW S. BELKNAP

Andrew Belknap, Regional Vice President, has more than 20 years of diverse local government management experience. He has served in California local government as a city manager, public works director and independent consultant. As a consultant he has directed many diverse projects and provided interim management assistance for cities, counties and special districts. Andy has been with Management Partners since 2001 and leads the operations of the western region, which is based in San Jose, California. He directs the work of approximately 20 full-time staff members.

Andy began his public service career in 1980 with the City of Oxnard, California, in facilities management. He created the city's first automated database for tracking infrastructure maintenance and gained statewide recognition for the city's energy management program. Eventually, Andy was named chief of staff to the public works director and was responsible for budgeting, utility rate setting, capital program management and organizational analysis.

In 1989, Andy was named city manager of Ojai, a nationally known resort community (he had been public works director there for the previous three years). Andy brought leadership and fiscal stability to a community that had been through a difficult period of political controversy, staff turnover and financial troubles. When he left this position in 2001, the city had achieved a reputation for credibility, professionalism, teamwork and innovation. While with the City of Ojai, Andy completed several major redevelopment projects including a difficult upgrade of unreinforced masonry in an historic downtown area, and several innovative affordable housing projects. He also negotiated an agreement (the first of its kind) with the Ventura County Sheriff for joint financing and construction of a new police station. At the regional level, as chair of his region's California City Manager's Association, in 1998 Andy helped devise a successful plan to create a joint powers library authority to serve seven cities and a over 600,000 residents. He has served on several League of California Cities working groups and was selected to represent the Santa Barbara area on the California City/County Youth Services Task Force.

Since joining Management Partners in 2001, Mr. Belknap has participated in over 170 individual consulting projects for cities, counties and special districts in California, Arizona, Nevada, Washington, Idaho and Montana. He has served as the key professional or project manager for most of these assignments. Clients range from very small to very large and include the cities of San Jose, Long Beach and Sacramento; the counties of Orange, Marin, Monterey, San Mateo and Ventura; and large special districts such as the Sacramento Port District and the Los Angeles Community College District. As a corporate officer with Management Partners, Mr. Belknap has helped develop the firm's consulting methodology, standards of practice and market presence, which has enabled the firm to successfully complete over 600 separate engagements for hundreds of local government throughout the United States.

As an economist, Andy brings a special expertise to public finance issues, including the analysis of local revenue measures. He has completed a broad range of organizational and management studies, cost-of-service and fiscal analyses, inter-jurisdictional service delivery studies, service consolidation and coordination efforts and other complex projects.

Andy earned a bachelor's degree in economics and econometrics from the University of California-Santa Barbara, and a master's degree in economics, with a specialty in public finance.

JAN C. PERKINS

Jan Perkins, Partner, has 30 years of local government management experience in five communities. She has held major leadership positions in professional organizations, has authored numerous articles, and is a frequent speaker at workshops and conferences. She joined Management Partners in 2005.

Jan was city manager of Fremont, California, for nearly 11 years, and earlier was city manager of Morgan Hill, California. She also served the city of Santa Ana, California as assistant city manager; and Grand Rapids and Adrian, Michigan, in a variety of senior management positions, including deputy city manager.

Since joining Management Partners in 2005, Jan has led complex projects that provided assistance to senior local government managers and elected officials. These have included strategic and business planning, budget policy development, organizational assessments, teambuilding, council/board effectiveness, goal setting, leadership development and executive coaching, executive performance evaluations, staffing analyses, and workforce and succession planning. She is based in the company's Irvine, California, office.

Some of the clients that Jan has assisted include the cities of Rio Rancho and Santa Fe, New Mexico; Las Vegas and North Las Vegas, Nevada; the California cities of Newport Beach, Burbank, Pasadena, Glendale, Palo Alto, Napa, San Jose, Concord, Laguna Beach, Laguna Hills, Pleasanton, Ceres, Livermore, Garden Grove, Cypress, La Palma, Alameda, El Monte, La Habra Heights, Anaheim, Huntington Beach, Long Beach, Orange, Santa Cruz, Santa Ana, Sunnyvale, Novato, Gilroy, Rancho Cordova, and Modesto; the counties of Alameda, Orange, Monterey, Marin, Riverside, Santa Clara, San Mateo and Ventura; the Alameda County City Managers' Association; the Southern California Association of Governments; the Sacramento Area Council of Governments; the Orange County Cemetery District; the Contra Costa Transportation Authority; the Alameda County Congestion Management Agency; the Sonoma Valley Fire and Rescue Authority; and the Coastside County Water District.

Her expertise was developed through an increasingly demanding series of jobs, beginning with the City of Grand Rapids. There, she served in a variety of management positions over a six-year period, concluding as deputy city manager. She also worked for the City of Adrian as assistant city administrator and community development director. In 1984, she was named assistant city manager of Santa Ana, California, followed by city manager positions in Morgan Hill and Fremont.

