REPORT FROM

OFFICE OF THE CITY ADMINISTRATIVE OFFICER

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Council District: All

To: The City Council
The Mayor

From: Miguel A. Santana, City Administrative Officer

Reference: 2015-16 Adopted Budget and Council File No. 14-1383

Subject: **OVERVIEW OF THE CITY'S DEBT CAPACITY AND CONSIDERATION OF VARIOUS FINANCING OPTIONS FOR THE CITY'S CAPITAL EQUIPMENT REPLACEMENT PROGRAM AND VARIOUS CAPITAL PROJECTS**

SUMMARY

In a sprawling city of four million residents, the infrastructure needs of the City of Los Angeles are vast. From roads, sidewalks, and bridges, to libraries, fire stations, and office buildings, the City of Los Angeles is never without improvements to be made or a construction project to complete. As illustrated in this report, over the next five years, the City will need to address a growing list of capital projects and equipment needs that could approach $2 billion. In the current fiscal year alone, the City will need to identify General Fund financing totaling $100 million for improvements to previously approved and on-going construction projects including Figueroa Plaza building, construction of a new Sixth Street Bridge, construction of the Asphalt Plant No. 1, and other various City facilities. A few notable capital projects under consideration to break ground within the next five years and that would traditionally use debt financing are Los Angeles Convention Center Expansion and Renovation Project, Los Angeles Street Civic Center Building Project, and Taylor Yard G2 Project which collectively total approximately $1 billion.

The needs of the City to replace its aging capital equipment in the next five years are no less challenging. The City almost exclusively relies on debt financing paid from the General Fund to replace its aging fleet and other capital equipment, which limits the City's ability to debt finance construction projects for new facilities or renovation and improvements to existing facilities. The impact of the financial crisis caused the City to dramatically underfund equipment purchases. As a result, approximately 50 percent of the City's equipment inventory is past the replacement life cycle criteria. To fully address the City's equipment replacement back-log, it will cost approximately $1 billion (excluding helicopters) over the next five years.

The intent of this report is to provide the Mayor and City Council with an overview of the City's real property and capital equipment replacement needs within the context of its General Fund debt capacity. Furthermore, as supported by the findings presented herein, this report calls for

the City to consider alternative financing options for both real property and equipment including pay as you go options and infrastructure partnerships.

Policies and Guidelines for Financing Capital Assets

The City's Debt Management Policy was developed to provide guidelines for the issuance of bonds and other forms of indebtedness to finance capital improvements, equipment acquisition and other items for the City. This Policy is intended to help preserve the City's credit strength and budget flexibility. The City relies on these guidelines in determining the appropriate uses for debt financing, structuring debt financings and establishing certain debt management goals. According to the Policy:

1. Debt should be used to finance essential capital assets such as facilities, real property, and certain equipment where it is appropriate to spread the cost of the asset over more than one budget year. In so doing, the City recognizes that future taxpayers, who will benefit from the investment, will pay a share of its cost. Projects that are not appropriate for spreading costs over future years will not be debt financed.

2. Under no circumstances will long-term debt be used to fund City operations or maintenance. Except in extenuating circumstances, the City will fund routine maintenance projects in each year's capital program with pay-as-you-go financing. Extenuating circumstances may include unusually large and non-recurring budgeted expenditures, or when depleted reserves and weak revenues would require the delay or deletion of necessary capital projects.

3. Lease financing for facilities and real property is appropriate if the City desires to finance them from existing revenue sources, and not through voter-approved bonds secured by an increase in property taxes. Lease obligations [through the Municipal Improvement Corporation of Los Angeles (MICLA)] are a routine and appropriate means of financing capital equipment. However, lease obligations also have the greatest impact on debt capacity and budget flexibility [since paid from General Fund revenues]. Therefore, efforts will be made to fund capital equipment with pay-as-you-go financing where feasible, and only the highest priority equipment purchases will be funded with lease obligations.

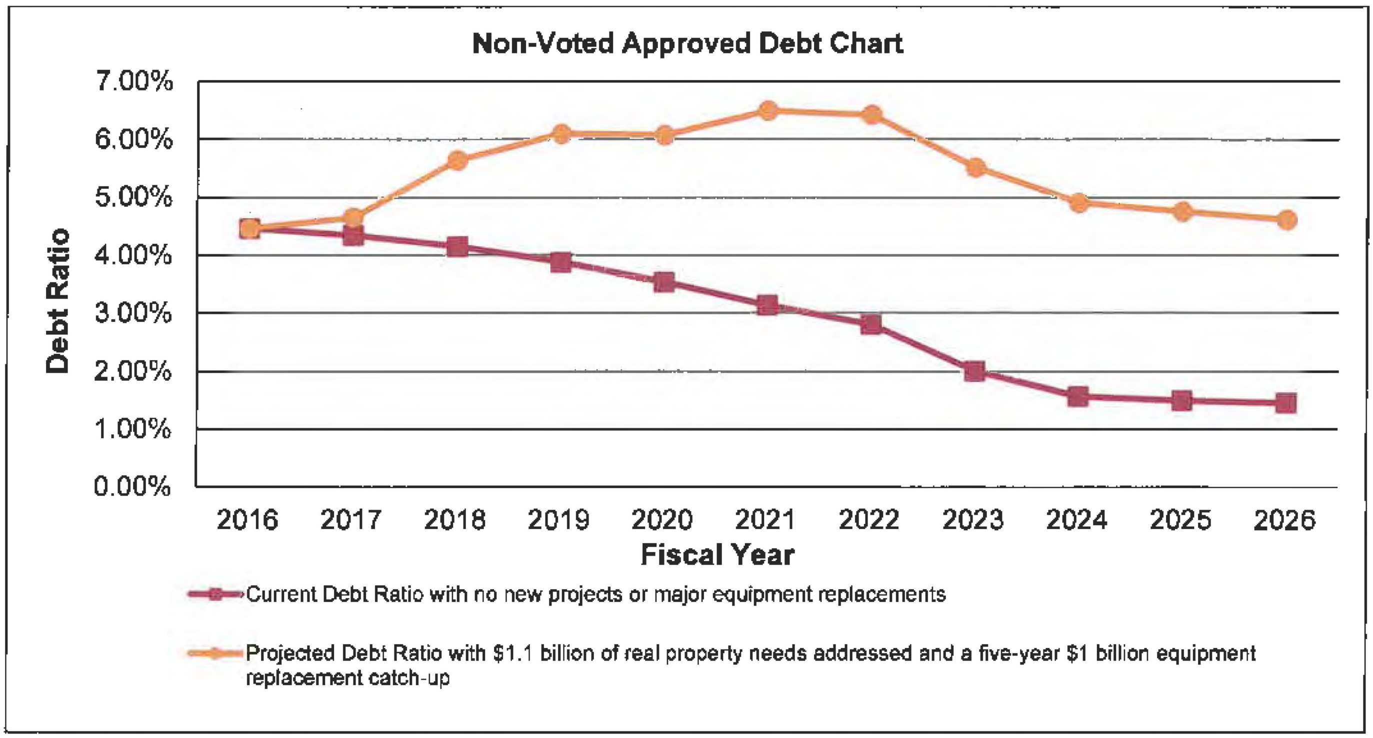
4. The issuance of debt must be carefully monitored to maintain a balance between debt and resources. Ceilings have been developed as guidelines in evaluating the affordability of future debt.

