City of San Gabriel

Its Ongoing Deficit Is Inhibiting Its Financial Recovery

April 27, 2021
April 27, 2021
2020-805

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, CA 95814

Dear Governor and Legislative Leaders:

As directed by the Joint Legislative Audit Committee, my office conducted an audit of the city of San Gabriel (San Gabriel) as part of our high-risk local government agency audit program. Our assessment focused on San Gabriel’s financial and operational risks, and after auditing San Gabriel, we found that the city is at high risk of financial instability because of its depleted general fund reserves, lack of available cash, and large unfunded retirement obligations, all of which threaten the city’s financial recovery.

Since San Gabriel depleted its general fund reserves, it has relied on borrowing from other city funds to cover its short-term expenses. This situation began when San Gabriel entered into a loan in 2014 to build a public works facility that set aside $7.8 million of its general fund cash as collateral for 10 years—essentially limiting the city’s ability to pay for city services from the general fund. Despite this condition, the city continued to spend more than the revenues it received between fiscal years 2015–16 and 2017–18, which further deteriorated its financial health. As of June 2020, the city’s general fund reserves had a deficit of $8.1 million. With the prolonged and uncertain economic impact of the COVID-19 pandemic exacerbating the situation, San Gabriel’s lack of financial reserves will continue to threaten the city’s financial health. Although the current city management has taken steps to strengthen its financial policies and practices, the city does not have a comprehensive plan to adequately address the city’s poor financial condition, including how to pay for its large retirement obligations, such as its rising retiree health care costs.

Among the recommendations to address our concerns, we recommend that San Gabriel develop a comprehensive financial recovery plan that includes strategies for building its reserves, renegotiating or refinancing the loan that restricts its available cash, and identifying opportunities to increase revenues and reduce expenditures.

Respectfully submitted,

ELAINE M. HOWLE, CPA
California State Auditor
## Selected Abbreviations Used in This Report

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<td>California Public Employees’ Retirement System</td>
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<td>CDIAC</td>
<td>California Debt and Investment Advisory Commission</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>GFOA</td>
<td>Government Finance Officers Association</td>
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<td>OPEB</td>
<td>Other post-employment benefits</td>
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<td>SCM</td>
<td>State Contracting Manual</td>
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# HIGH RISK ISSUES

## Risks the City of San Gabriel Faces

**Risk Designation:** High Risk

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### Agency Response

- City of San Gabriel
- California State Auditor’s Comments on the Response From the City of San Gabriel
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Risks the City of San Gabriel Faces

In November 2019, the California State Auditor’s Office (State Auditor) informed the city of San Gabriel (San Gabriel) that it had been selected for review under the high-risk local government agency audit program (local high risk program). This program authorizes the State Auditor to identify local government agencies that are at high risk for potential waste, fraud, abuse, or mismanagement or that face major challenges associated with their economy, efficiency, or effectiveness. We first identified that San Gabriel might be classified as a high-risk local government entity based on publicly available audited financial statements and unaudited pension-related information from the California Public Employees’ Retirement System (CalPERS). We conducted an initial assessment of the city in December 2019 and identified concerns regarding its financial condition. The city had depleted its general fund reserves to such an extent that it was relying on borrowing from other city funds to cover its short-term expenses. San Gabriel had also entered into a loan in fiscal year 2014–15 to build a public works facility (public works loan) that set aside millions of dollars of its general fund cash for 10 years—further inhibiting its ability to pay its bills. In addition, we found that its former city management had failed to disclose issues related to the city’s financial stability, and the city did not have a comprehensive plan to adequately address San Gabriel’s dire financial condition. The city also appeared to lack adequate management controls over its contracting processes.

In its response to our December 2019 assessment, San Gabriel generally agreed that the city’s depleted general fund reserves put it at financial risk should an economic downturn occur, but it suggested that we should monitor its progress over time to allow it to take actions to address the issues we raised in our assessment. For example, city management expected to generate additional revenue from a sales tax measure that its voters approved in March 2020. The city also intended to refinance the loan that caused its initial cash flow problems and to revise its fiscal policies. Nevertheless, based on our continued concerns about its financial and operational management, we recommended an audit of San Gabriel, which the Joint Legislative Audit Committee (Audit Committee) approved in February 2020.