Among Jan's articles are "Hiring 2.0: 23 Creative Ways to Recruit and Keep Great Staff," which appeared in the January/February 2011 issue of *Public Management* magazine; "Successful Leadership," which appeared in the March 2005 issue of *Public Management* magazine; "The Value of Going Back to the Basics," co-authored with former Fremont Mayor Gus Morrison, which appeared in the June 2005 issue of *Western City* magazine; "Ethics: Alive and Well," co-authored by Elizabeth Keller and published in the January/February 2007 issue of *Public Management*, and "Assessing the Ethical Culture of Your Agency," co-authored by JoAnne Speers and Arne Croce, which appeared in the January/February 2007 issue of *Public Management.*

Jan served as president of the California City Management Foundation, president of the Alameda County City Managers Association, and as executive board member of the City Manager's Department of the League of California Cities. She also chaired a number of ICMA committees, is a fellow with the National Academy for Public Administration and is on the board of ICMA's Women Leading Government organization. Jan earned a bachelor's degree in sociology and a master's degree in public administration from the University of Kansas. She is a graduate of Harvard University's Program for Senior Executives in State and Local Government. She is recognized by ICMA as a Credentialed Manager and serves as an ICMA Senior Advisor.

DAVID N. MILLICAN

Dave Millican has been committed to government management, municipal finance and urban economics since he started his career. He has served as a Peace Corps volunteer in Afghanistan, was the practice leader for state, local and not-for-profit organizations for the San Francisco office of a major CPA firm, was vice president for a multi-application municipal information system software supplier and served as the chief financial officer of four cities.

He also contributed as a problem solver and negotiator for complex land use entitlements, developed comprehensive development impact fee systems, settled lawsuits and claims, structured multi-vendor franchise agreements, negotiated labor contracts and formed redevelopment project areas obtaining approval of major plan amendments. Dave developed a broad knowledge of project management, policy and contract decision process design and community outreach to citizens and business, other agencies and special interests.

While serving as the chief financial officer of the Cities of Burlingame, South Lake Tahoe, and Fremont, California and Santa Fe New Mexico for over 27 years, he dealt with resource limits caused by taxpayer revolts, seizure of local revenue sources by the state and severe economic dislocation resulting from the high-tech crash at the beginning of this decade. In the course of meeting those challenges he successfully used participative budget and change management processes that included policy makers, executive leaders, employees and labor leaders, citizens and other stakeholders in developing action plans to redefine services and change city financing structures.

Fremont, in particular, faced opportunities and challenges as a growing high tech center, the fourth largest city in the San Francisco Bay Area and one of the most diverse cities in the country. In Santa Fe, a tourist destination second only to New York and San Francisco, he successfully negotiated the rescue of a failing 150 year old private college with minimal cost and risk to the City.

Dave served as a member of the Board of Directors of the California Society of Municipal Finance Officers (CSMFO), as a member of several League of California Cities (LOCC) policy committees, as a member of the California Committee on Municipal Accounting and as a member of the CSMFO/LOCC joint task forces on government reorganization, the League's working group on "triple flip" implementation and the contract agency task force on California Public Employee Retirement System rate setting and services and services to contract agencies. Recently he served as a member of the Government Finance Officers Association technical advisory committee on fiscal first aid and recovery.

With Management Partners, Dave has advised clients throughout northern California on financial management matters. Notable on the list of those clients was the City of Vallejo as it was working through its very difficult bankruptcy issues.

Dave is an accounting graduate of the University of California at Berkeley and did graduate work and taught accounting at the University of Texas at Austin.

THOMAS M. GARDNER, DPA

Tom Gardner, Special Advisor provides expert assistance in the development of management and financial plans, fiscal analysis and strategies for organizational innovations, reorganizations, and performance measures to meet the continuing challenges of fiscal stability and sustainability.

Tom rejoined Management Partners after retiring from the City of Vista as finance director. His career has spanned 31 years of public service with 19 years in service to California counties, seven years with cities, more than seven years consulting, as well as a significant academic career over 20 years. His last county assignment was as assistant county administrator in Yolo County, California.

Tom's practical experience is broad-based with assignments ranging from budget and finance, telecommunications and information technology development, emergency services, regional park management and facility construction and facility maintenance in counties; to finance, purchasing and treasury responsibilities in city jurisdictions.

He has been a leader in developing long-term financial strategies to insure fiscal stability in organizations facing fiscal crisis. This has included small city restructuring, special district long-range planning and major program restructuring in counties.

He has also worked successfully to improve performance in purchasing and collection processes for cities. He has advised and developed solutions to restructure countywide healthcare, criminal justice and financial systems. Tom also has extensive experience with redevelopment agencies, annexations and intergovernmental tax sharing issues. Recognized for his leadership and research in the advancement of joint powers authorities, he brings unique qualifications to joint efforts, the merger of services, as well as intergovernmental relations.

Dr. Gardner has served as national chair of the Section on Intergovernmental Administration and Management of the American Society for Public Administration and as a member of International City/County Management Association on its California Ethics Committee. He has taught for five California universities and colleges including University of Southern California, the University of San Francisco and San Jose State. He has also served as an expert witness in six state and federal cases where measuring the impacts of fiscal stress were central to the case.