Debt Ratio	Ceiling
Total Direct Debt Service as % of General Fund Revenues	15%
Non-Voted Direct Debt Service as % of General Fund Revenues	6%

Direct debt includes all debt that is repaid from the General Fund or from any tax revenues deposited into special funds not supporting revenue bonds, such as General Obligation bonds and City-wide parcel tax bonds. "General Revenues" consist primarily of the General Fund, as well as the revenues to the special funds supporting direct debt.

Debt Affordability Analysis

Although the City is safely within its debt limit at this time, there is cause for concern as there are a number of significant capital projects that are ready to initiate construction in the current fiscal year, resulting in an increase to the non-voted debt ratio. Maintaining the City's status quo approach of fully debt financing its capital equipment replacement needs and its major capital projects through the MICLA will result in the City's debt ratio for non-voted approved direct debt to exceed its six percent ceiling as illustrated in the following chart.



While the consequences of exceeding the debt ceiling are uncertain, noncompliance with the City's own policy will negatively portray the City as a greater credit risk. Rating agencies assign a "grade" to municipal bonds as a measure of the issuer's risk of repaying its debt to investors. Bond ratings are also an assessment of the financial health of the City. It is the City's financial report card. The City has earned some of the highest credit ratings of any major urban area in the nation. These high credit ratings reduce the interest costs paid by the City on the amounts borrowed. Lower interest costs result in lower tax rates and a reduced burden on the General Fund. One of the Debt Management Policy's main objectives is to help maintain the City's high credit ratings so that access to borrowed funds is provided at the lowest possible interest rates.

Rating agencies use factors to evaluate the general creditworthiness of an issuer such as 1) overall debt structure and burden; 2) economic and tax base factors; 3) financial flexibility, performance and position; and, 4) management. Some rating factors have more scoring weight than others but nonetheless all factors play an important role in the overall rating. When Fitch Ratings (Fitch) evaluates debt and other liabilities, it focuses on affordability and flexibility. Fitch considers debt service below six percent of general fund spending as a credit positive. By policy, the City has established a six percent debt ceiling for its General Fund non-voted obligations. Historically, the City has remained below the six percent ceiling. The 2015-16 debt ratio for non-voted approved debt is 4.46 percent. The CAO believes that if the City exceeded its debt ceiling, the financial management position will be weakened and may imply that the City's ability to identify revenues to pay for capital expenditures is low.

Policy in Practice

Pursuant to the City's Debt Policy and the debt affordability analysis, when comparing debt financing of equipment versus acquisition and improvements of real property, the latter is more appropriate and a better asset to finance as it has a much longer asset life (20 to 40 years) than equipment (five to 15 years). Given the almost $1 billion in capital improvements projects discussed in this report, the availability of debt capacity is critical for the City to address its needs.

Over the long-term, the City can best focus on infrastructure by planning for recurring equipment costs as a part of its annual budget process. As part of the proposed budget process, the City should move towards budgeting an amount sufficient for each department to meet its routine equipment replacement needs. Departments should only submit MICLA budget requests for capital equipment that are deemed extraordinary. For example, if a significant number of vehicles were damaged from an earthquake and replacement is necessary to continue services, debt financing would be appropriate. Debt financing may also be suitable if the City decides to restore services or implement a new program involving costly new equipment where there is a high upfront expenditure that should be spread over several years; for example, debt financing was used in the past to implement new parking management programs and the transition to automated trash collection.

Equipment Financing Options

While getting to a pay-go program for capital equipment may be the best way for the City to achieve a well maintained fleet, it cannot occur without a plan. This Office, with the assistance of the Departments of General Services (GSD), Fire (LAFD), and Police (LAPD), has begun a review of the current status of the City's capital equipment replacement needs to develop a comprehensive multi-year capital equipment replacement plan to eliminate the City's capital equipment backlog and transition the majority of equipment purchases from tax-exempt lease financing to a pay-go basis.

Given the current status of the City's overall capital equipment situation, a combination of debt and cash financing is appropriate in the near term. The City may need to rely on debt financing more heavily in the first five years to "catch up" and shift its financing practice to a pay-go plan of finance. Assuming this back-log is addressed over the next five years, estimated average annual costs for replacement equipment would be $102 million (in current dollars, not adjusted for inflation). The following scenarios outline a general plan of finance to restoring an appropriate equipment replacement program over the next 10 years.

1. Scenario A: Fully Debt Finance Equipment. Current practice has been to rely on debt financing, reducing costs in the early years but eventually requiring that the City fund both the principal and interest components of debt service. Under this scenario, equipment purchases would be debt financed over the next five years, with a return to cash funding of $102 million annually in Fiscal Year 2021-22. MICLA would issue approximately $1 billion of lease revenue bonds. The resulting annual average lease payment is estimated at $119 million over 10 years.

2. Scenario B: Establish a stable expenditure goal. If the City were to address its equipment backlog without fully relying on debt in the early years, it could set a total expenditure target that would supplement pay-go investment with debt so that the total of pay-go and debt service would be relatively level. Under this scenario, MICLA would issue approximately $390 million of lease revenue bonds and pay-go for the remainder. The resulting annual average lease payment is estimated at $49 million over 10 years.

3. Scenario C: Establish an internal service fund (best practice). A number of municipalities effectively fund their equipment needs in advance, reserving moneys as equipment depreciates, so that at the end of its life cycle, funds are available for replacement. This is the most pro-active approach and is considered a best practice by the Government Finance Officers Association. Under this scenario, in the early years, equipment purchases would be debt and pay-go financed and phased in funding for an internal service fund. MICLA would issue approximately $232 million of lease revenue bonds. The resulting annual average lease payment is estimated at $32 million over 10 years.

Given this outlook, for financial planning purposes and the overall fiscal management of the City's equipment and capital needs, the City must expand its financing options beyond debt financing through MICLA. The City must begin to consider other avenues of financing such as public-private partnerships, equipment leasing, pay-as-you-go (pay-go or cash), and even voter approved debt authorizations. Pursuant to Mayor and Council direction, this Office has begun to explore other financing alternatives and revenue opportunities to fund two capital projects: the Los Angeles Convention Center Expansion and Renovation Project and the LA Streetcar Project. The CAO recommends issuing a Request for Information to subject matter experts to explore various alternative financing options for other major capital projects including the Los Angeles Street Civic Center Building Project.