Our audit found that San Gabriel still faces several significant risks related to its financial condition and operational management. For example, for fiscal year 2019–20, the city’s general fund reserves had a deficit of $8.1 million. The city consistently received less revenue than it budgeted but did not curtail spending between fiscal years 2015–16 and 2017–18, which resulted in the city overspending and depleting its general fund reserves. One reason may be that, for years, former city officials did not provide the city council with accurate information on the city’s financial condition, while the city council in turn failed to exercise its own due diligence in overseeing city management. Moreover, when the city council approved the public works loan and the associated collateral, it essentially constrained the city from accessing a significant amount of its general fund cash, which has eroded the city’s ability to pay for city services from the general fund. The city’s attempts to refinance this loan have not been successful, greatly hampering its financial recovery.

Despite the city’s poor financial condition, the city has still not developed a comprehensive financial recovery plan, and it continues to use its general fund to subsidize activities it cannot afford. For example, the city has relied on its general fund to sustain the operations
of its Mission Playhouse, a performing arts venue and community center, by contributing over $4.2 million between fiscal years 2014–15 and 2019–20, which has further exacerbated its general fund deficit. Additionally, the city has not adjusted the majority of its fees for services for years, likely causing it to forgo additional revenue. The city is also unable to track all of its current contracts or the associated costs, likely contributing to some city programs routinely exceeding their contractual expenditure budgets. For example, San Gabriel exceeded its total citywide budget for contractual service expenditures by $468,000, or 19 percent, in fiscal year 2017–18.

Although current city management has taken some steps to improve its financial practices and has developed projections that suggest it will be able to increase its general fund balance, those projections do not consider key factors. For example, the unexpected onset of the COVID-19 pandemic (pandemic) has hampered the city’s efforts to rebuild its general fund reserves and may have longer-term negative impacts on revenues. By lacking a comprehensive recovery plan to ensure that the city management is transparent and proactive about addressing the city’s financial challenges, San Gabriel continues to be at a high financial risk.

To help San Gabriel address the risk factors we identified, we developed numerous recommendations the city should implement, including the following:

- Develop a financial recovery plan that includes short-term and long-term goals, strategies to build the general fund reserves, analysis of the external and internal factors affecting its finances, and actions and timelines.

- Quantify the costs it incurs in providing its services, adjust city fees to cover those costs, and identify opportunities to reduce expenditures.

- Strengthen and enforce its contracting policies to better monitor its contract costs and to ensure that it receives the best value when procuring goods and services.

**Agency’s Proposed Corrective Action**

San Gabriel generally agreed with our recommendations. The city highlighted various efforts that it has taken or plans to take to address its financial condition. However, because San Gabriel did not submit a corrective action plan as part of its response, we look forward to receiving the plan by June 2021 to understand the specific actions it has undertaken or plans to take to address the conditions that caused us to designate it as high risk.
Introduction

Background

San Gabriel is located in the San Gabriel Valley of Los Angeles County and has approximately 40,000 residents. San Gabriel is a general law city and is therefore subject to the State’s general law that governs municipal affairs.¹ For fiscal year 2020–21, San Gabriel authorized nearly 200 full-time city staff members to provide services to residents, including public safety, public works, recreational and cultural activities, planning, zoning, and general administrative services. The city operates under a council-manager form of government: residents elect officials to a five-member city council serving staggered four-year terms; they in turn appoint a city manager to carry out the council’s initiatives and provide administrative direction to the city. The city manager is also responsible for keeping the city council fully advised of San Gabriel’s financial condition, including any financial challenges.

San Gabriel’s Governance Structure and Financial Resources

Although city council membership has largely remained consistent over the past seven years, the city has recently undergone changes in other important leadership roles. Three of the five current city council members have served on the council since at least 2014 and one former council member currently serves as the city’s treasurer. Another former council member served from 2014 until the election in 2020. The current city manager and finance director inherited the poor financial situation of the city when they began their employment. The previous city manager was with the city for nine years until his retirement in January 2018; in February 2018, the city council appointed the current city manager. The former finance director held his position for almost 19 years before retiring early 2019; two individuals then served in an interim capacity until the current finance director began his employment in January 2021. The city manager and finance department prepare and administer the city’s annual budget; the city council is responsible for safeguarding the city’s financial health and adopting its budget.