DIANNE GERSHUNY

Dianne Gershuny has over 20 years of local government management experience as both a city manager and finance director. She was city manager of Los Altos, California, for nine years and for several years prior to that, served Los Altos as finance director/assistant city manager. She was also finance director/assistant city administrator for the City of San Carlos. Dianne began her local government career with the Ventura Regional Sanitation District where she served in increasingly responsible management positions.

Dianne has been responsible for all aspects of municipal financial operations including budgeting, long-range financial planning, financial accounting and reporting, debt management, investments, and financial policy development. She has been a member of the League of California Cities Revenue and Taxation Committee. Her city budgets received awards from both the Government Finance Officers Association (GFOA) and the California Society of Municipal Finance Officers (CSMFO).

Since joining Management Partners, Dianne has assisted clients by conducting reviews of finance departments and recommending improvements to operations, systems and processes. Two recent clients include the Solano Irrigation District and the City of West Sacramento.

Dianne has a significant background in identifying and implementing both cost reduction and revenue enhancement strategies. Examples include leading a study that resulted in contracting fire protection services at less cost and better quality service and implementing a biennial budgeting that saved hundreds of hours annually for staff, council, and community and helped focus the city on longer range goals and needs. Revenue enhancement strategies she has implemented include implementing a major revision of service fee policies, initiating an economic development program and a redevelopment district, issuing tax anticipation notes, and providing financial analyses and voter information that assisted in the successful passage of a utility users tax.

Dianne has served as treasurer and on the finance committees of non-profit organizations. She served as chair and was a founding member of Association of Bay Area Governments (ABAG) Pooled Liability Assurance Network (PLAN) Corporation, vice-chair of the California City Management Foundation, and chair of the Santa Clara County City Managers Association. She received the League of California Cities John Nail Award as well as the Municipal Management Assistants of Northern California outstanding assistant award.

Dianne earned a master's of business administration degree from the University of California at Los Angeles and a bachelor's degree in neurobiology from the University of California at Berkeley. She also received a certificate of completion from the League of California Cities City Mangers Executive Institute and is a certified trainer for the Zenger Miller frontline leadership program.

LARRY D. LISENBEE

Larry D. Lisenbee, Special Advisor, joined Management Partners in 2009 after 35 years experience in local government management in three California community agencies. Prior to joining Management Partners in 2009, Larry served as the budget director for the City of San Jose California for over 21 years. He earlier worked in various budget and management positions in the County of Santa Clara and the County of San Bernardino.

Throughout his term of service, Larry gained broad expertise in all facets of local government management including policy development, strategic planning, finance, public/private partnerships, performance measurement systems, public information and civic engagement. His primary expertise and experience is in California local government budget development and management.

During his tenure as budget director for the City of San Jose, Larry led a team of just under 20 individuals. He reported directly to the city manager and was responsible for all facets of the City's budget management. The responsibilities of this office included developing the annual proposed budget for 115 funds, monitoring and reporting to the City Council during key points in the fiscal year about the status of the budget for all City funds as well as clearing and bringing to City Council any and all amendments to the approved budget.

In this role Larry was the key coordinator and advisor to both the city manager and the City Council for all budget related issues. During his tenure he served under six city managers and four Mayors. Also during this time he helped lead the City through major budget difficulties resulting from the recessions of the early 1990s, the "dot com" bust of the early 2000s, and through the initial phases of the most recent economic collapse. His experience and leadership during this two-decade tenure was a key element to helping the City of San Jose create and maintain its reputation for leadership in fiscal responsibility among the major cities in the United States. He also led the efforts to create the model performance budgeting system and budget format for which that city is known.

Previous to that, Larry served as a budget analyst, senior budget analyst and supervising budget analyst for Santa Clara County over a twelve-year period. He began his career working as an analyst for the San Bernardino County Health Department.

Larry earned a bachelor's degree from San Jose State University, and a master's degree from the University of California at Los Angeles (UCLA).

JOVAN D. GROGAN

Jovan Grogan, Senior Management Advisor, has a breadth of local government experience that ranges from hands-on leadership to community relations and national agency work. Jovan has provided interim management and analytical assistance to general and special purpose governments in the western United States.

Since joining the firm in 2006, Jovan has been an integral part of projects to improve cities' development review processes, conducted reviews of entire governmental organizations, and performed organization structure reviews as well as staffing studies. He is knowledgeable of best practice areas in municipal management and has facilitated workshops for mid-level and executive managers.

Most recently, Jovan served as the interim general manager for the Canyon Lake Property Owners Association in southern California. While on assignment in Canyon Lake, Jovan led the organization's efforts to improve services, communication, and budgeting. He also led efforts to formalize business practices and document procedures.

Prior to joining Management Partners, Jovan served as the special assistant to the county administrator of Tompkins County, New York. In this capacity, he was responsible for budgetary and fiscal analyses, facilitated an effort to establish a data sharing network among county-wide criminal justice agencies, and provided staff support to the Budget and Capital Committee of the County Legislature. Jovan also managed the county's Public Information Program, dealing with media, overseeing the provision of Government Access Television for the county and supervising interns.