The recommendations are in compliance with the City's Financial Policies.

RECOMMENDATIONS

That the City Council, subject to the approval of the Mayor:

1. INSTRUCT the City Administrative Officer, with the assistance of the Departments of General Services, Fire and Police, to report back in 120 days with a comprehensive financing plan to address the City's equipment replacement needs and the impact to service rates, staffing levels, maintenance and repair costs; and

2. INSTRUCT the City Administrative Officer to explore alternative financing options for major capital projects by issuing a Request for Information to subject matter experts with a report back in 120 days.

FISCAL IMPACT STATEMENT
This report will not result in a fiscal impact to the General Fund.

DEBT IMPACT STATEMENT
This report will not result in a debt impact to the General Fund.

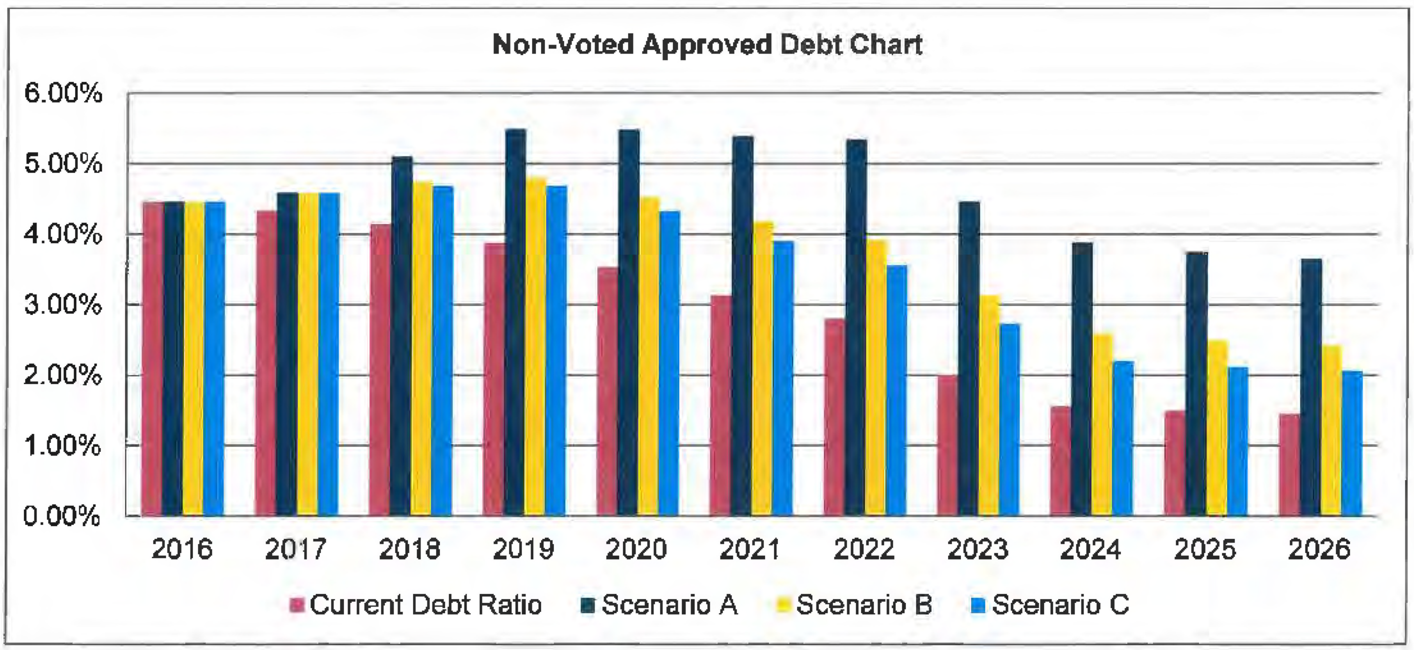
FINDINGS

Debt Affordability Analysis

The debt affordability analysis is a financial planning tool used in the capital planning process to evaluate how much debt the City can afford to issue today and in the future. In other words, it is an assessment of debt relative to the resources available for repaying debt. By policy, the City has established two debt affordability ceilings:

Debt Ratio	Ceiling	Adopted Budget 2015-16
Total Direct Debt Service as % of General Fund Revenues	15%	6.98%
Non-Voted Direct Debt Service as % of General Fund Revenues	6%	4.46%

The debt ratio for non-voted direct debt includes judgment obligation bonds and lease obligations issued through MICLA and the Los Angeles Convention & Exhibition Center Authority. The debt ratio for total direct debt includes all non-voted direct debt obligations and general obligation bonds. For purposes of this analysis, we will focus on the debt ratio for non-voted direct debt because debt financing of equipment will be issued through MICLA. Based on the equipment replacement scenarios, described above, the following chart illustrates the impact to the non-voted approved debt limits.