Jovan has also worked for the city manager of Oakland, California, Habitat for Humanity and the International City/County Management Association in Washington, D.C. He began his life of public service as a member of Oakland's Planning and Oversight Committee, where he helped to evaluate grant proposals and allocate funds for children and youth programs.

Jovan completed his undergraduate and graduate education at Cornell University. He holds a bachelor's degree in urban and regional studies, with a concentration in law and society; and a master's degree in regional planning, with a concentration in economic development planning.

EXHIBIT B

INSURANCE REQUIREMENTS

The Consultant shall procure and maintain for the duration of the Agreement insurance against all claims for injuries to persons or damages to property that may arise from or in connection with the performance of the work hereunder by the Consultant, its agents, representatives or employees.

Minimum Limits of Insurance

1. INSURANCE Throughout the life of this Contract, the Consultant shall pay for and maintain in full force and effect with an insurance company admitted by the California Insurance Commissioner to do business in the State of California and rated not less than "A: VII" in Best Insurance Key Rating Guide, the following policies of insurance:

A. COMMERCIAL (BUSINESS) AUTOMOBILE LIABILITY insurance, endorsed for "any auto" with combined single limits of liability of not less than $1,000,000 each occurrence.

B. WORKERS' COMPENSATION insurance as required under the California Labor Code and Employers Liability Insurance with limits not less than $1,000,000 per accident/injury/disease.

C. COMMERCIAL OR COMPREHENSIVE GENERAL LIABILITY AND MISCELLANEOUS SUPPLEMENTARY INSURANCE;

FOR ADDITIONAL REQUIREMENT(S):

(i) COMMERCIAL OR COMPREHENSIVE GENERAL LIABILITY insurance which shall include Contractual Liability, Products and Completed Operations coverages, Bodily Injury and Property Damage Liability insurance with combined single limits of not less than $1,000,000 per occurrence, and if written on an Aggregate basis, $2,000,000 Aggregate limit.

(ii) PROFESSIONAL ERRORS AND OMISSIONS, Not less than $50,000 per Claim./$1,000,000 Aggregate. Certificate of Insurance only required.

Deductibles and Self-Insured Retention

Any deductibles or self-insured retention must be declared to and approved by the City.

Other Insurance Provisions

The general liability and automobile liability policies are to contain, or be endorsed to contain, the following provisions:

1. The City, its officers, officials, employees, and volunteers are to be covered as additional insured on general liability and automobile liability policies as respects: liability out of activities performed by or on behalf of the Consultant; premises owned, occupied or used by the Consultant; and automobiles owned, leased, hired or borrowed by the Consultant. The coverage shall contain no special limitations on the scope of protection afforded to City, its officers, officials, employees or volunteers.

2. For any claims related to the project, the Consultant's insurance coverage shall be primary insurance as respects City, its officers, officials, employees, and volunteers. Any insurance or self-insurance maintained by City, its officers, officials, employees, or volunteers shall be excess of the Consultant's insurance and shall not contribute with it.

3. Any failure to comply with the reporting or other provisions of the policies shall not affect coverage provided to City, its officers, officials, employees, or volunteers.

4. The Consultant's insurance shall apply separately to each insured against whom claim is made or suit is brought, except with respect to the limits of the insurer's liability.

5. Each insurance policy required by this Agreement shall be endorsed to state that coverage shall not be suspended, voided, canceled by either party, reduced in coverage or in limits except after thirty (30) days' prior written notice by certified mail, return receipt requested, has been given to City.

Subcontractors

Before permitting any subcontractors to perform work under this Agreement, the Consultant shall require subcontractors to furnish satisfactory proof that insurance has been issued and is maintained similar to that provided by the Consultant as may be applied to each subcontractor's work.

Acceptability of Insurers

Insurance is to be placed with insurers that are admitted insurance carriers in the State of California, or must otherwise be approved by City.

Verification of Coverage

The Consultant shall furnish City with original endorsements of effective coverage for policies on which City is included as an additional insured as required by this Exhibit, and shall furnish original certificates of insurance for all other required policies. The endorsements are to be signed by the person authorized by the insurer to bind coverage on its behalf. All endorsements and certificates are to be received and approved by City before work commences.

Upon request, the Consultant shall furnish City a certified copy of any or all policies of insurance covering the work required under this Agreement.

RESOLUTION NO. ________

STOCKTON CITY COUNCIL

RESOLUTION AUTHORIZING THE COMMENCEMENT OF A CONFIDENTIAL NEUTRAL EVALUATION PROCESS BY THE CITY OF STOCKTON PURSUANT TO CALIFORNIA GOVERNMENT CODE SECTION 53760 ET SEQ., AND DESIGNATING THE CITY MANAGER AS THE REPRESENTATIVE OF THE CITY OF STOCKTON; ACCEPTING THE REPORT PREPARED BY MANAGEMENT PARTNERS OF THE CITY OF STOCKTON'S FINANCIAL CONDITION; AUTHORIZING THE CITY MANAGER AND APPROPRIATE OFFICERS TO TAKE IMMEDIATE ACTIONS TO PRESERVE GENERAL FUND CASH LIQUIDITY AND RATIFYING CERTAIN ACTIONS IN CONNECTION THEREWITH INCLUDING SUSPENSION OF LEAVE BUYOUTS FOR SEPARATING EMPLOYEES; APPROVING ACCOUNTING ADJUSTMENTS FOR FISCAL YEAR 2010-11 AND AUTHORIZING THE PREPARATION OF FINAL ANNUAL FINANCIAL STATEMENTS FOR FISCAL YEAR 2010-11; APPROVING MID-YEAR BUDGET ADJUSTMENTS FOR FISCAL YEAR 2011-12; DIRECTING THE CITY MANAGER AND CITY ATTORNEY TO CONDUCT AN INVESTIGATION OF MATTERS IN CONNECTION WITH THE CITY OF STOCKTON'S FISCAL CRISES AND TO RECOMMEND TO THE CITY COUNCIL APPROPRIATE LEGAL ACTION; APPROVING A CONTRACT WITH MANAGEMENT PARTNERS TO PROVIDE ONGOING FINANCIAL AND MANAGEMENT CONSULTING SERVICES; AND AUTHORIZING RELATED ACTIONS

The City Council (the "Council") of the City of Stockton (the "City") has determined that the City faces an immediate and severe fiscal crisis and that it is or likely will become unable to meet its financial obligations as and when those obligations are due or become due and owing; and

Government Code sections 53760 through 53760.7 (collectively, the "Act") establish a confidential neutral evaluation process that the City and certain interested parties (as defined in the Act) (the "Interested Parties") can use to attempt to reach a mediated and negotiated resolution of their disputes in order to avoid a filing by the City pursuant to Chapter 9 of the United States Bankruptcy Code; and

The Council has determined that it is in the best interest of the City, its citizens, employees, creditors, and Interested Parties to promptly commence a confidential neutral evaluation process pursuant to the Act; and

City Atty
Review ________
Date February 23, 2012

The Council desires to designate the City Manager as the City's official representative for such process, and to delegate to the City Manager and his delegees the power to negotiate on the City's behalf with those Interested Parties who participate in the Act's neutral evaluation process, with any agreements reached in the mediation subject to final approval by this Council; and

The City has received a Financial Assessment Report from Management Partners concerning the City's financial condition, which report makes certain recommendations consistent with the provisions of this Resolution; and

The City must take immediate steps to preserve cash liquidity in the City's general fund in order to enable the City to continue to operate through the balance of Fiscal Year 2011-12; and

The Council desires to direct the City Manager to take specific steps to preserve cash liquidity and to ratify certain action already taken by the City Manager under emergency authority granted by this Council; and

In order to finalize the City's financial statements for Fiscal Year 2010-11, certain adjustments must be made and the Council desires to direct staff to make such adjustments; and

In order to maintain budget balance for the remainder of Fiscal Year 2011-12, certain mid-year budget adjustments must be made and certain findings must be made with respect to the City's previously declared Fiscal emergency and the Council desires to make such adjustments and findings; and

The Council has received a detailed report from Management Partners which concludes that the City is in dire financial condition and must take immediate steps to attempt to resolve its financial crises and put it on a firm financial footing going forward; and

The causes of this financial crises may include wrongful, unauthorized, or illegal acts and the Council desires to direct the City Manager and City Attorney to undertake an investigation to determine if the City has legal recourse against any party in connection with such acts; and

The City desires to enter into a new contract with Management Partners in order to assist it in implementing the steps provided for in this Resolution; now, therefore,

BE IT RESOLVED BY THE COUNCIL OF THE CITY OF STOCKTON, AS FOLLOWS:

<u>Section 1.</u> <u>Findings.</u> The foregoing recitals are true and correct and this Council hereby so finds and determines. The Council hereby makes the following additional findings:

(a) On May 17, 2011, the City Council adopted Resolution #11-0113 and Resolution #11-0114 declaring that the City was experiencing an ongoing fiscal emergency. That declaration is still in effect and continues today. That emergency declaration resolution gives the City Manager authority to take further emergency actions to preserve the City's ability to provide essential services to the citizens of Stockton in order to safeguard public health and safety.

(b) In Resolution #11-0113 and Resolution #11-0114, the Council declared a state of emergency based on fiscal circumstances and directed the City Manager to take appropriate and lawful measures to achieve a balanced budget including any change to existing labor agreements determined necessary by the City Manager, limited to the duration of the fiscal emergency. Based upon the information present in the record of this action, the Council finds that the City's financial condition has further deteriorated and the City therefore remains in a state of fiscal emergency. Further, the Council reiterates and reaffirms its findings and actions contained in Resolution #11-0113 and Resolution #11-0114.

(c) The City is dangerously low on available cash resources necessary for current operations, including the operation of the City's police and fire departments, which are funded almost entirely from unrestricted general fund revenues.