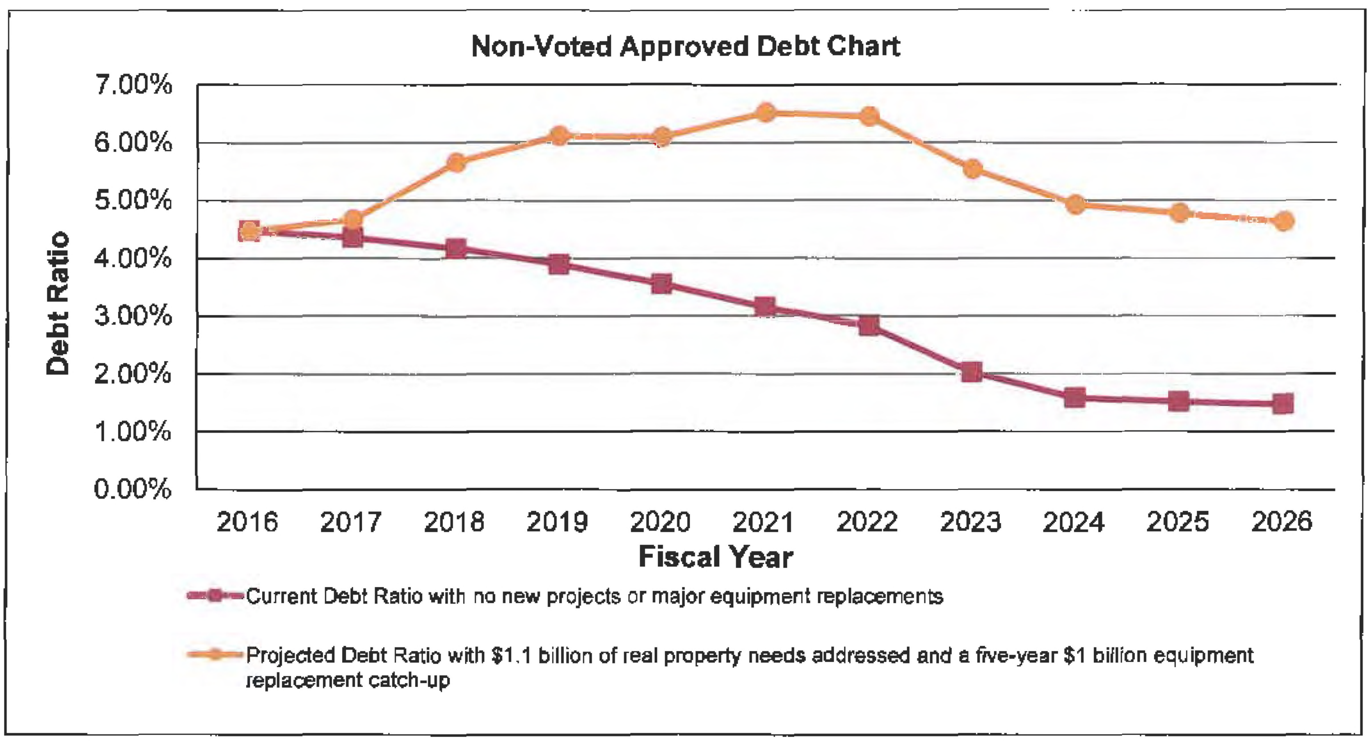
Although the City is safely within its debt limit at this time, there is cause for concern as there are capital infrastructure needs the City will need to address in the near future. In addition to capital improvement projects that were approved in the 2015-16 Adopted Budget, the City will also need to address approximately $100 million of various capital improvements this fiscal year. These projects include construction and improvements to Figueroa Plaza, Sixth Street Bridge, Asphalt Plant No. 1, and other various City facilities. Also, notable capital projects under consideration that would traditionally use debt financing are (project costs and dates are estimates and may change):

- **Los Angeles Convention Center Expansion and Renovation Project**
    - Start and Completion Dates: 2017 – 2019
    - Project Cost: $470 million

- **Los Angeles Street Civic Center Building Project**
    - Start and Completion Dates: 2017 – 2020
    - Project Cost: $475 million

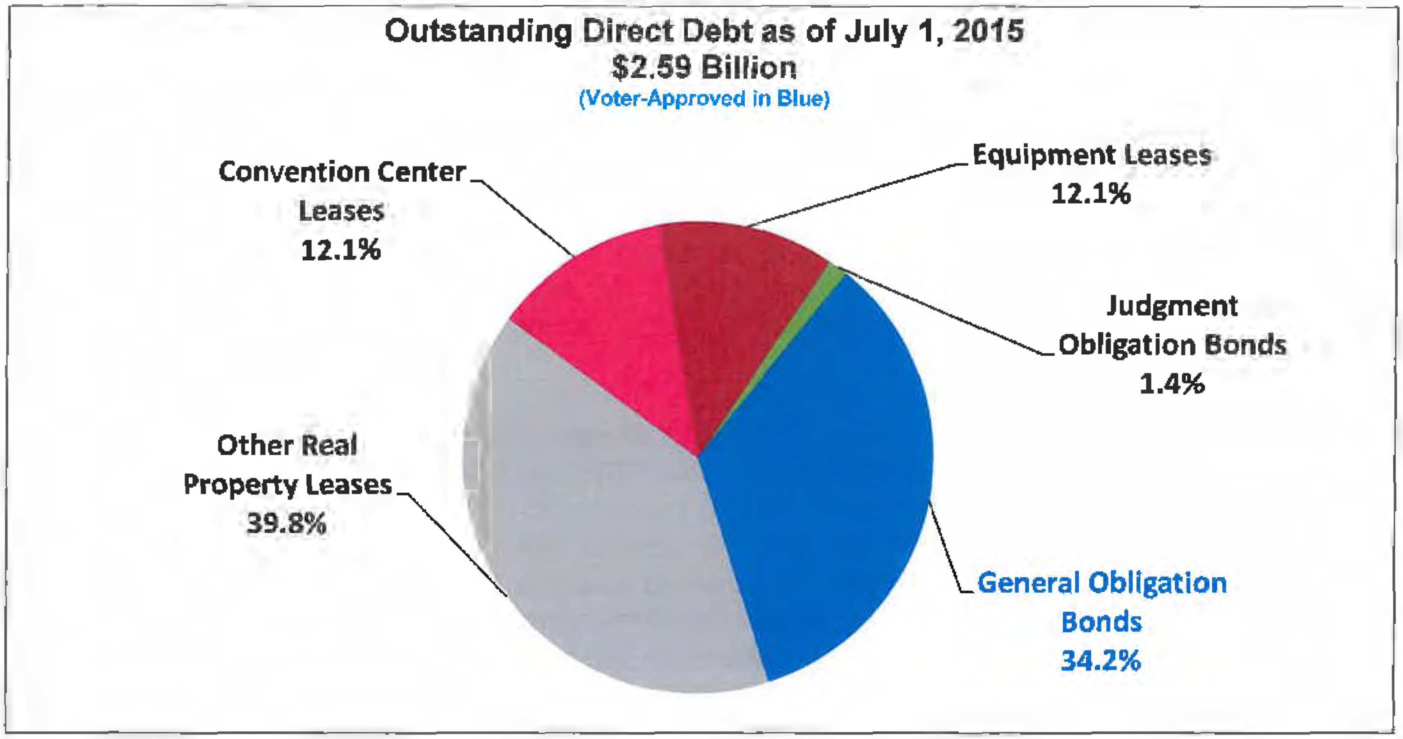
- **Taylor Yard G2 Project**
    - Start and Completion Dates: 2016 – 2024
    - Project Cost: $100 million (of which $50 million to $70 million may require financing through MICLA)

If the City moved forward with fully debt financing its capital equipment replacement needs (Scenario A) and its major capital projects through MICLA, the debt ratio for non-voted approved direct debt would be exceeded in Fiscal Years 2018-19, 2019-20, 2020-21 and 2021-22, as illustrated below. This assumes no economic downtown and no bond issuances to finance potential judgments resulting from litigation.



Background on the City's Direct Debt Portfolio and Bond Ratings

As of July 1, 2015, the City's total direct debt was $2.59 billion.