(d) The ability of the City to continue funding basic public safety services during the pendency of this condition of fiscal emergency is of paramount importance to the citizens of Stockton.

(e) City employees have, through valued and continuous service, accumulated leave balances in the form of both sick leave and vacation and these balances represent a significant unfunded general fund obligation.

(f) It is anticipated that due to the current financial position of the City certain employees (some with very large leave balances that may be converted to cash upon separation) will choose to immediately separate from City service, and that these employee separations will cause extreme pressure on the City's greatly depleted unrestricted cash resources.

(g) The City currently does not have sufficient unrestricted cash resources available to both maintain necessary levels of public safety-related services and immediately pay separating employees for accumulated leave balances without an unacceptable risk of depleting available cash resources to the point that public safety services may be put in jeopardy.

(h) While any risk to the City's ongoing ability to provide necessary public safety services to its citizens is a grave concern, the current level of crime in Stockton makes this risk one that this Council is unwilling to incur. To place at greater risk the safety of the community in this time of greatest need would be an unconscionable dereliction of this Council's most basic obligation to its citizens.

(i) It is necessary at this time to immediately delay the further payment of all leave balances to separating employees until such time as there are sufficient unrestricted cash resources available to the City to allow for the payment of such leave balances while ensuring the City will have adequate resources remaining to fund basic services.

Section 2. The Neutral Evaluation Process

(a) The City hereby determines to commence a confidential neutral evaluation process pursuant to the Act.

(b) The City Manager is hereby designated as the City's official representative for the confidential neutral evaluation process. The City Manager may designate one or more delegates to participate in the confidential neutral evaluation process, subject to the direction and supervision of the City Manager. The City Manager and his delegates shall have the authority to represent the City in the neutral evaluation process, and shall have the power, among other things, to negotiate with Interested Parties and to make recommendations to this Council, subject to the final approval of this Council of any settlement or other action related to the City's obligations. The City Manager shall report periodically to this Council concerning the status of the confidential negotiations.

(c) The City Manager shall cause notice of the commencement of the confidential neutral evaluation process to be provided to all Interested Parties as required by the Act.

(d) The City Manager shall conduct a process with the Interested Parties to select a Neutral Evaluator as required by the Act (the "Neutral Evaluator"), and shall be authorized to accept or reject proposed Neutral Evaluators recommended by the Interested Parties and, if necessary, to select a list of five proposed Neutral Evaluators and to choose a Neutral Evaluator pursuant to Section 53760.3(c)(2) of the Act; provided, that the contract or engagement agreement with the selected Neutral Evaluator shall be subject to the final approval of this Council.

(e) The City Manager shall work with other City staff, Management Partners, outside counsel. and financial advisors to develop a proposed settlement structure with the Interested Parties that will enable the City to function with a balanced budget and on a sound fiscal footing going forward. This proposed settlement structure will form the basis for negotiations as a part of the confidential neutral evaluation process pursuant to the Act.

Section 3. Acceptance of Management Partners Report. The Financial Assessment Report prepared by Management Partners, on file with the Clerk and presented to this meeting, is hereby accepted.

Section 4. Actions to Preserve Liquidity. The City Manager is hereby authorized and directed to take immediate action to preserve cash liquidity in the City's General Fund, including the following:

(a) On February 24, 2012, under authority granted to him by this Council in Resolution #11-0113 and Resolution #11-0114, the City Manager took the following actions to stabilize and preserve the finances and available cash of the City in order to continue to provide services. Each such action taken by the City Manager prior to the effective date of this Resolution is hereby ratified and confirmed and the City Manager shall continue to implement the provisions described below until further direction is provided by this Council. The City Manager shall also develop alternatives to the measures set forth below and report back on such alternatives to this Council as soon as is practicable.

(1) *Annual Vacation Sell back or Cash Payoffs of Vacation.* Effective the pay period starting February 16, 2012, whatever annual vacation sell backs or pay offs as provided for in various Memorandums of Understanding are temporarily suspended. This applies to all bargaining units and employees, including those units where the annual sellbacks or cash outs have already been suspended during the furloughs.

(2) *Vacation Hours Paid at Separation.* Effective the pay period starting February 16, 2012, all pay offs of unused vacation hours that would otherwise be made to an employee upon separation from City employment, and as provided for in various Memorandums of Understanding, are hereby temporarily suspended. This applies to all bargaining units and all employees. This suspension of pay offs of unused vacation shall also apply to Fire and Fire Management Longevity Vacation. This provision shall not apply to employees who are involuntarily separated from City service.

(3) *Sick Leave Hours Paid at Separation.* Effective the pay period starting February 16, 2012, all payments of unused sick leave that would otherwise be made to an employee upon separation from City employment for any reason, and as provided for in various Memorandums of Understanding, are hereby temporarily suspended. This applies to all bargaining units and all employees.