As of July 1, 2015, the bond ratings for the above direct debt are as follows:

Bond Program	Moody's Investors Service	Standard & Poor's Rating Services	Fitch Ratings	Kroll Bond Rating Agency
General Obligation Bonds	Aa2	AA-	AA-	AA
Convention & Exh. Center Lease Rev Bonds (Real Property)	A1	A+	A+	n/a
Judgment Obligation Bonds	A1	A+	A+	n/a
MICLA Lease Revenue Obligations (Real Property)	A1	A+	A+	AA-
MICLA Lease Revenue Obligations (Equipment)	A2	A+	A+	AA-

One of the Debt Management Policy's main objectives is to help maintain the City's high credit ratings so that access to borrowed funds is provided at the lowest possible interest rates. Rating agencies use factors such as 1) overall debt structure and burden, 2) economic and tax base factors, 3) financial flexibility, performance and position, and 4) management to evaluate the general creditworthiness of an issuer. Some rating factors have more scoring weight than others but nonetheless all factors play an important role in the overall rating.

According to Standard and Poor's Rating Services (S&P), "an obligation rated "AA" differs from the highest rated obligation only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong. An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong." The City's current bond ratings fall into these two categories.

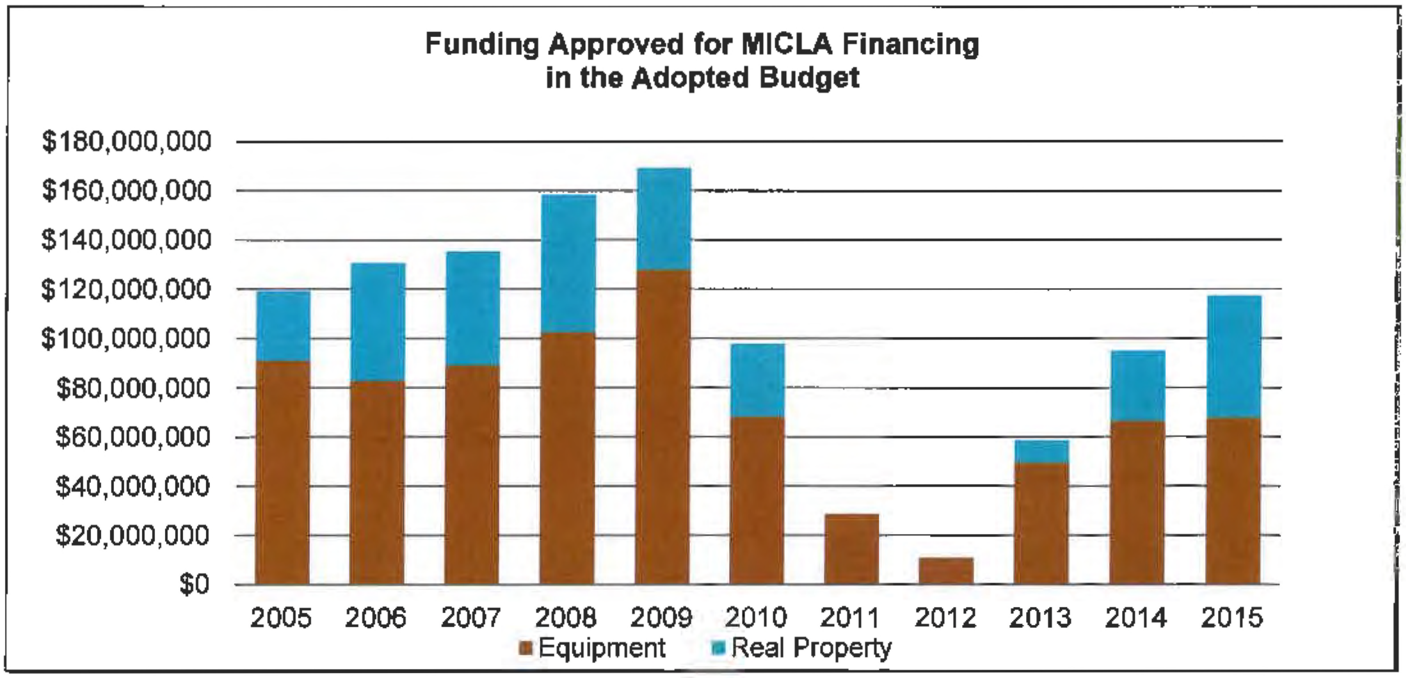
When Fitch Ratings (Fitch) evaluates debt and other liabilities, it focuses on affordability and flexibility. Fitch considers debt service below six percent of general fund spending as a credit positive. By policy, the City has established a six percent debt ceiling for its General Fund non-voted obligations. Historically, the City has remained below the six percent ceiling. The CAO believes that if the City exceeded its debt ceiling, the financial management position will be weakened and may implicate that the City's ability to identify revenues to pay for capital expenditures is low.

Since the City's lease obligations are the majority of its direct debt, it is important to discuss rating factors specific to leases. With respect to debt issued through MICLA, Moody's Investors Service (Moody's) and Kroll Bond Rating Agency (Kroll) consider the financed asset's essentiality as a rating factor. According to Kroll, "[it] will generally assess essentially in the context of the kind of asset being leased (whether equipment or building) and the importance of the leased asset to governmental operations and/or economic viability of the particular community." Moody's believes essentiality matters because "the more important an asset is to the borrower, the less likely the borrower will be to exercise its right to not appropriate on [its debt]." The essentiality concept is highly subjective and may differ among municipalities; however, as a rule of thumb, Moody's has categorized essentiality into two broad categories. Moody's considers assets such as affordable housing, nursing homes, courthouses, jails, landfills, libraries, parking garages attached to essential facilities, parks, police and fire stations, roads, streets, school buildings, and water and sewer system facilities as more essential to core government operations. Moody's considers assets such as animal shelters, community centers, convention centers, golf courses, hotels, miscellaneous economic development projects, sports stadiums, theaters, and undeveloped land as less essential to core government operations.

The previous table shows that MICLA obligations related to equipment (A2) is rated lower than real property (A1) by Moody's. According to Moody's rating methodology report dated December 2011, this rating distinction was Moody's belief that equipment is more easily lost or stolen than real property and depreciates whereas real property, if properly maintained, appreciates over time. Additionally, information technology equipment such as computers and high-tech systems and software are considered greater risks or of lesser value than heavy equipment such as fire trucks. However, Moody's recently released a Request for Comment Report which, among other things, proposes to "eliminate the additional downward notch [they] currently assign for lease-backed obligations for equipment relative to...real property of equivalent essentiality." The request for comment period will end on December 1, 2015.

Background on City's Equipment Financing Practice

Beginning in the mid-1980s, the City began to issue debt obligations through MICLA to finance the acquisition of certain capital equipment to meet its replacement needs. The original program was established to address a back-log that developed following Proposition 13. Subsequently, the City set a goal of debt financing one-third of its capital equipment with the remaining purchased with cash. Unfortunately, over the last two decades, the City gradually debt financed all of its capital equipment with the exception of police patrol vehicles and motorcycles. The use of debt financing through MICLA has almost become an "automatic" financing mechanism for capital equipment. This is evidenced by the lack of cash funding in GSD, LAFD, and LAPD budgets and the increase of MICLA financing authority for equipment purchases. LAPD is the only department that has funding in their department budget to purchase patrol vehicles and motorcycles. As demonstrated in the chart below, the majority of funding approved for MICLA financing is for equipment, reflecting the difficulty of identifying cash to pay for equipment. Eventually, of course, cash from the General Fund had to be identified to pay debt service.



Policies and Guidelines for Financing Capital Assets

City's Debt Management Policy

According to the City's Debt Management Policy, "debt should be used to finance essential capital assets such as facilities, real property, and certain equipment where it is appropriate to spread the cost of the asset over more than one budget year. In so doing, the City recognizes that future taxpayers, who will benefit from the investment, will pay a share of its cost. Projects that are not appropriate for spreading costs over future years will not be debt financed. Under no circumstances will long-term debt be used to fund City operations or maintenance. Except in extenuating circumstances, the City will fund routine maintenance projects in each year's capital program with pay-as-you-go financing. Extenuating circumstances may include unusually large and non-recurring budgeted expenditures, or when depleted reserves and weak revenues would require the delay or deletion of necessary capital projects. Lease financing for facilities and real property is appropriate if the City desires to finance them from existing revenue sources, and not through voter-approved bonds secured by an increase in property taxes." Specifically, in regards to equipment financing, the City's Debt Management Policy states that "lease obligations [through MICLA] are a routine and appropriate means of financing capital equipment. However, lease obligations also have the greatest impact on debt capacity and budget flexibility [as it is paid from General Fund revenues. Therefore, efforts will be made to fund capital equipment with pay-as-you-go financing where feasible, and only the highest priority equipment purchases will be funded with lease obligations." Thus, when comparing debt financing of equipment versus acquisition and improvements of real property, the latter is more appropriate and a better asset to finance as it has a much longer asset life (20 to 40 years) than equipment (five to 15 years).

California Debt Advisory Commission Guidelines

According to the Financial Management Guidelines for Leases and Certificates of Participation by the California Debt Advisory Commission, several guidelines should be used to determine how to finance equipment and capital projects through MICLA. The main guidelines are described below.

1. **Identify the General Fund Lease Capacity**. Government agencies should identify a maximum percentage of general fund revenues which *safely* can be devoted to lease payments on an annual basis.

    a. Most agencies do not permit their general fund lease capacities to exceed 6 to 8 percent of their general fund revenues but resource constraints usually keep the lease capacity below that range.

    b. Pay-as-you-go and tax-exempt leasing analysis – If this analysis indicates that an agency can afford to devote more than 5 percent of its general fund revenues to lease payments, it should consider paying for more capital outlays on a cash basis, to reduce interest expenses. Alternatively, agencies will gravitate more toward tax-exempt leasing to the extent that resources constraints necessitate leveraging the general fund to address capital needs.

    c. Government agencies should not lease small equipment items out of habit. By paying for certain equipment items out of current revenues, agencies can avoid interest charges altogether.

2. **Determine the Necessity for the Proposed Project**. The necessity for the project, rather than the expediency of its financing, should justify the funding decision.

a. Investors and rating agencies prefer to see tax-exempt leases executed for facilities required for the delivery of essential government services, such as police and fire protection, rather than for discretionary facilities, such as parks and recreational facilities and museums. The investment community believes, not without reason, that government agencies are more likely to honor lease obligations involving essential government property.

3. **Evaluate the Cost-Effectiveness of Tax-Exempt Leasing** relative to other financing alternatives, and keep in mind that non-cost factors may influence the financing decision.

   a. Government agencies should not lease small equipment items out of habit.

   b. A basic tenet of debt management is to avoid unnecessary borrowing. By paying for capital expenses out of current revenues, agencies can avoid interest charges and minimize the administrative chores associated with debt management.

   c. Although it is not usually feasible to finance large capital projects out of current revenues, it is not true for certain equipment items. If an agency's administrative overhead is large enough for its equipment outlays to recur on a predictable basis, it may be able to shift to a pay-as-you-go financing scheme for at least some of its equipment items.

4. **Do Not Fund Operating Expenses with Long-Term Lease Obligations**. The proceeds from the issuance of lease obligations should not be used for deficit financing.

   a. Deficit financing in this manner reflects an unwillingness or inability on the part of management to address the underlying discrepancy between revenues and expenditure obligations.

   b. Borrowing should not substitute for difficult budget-balancing decisions.

5. **The term of the lease should not exceed useful life of the asset.**

   a. To promote sound debt management and ensure the marketability of the obligation, agencies usually should establish a lease term shorter than the anticipated useful life of the asset.

   b. Useful Life means a period of time during which an asset will provide the desired service to the party using it. The useful life of a piece of technical equipment could be substantially less than its expected technical life (e.g. computers due to technical obsolescence.)

Best Practices for Financing Capital Assets

The Government Finance Officers Association (GFOA) released best practice guidelines for capital asset maintenance and replacement needs of governments. Capital assets include major government facilities, infrastructure, equipment and networks that enable the delivery of public sector services. GFOA states that governments should "identify and dedicate fees or other revenue sources...and [allocate] sufficient funds in [a] multi-year capital plan and annual operations budget for condition assessment, preventative maintenance, repair and replacement of capital assets in order to continue the provision of services that contribute to public health, safety, and quality of life of the public."

Practices vary widely among municipalities in the extent to which they debt finance capital equipment. Every municipality has its own unique circumstances and resources, thus the right balance between debt and cash can only be determined on a case-by-case basis. Ideally, due to the size and diversity of its equipment inventory, the City's equipment requirements should be reasonably stable from year to year, without major surges in new or replacement requirements, which make it best suited for a pay-go plan of financing. Debt financing is best suited for programs that require an extraordinary expenditure in a given year. Debt financing provides a tool to smooth or level the cash requirements over a period of time.