(4) *Holidays Leave Hours Paid at Separation.* Effective the pay period starting February 16, 2012, all payments of unused holiday leave hours that would otherwise be made to an employee upon separation from City employment for any reason, and as provided for in various Memorandums of Understanding, are hereby temporarily suspended. This provision shall not apply to employees who are involuntarily separated from City service.

(5) *Other Payments.* Other leave balance pay offs at separation including payments of unused compensatory time in lieu of overtime or furlough hour banks shall not be impacted by these suspensions.

(b) The City Manager shall suspend payment on certain general fund lease obligations due during the remainder of Fiscal Year 2011-12, as shown in Exhibit A, attached hereto and incorporated herein.

(c) The City Manager shall take such other actions as are necessary, in the judgment of the City Manager in consultation with the City's legal and financial advisors, to preserve cash liquidity to allow the City to continue to operate during the remainder of Fiscal Year 2011-12.

Section 5. Fiscal Year 2010-11 Accounting Adjustments. The adjustments to financial accounts, transfers, and restatements with respect to Fiscal Year 2010-11 described in Exhibit B, attached hereto and incorporated herein, are hereby approved. The Chief Financial Officer is hereby authorized and directed to make such adjustments and to finalize the City's annual financial statements for Fiscal Year 2010-11 and submit the same to the City's outside auditors for review.

Section 6. Fiscal Year 2011-12 Budget Adjustments. The mid-year budget adjustments for Fiscal Year 2011-12 described in Exhibit C, attached hereto and incorporated herein, are hereby approved.

Section 7. Investigation. The City Manager and City Attorney are hereby authorized and directed to commence an investigation of actions, expenditures, transfers, transactions, and other activities undertaken in the past that contributed to the City's fiscal crises to determine whether any wrongful, unauthorized. or illegal actions took place, including any actions undertaken without required authorization by the Council or other requisite authority, and to report to the Council with respect to any legal recourse the City may have against any person or entity for any such wrongful, illegal, and/or unauthorized act.

Section 8. Management Partners Contract. The contract by and between the City and Management Partners, on file with the City Clerk and presented to this meeting, is hereby approved. The Council hereby makes the following findings in connection with such contract:

(a) There is an immediate need to initiate the AB 506 mediation and neutral evaluation process.

(b) The fiscal sustainability of the City is the top priority of the City Council.

(c) The City does not have the expertise, resources, or staff time to support the AB 506 process.

(d) There would be a significant delay in engaging in a formal Request for Proposals (RFP) process for AB 506 support services.

(e) Management Partners is uniquely familiar with the financial condition of the City based on their work conducting the financial condition assessment.

(f) Management Partners has working knowledge of the City and its staff that will expedite the process.

(g) Management Partners has the expertise and staff available to begin the preparation for the AB 506 process immediately.

(h) Management Partners has demonstrated the expertise and capability to manage time sensitive, high profile projects with outstanding performance and attention to detail.

(i) The proposed fees are reasonable and comparable to the costs for similar project management engagements.

Section 9. Other Actions. The City Manager, City Attorney, Chief Financial Officer, City Clerk, and other appropriate officers of the City, each acting alone, are authorized to take such other actions as are appropriate to carry out the intent of this Resolution.

Section 10. Effectiveness. This Resolution shall take effect immediately upon its adoption.

PASSED, APPROVED, and ADOPTED ______February 28, 2012________.

____
ANN JOHNSTON
Mayor of the City of Stockton

ATTEST:

____
BONNIE PAIGE
City Clerk of the City of Stockton

Exhibit A

Stockton Public Financing Authority Lease Revenue Bonds
Series 2004 (Parking and Capital Projects)

Stockton Public Financing Authority Variable Rate Demand Lease Revenue Bonds
2007 Series A and 2007 Series B (Building Acquisition Financing Project)

Stockton Public Financing Authority Lease Revenue Bonds
2009 Series A (Capital Improvement Projects)

Exhibit B

Amendments to the 2010-2011 Annual Budget and Transfers to Cover Fund Deficits

	Aug. 23, 2011 Amended Budget	Budget Increase/ (Decrease)	Feb. 28, 2012 Amended Budget
1) Transfer unappropriated balances from unrestricted funds to the General Fund			
Transfer From:			
Library Fund #041	-	(721,000)	(721,000)
400 E. Main Operating #085	-	(590,000)	(590,000)
Entertainment Venues #086	-	(570,000)	(570,000)
General Capital Fund #301	-	(798,000)	(798,000)
ESB & 400 Main Capital #305	-	(1,930,000)	(1,930,000)
Fleet ISF #501	-	(2,286,000)	(2,286,000)
Retirement ISF #561	-	(3,731,000)	(3,731,000)
Arts Endowment Trust #613	-	(1,300,000)	(1,300,000)
		(11,926,000)	(11,926,000)
Transfer To: General Fund	10,390,622	11,926,000	22,316,622
2) Cover shortages in other funds with transfers from the General Fund			
Transfer From: General Fund #010	(2,901,648)	(4,516,000)	(7,417,648)
Transfer To:			
Redevelopment Waterfront #343	-	3,876,000	3,876,000
Recreation Fund #044	2,901,648	20,000	2,921,648
HUD Grants placeholder	-	88,000	88,000
Development Services Fund #048	-	526,000	526,000
City Debt Service Fund #201	773,622	6,000	779,622
	3,675,270	4,516,000	8,191,270
Increase 2010-11 Expenditure Appropriation			
Redevelopment #343	1,871,406	3,876,000	5,747,406
Recreation Fund #044	5,521,259	20,000	5,541,259
HUD Grants placeholder	6,222,913	88,000	6,310,913
Development Services Fund #048	8,314,184	526,000	8,840,184
City Debt Service Fund #201	20,267,500	6,000	20,273,500
	42,197,262	4,516,000	46,713,262
3) Increase 2010-11 Expenditure Appropriation			
General Fund #010			
Various Dept. - Payroll Accrual	-	650,000	650,000
Measure W Fund #081	7,706,930	1,232,000	8,938,930