A number of municipalities effectively fund their equipment needs in advance, reserving moneys as equipment depreciates, so that at the end of its life cycle, funds are available for replacement. This is known as an internal service fund (sometimes referred to as a Vehicle and Equipment Replacement Fund) and is considered a best practice. An internal service fund is a sustainable set-a-side (capital reserve) for funding targeted or necessary capital equipment. The purpose of this type of fund is to ensure that appropriate funds are available to purchase vehicles and equipment, especially when a large amount of replacements are required in the near future. Under this fund, each department that operates its own fleet is charged a monthly fee based on the individual assets used by the department. The payment serves as an internal lease where payments are based on a calculated amount that takes into account the age of their assets and the replacement value of those assets. Once the capital equipment is due for replacement, the funds accumulated in the funds are transferred out of the internal service fund to pay for the replacement. This method substantially reduces problems with identifying funding once they become necessary and ensures an enduring commitment to maintenance—frequent lease payments could encourage fleet users to pay additional attention to fleet utilization levels. The drawbacks of these funds are the difficulty of properly administering a charge-back system and the susceptibility of fund raiding during a recession. The City currently does not have a policy in place to establish a Vehicle and Equipment Replacement Fund.

Over the long-term, the City will best achieve the goal of sustaining a well-maintained fleet and reducing its costs for planning for recurring equipment costs as a part of its annual budget. Debt would be appropriate to help in the transition to a full pay-go program. Debt would also be appropriate for replacements that are extraordinary in nature. As part of the proposed budget process, the City should budget an amount sufficient to each department to meet their routine equipment replacement needs. Departments should only submit MICLA budget requests for capital equipment that are deemed extraordinary. Debt financing may also be suitable if the City decides to restore services or implement a new program involving costly new equipment where the expenditure is high upfront and should be spread over several years.

Equipment Replacement Needs

The impact of the financial crisis caused the City to dramatically underfund equipment purchases. As a result, 50 percent of the City's equipment inventory is past the replacement life cycle criteria. Generally, the continued use of old equipment significantly increases maintenance and repair costs, reduces salvage value, and most importantly poses safety ramifications for City employees performing city services and residents relying on city services.

Department	No. of Total Assets	No. of Assets Past Life Cycle	Percentage of Assets Past Life Cycle
GSD	6,322	2,488	39%
LAFD	1,078	783	73%
LAPD	5,000	2,956	59%
Total:	**12,400**	**6,227**	**50%**

To fully address the City's back-log, it will cost approximately $1 billion (excluding helicopters) over the next five years, as described below, to replace all equipment past the replacement life cycle criteria.

Department	Year 1	Year 2	Year 3	Year 4	Year 5	Total Cost
GSD	$156,941,538	$156,787,471	$48,511,861	$43,625,637	$44,267,931	$450,134,438
LAFD	54,327,405	54,327,405	54,327,405	54,327,405	54,327,405	271,637,025
LAPD	60,736,003	60,736,003	50,959,467	51,550,538	51,550,538	275,532,549
Total Cost:	**$272,004,946**	**$271,850,879**	**$153,798,733**	**$149,503,580**	**$150,145,874**	**$997,304,012**

Assuming this back-log is addressed over the next five years, average annual costs for replacement equipment would fall to the following annual requirement (in current dollars, not adjusted for inflation):

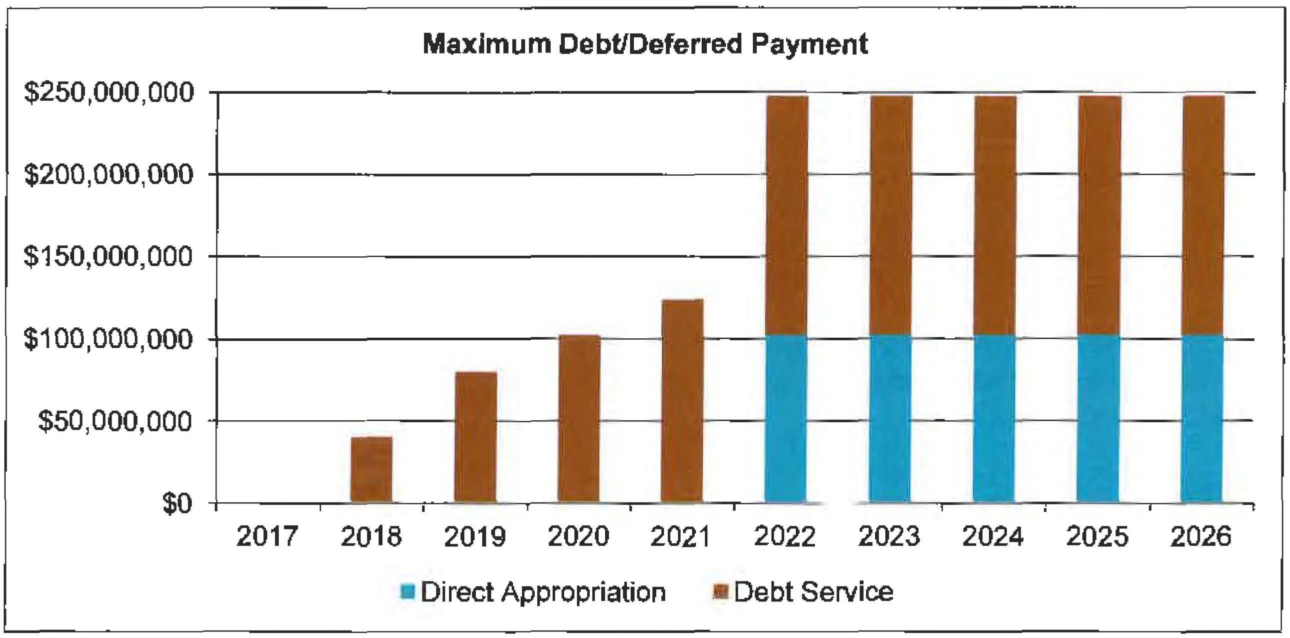
Department	Annual Cost
GSD	$30,000,000
LAFD	27,000,000
LAPD	45,000,000
Total Cost:	**$102,000,000**

Replacing equipment involves labor from the time the equipment is received through the end of its life cycle. Staffing levels for each department should be reviewed to determine the appropriate levels necessary to maintain the equipment. Conventional wisdom would indicate that replacing equipment timely would save money in the long run and generate efficiencies and higher service levels. The effects of this plan on service rates, equipment parts, maintenance and repair costs, and salvage value should be analyzed and quantified. The CAO recommends that these issues be vetted in the next report back.

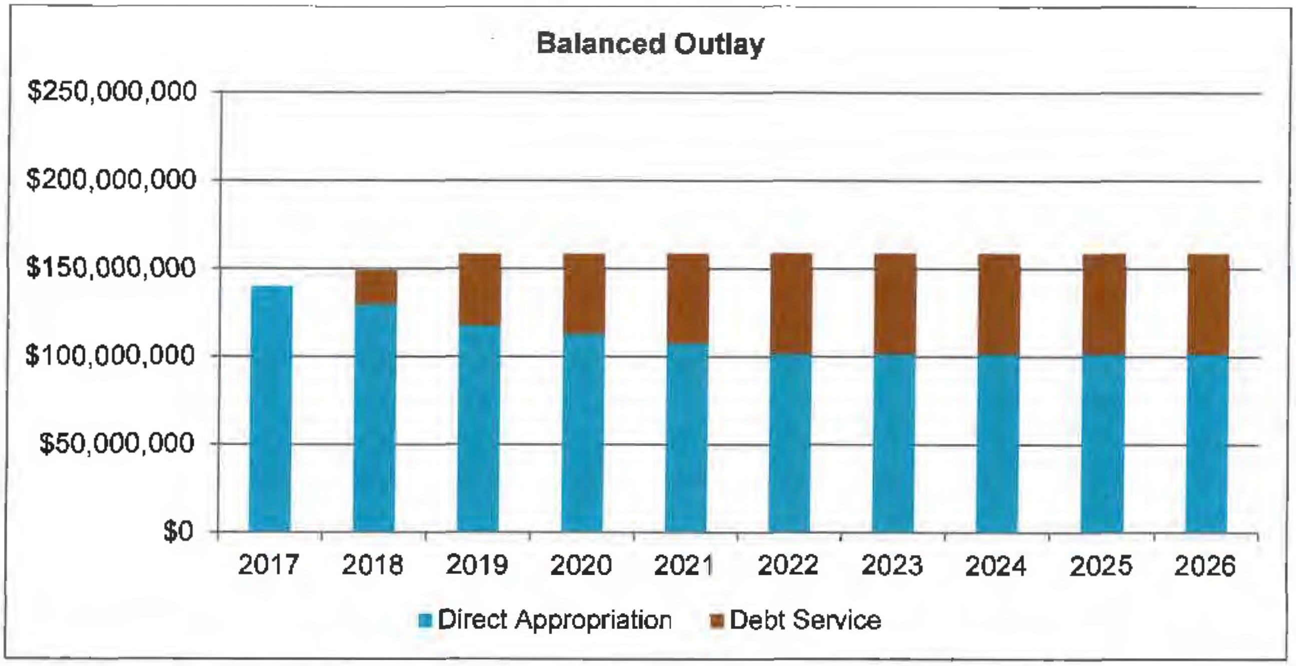
Equipment Financing Options

Given the current status of the City's overall capital equipment situation, a combination of debt and cash financing is appropriate in the near term. The City may need to rely on debt financing more heavily in the first five years to "catch up" and shift its financing practice to a pay-go plan of finance. Replacing capital equipment should be prioritized and treated as a basic need of the City. The following scenarios outline a general plan of finance to restoring an appropriate equipment replacement program over the next ten years.

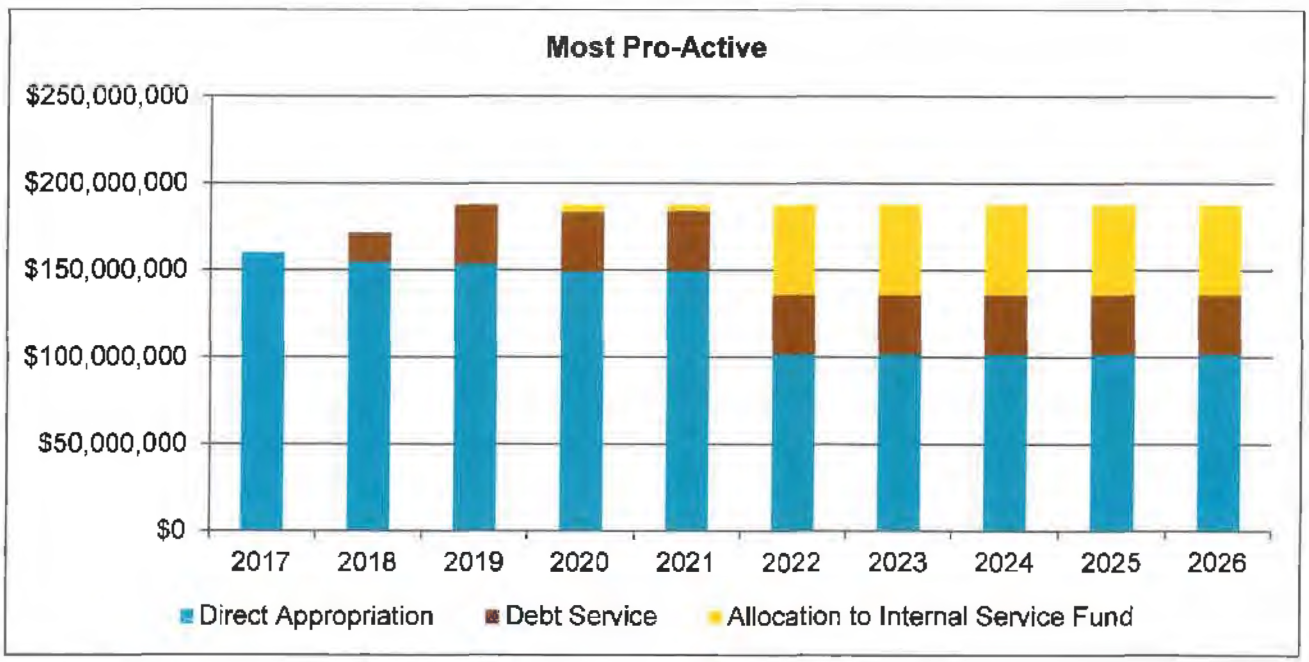
4. **Scenario A: Fully Debt Finance Equipment.** Current practice has been to rely on debt financing, reducing costs in the early years but eventually requiring that the City fund both the principal and interest components of debt service. This practice is not appropriate for the City's relatively stable funding needs. Nevertheless, we have calculated such a program for equipment purchases over the next five years, with a return to cash funding of $102 million annually in Fiscal Year 2021-22, to illustrate the long-term impacts. Under this scenario, MICLA would issue approximately $1 billion of lease revenue bonds. The resulting annual average lease payment is estimated at $119 million over 10 years from the General Fund.



5. **Scenario B: Establish a stable expenditure goal.** If the City were to address its equipment backlog without fully relying on debt in the early years, it could set a total expenditure target that would supplement pay-go investment with debt so that the total of pay-go and debt service would be relatively level. The following illustrates what such a program might look like. Under this scenario, MICLA would issue approximately $390 million of lease revenue bonds. The resulting annual average lease payment is estimated at $49 million over 10 years from the General Fund.



6. **Scenario C: Establish an internal service fund (Best Practice).** The following illustrates what a program that transitions from a combination of debt and pay-go to a pay-go through use of an internal service fund approach might look like. Under this scenario, MICLA would issue approximately $232 million of lease revenue bonds. The resulting annual average lease payment is estimated at $32 million over 10 years from the General Fund.



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