Exhibit C

General Fund
2011-12 February Midyear Budget Update

	Adopted Budget 6/21/2011	Amended Budget A	Budget Increase/ (Decrease) B	Feb. 28, 2012 Amended Budget (A + B)
Beginning Available Balance	-	-	6,603,929	6,603,929
Revenues				
Property Tax Revenues /Decline in Assessed Valuation	46,845,775	44,613,175	(100,205)	44,512,970
Sales Tax	35,650,000	35,650,000	530,000	36,180,000
Utility Users Tax	31,141,736	31,141,736	95,000	31,236,736
Franchise Tax	11,756,238	11,756,238	451,000	12,207,238
Business License Tax	8,669,432	8,669,432	476,000	9,145,432
State Budget/Loss of Vehicle License Fee Allocations	1,047,400	-	-	-
Other Taxes	2,440,000	2,440,000	(36,000)	2,404,000
Interest	668,250	668,250	(528,000)	140,250
Fire District Contracts	3,990,981	3,990,981	925,000	4,915,981
Code Enforcement	4,038,100	4,038,100	(772,016)	3,266,084
Redevelopment Pass Through	395,000	395,000	(105,000)	290,000
State Mitigation - Prison Hospital	-	347,000	(347,000)	-
Indirect Cost Allocation	5,800,000	5,800,000	(500,000)	5,300,000
Rents/Lease/ Concessions	2,302,200	2,302,200	294,000	2,596,200
Program sources	7,016,201	7,016,201	(1,208,578)	5,807,623
	161,761,313	158,828,313	(825,799)	158,002,514
Expenditures				
Programs				
Police - Grants and Vacancies	84,862,036	83,172,036	(223,500)	82,948,536
Fire	39,812,835	40,290,835	47,000	40,337,835
Public Works - Service Reductions	7,080,990	6,884,990		6,884,990
Economic Development	485,199	485,199		485,199
Peacekeeper Program - Grant	328,354	128,354		128,354
Arts	36,737	36,737		36,737
	132,606,151	130,998,151	(176,500)	130,821,651
Program Support/Other Funds				
Library - Vacancy Savings	4,027,759	3,977,759	-	3,977,759
Recreation - Vacancy Savings	2,807,263	2,757,263	-	2,757,263
Entertainment Venues	2,441,299	2,441,299		2,441,299
Redevelopment	1,000,000	1,000,000	2,100,000	3,100,000
Marina	732,000	732,000		732,000
Capital Improvement - Project Reductions	575,000	500,000	-	500,000
Grant Match (Federal COPS; CHRP)	300,000	300,000		300,000
Development Services	150,000	150,000		150,000
	12,033,321	11,858,321	2,100,000	13,958,321
Administration				
City Council	521,797	521,797		521,797
City Manager	735,926	735,926	1,800	737,726
City Attorney	913,115	913,115		913,115
City Clerk	760,597	760,597		760,597
City Auditor	405,801	405,801	100,000	505,801
Admin Services	3,201,627	3,201,627	1,500	3,203,127
Human Resources	1,272,332	1,272,332	1,700	1,274,032
Tax Collection and Election	2,310,000	2,310,000	310,000	2,620,000
Other Admin / Non-Departmental	1,363,178	1,513,178	(368,370)	1,144,808
Vacancy savings	-	(150,000)		(150,000)
Labor Litigation	1,500,000	1,500,000	3,500,000	5,000,000
	12,984,373	12,984,373	3,546,630	16,531,003
Debt Service	2,137,468	2,137,468	-	2,137,468
Increase PFF, POB, 400 E. Main Subsidies			2,357,000	2,357,000
Suspension of PFF and 400 E. Main Debt Payments	-	-	(1,245,000)	(1,245,000)
Transfer in from Parking Fund #416			(804,000)	(804,000)
	2,137,468	2,137,468	308,000	2,445,468
Contingency	2,000,000	850,000		850,000
Subtotal, Expenditures	161,761,313	158,828,313	5,778,130	164,606,443
Net Annual Activity	-	-	(6,603,929)	(6,603,929)
Ending Available Balance	-	-	-	-