In fiscal year 2019–20, San Gabriel adopted a $67 million operating budget, of which the general fund accounted for nearly $42 million. The city’s main sources of income for its general fund include tax revenue and transfers from the Retirement Special Revenue Fund (retirement fund). The general fund obtains 58 percent of its revenue through taxes, such as property taxes, utility users’ taxes, and sales taxes, and 22 percent from transfers from the retirement fund. Specifically, San Gabriel receives revenue from a property tax to pay for the city’s share of CalPERS retirement costs. Additionally, the city has special revenue funds; these revenues are from sources restricted to expenditures for specific purposes. Some special revenue funds include the Capital Improvements Program Fund, the Sewer Fund, and the Waste Management Fund. As highlighted in Figure 1, the majority of San Gabriel’s general fund expenditures go toward funding services such as public safety (police and fire), public works, and community development. Additionally, of the nearly $42 million total general fund expenditures,
approximately 71 percent, or $30 million, pay for personnel costs, including salaries and retirement benefits.

**Figure 1**
San Gabriel's Budgeted General Fund Expenditures for Fiscal Year 2019–20 by Category

![San Gabriel's Budgeted General Fund Expenditures for Fiscal Year 2019–20 by Category](image)

San Gabriel’s Poor Financial Management Has Eroded Its Financial Condition

San Gabriel Continues to Rank as High Risk for Most Indicators of Financial Health

San Gabriel’s lack of available cash will continue to constrain its efforts to respond to unforeseen events and to reduce the risk to its financial health. This situation began when city leadership—city council and city management—prevented San Gabriel from using $7.8 million of its general fund cash beginning in fiscal year 2014–15 when it entered into a questionable loan and committed that amount as collateral. As a result, San Gabriel had no available cash in its general fund by the end of fiscal year 2015–16. Despite this condition, from fiscal years 2015–16 through 2017–18, the city continued to spend more than the revenues it received—further deteriorating its financial health—and had to rely on borrowing from other city funds to support its operations. Even though the city has taken recent steps to address its financial condition, the effects of the pandemic and its lack of available cash have negatively affected the city’s financial stability.

Since fiscal year 2016–17, San Gabriel has remained high risk in many indicators of financial health. Based on our analysis of its audited financial statements for fiscal year 2019–20, San Gabriel continues to show signs of fiscal distress for seven out of 10 of our financial indicators, as shown in Table 1. Specifically, it remains high risk for general

Table 1
San Gabriel Continues to Exhibit High Financial Risk

<table>
<thead>
<tr>
<th>INDICATOR EVALUATION</th>
<th>FISCAL YEAR</th>
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<td>General Fund Reserves</td>
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<td>Debt Burden</td>
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<td>Future Pension Costs</td>
<td>High Risk</td>
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<tr>
<td>OPEB Obligations†</td>
<td>Moderate Risk</td>
</tr>
<tr>
<td>OPEB Funding†</td>
<td>High Risk</td>
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California State Auditor’s Local High Risk Dashboard

San Gabriel’s audited financial statements


* Several financial indicators temporarily improved in fiscal year 2018–19 because of a one-time noncash contribution of $70 million that San Gabriel received from the San Gabriel Valley Council of Governments related to infrastructure, which cannot be used to pay for the city’s obligations.

† The fiscal year 2019–20 results are based on audited financial statements but are not yet available on our local high risk dashboard.

‡ OPEB = other post-employment benefits.
fund reserves and liquidity indicators because it still has a general fund reserves deficit of $8.1 million and roughly $6.4 million of its cash continues to be restricted as collateral with a lender. Furthermore, the city’s fiscal year 2019–20 level of risk related to its ability to fully pay for retirement benefits—pensions and OPEB—continues to mirror its risk during fiscal year 2016–17. Current and former employees have earned these benefits, but the city has not set aside enough funds to pay for the full cost of these retirement obligations. In addition, these obligations are expected to grow, putting more pressure on the city’s finances. If San Gabriel does not implement changes and adequately plan for the city’s long-term financial health, the status of its financial condition will continue to be poor—raising concerns about the impact this could have on the future operations of the city.

San Gabriel’s City Council and Former Management Have Allowed the City to Deplete Its Financial Reserves

San Gabriel remains in a precarious financial condition because it does not have financial reserves and has no available cash in its general fund. As a result, San Gabriel has had to borrow from its other funds to cover its obligations. As Figure 2 shows, San Gabriel had positive general fund reserves of $10.2 million in fiscal year 2014–15. That decreased over the next three years to a deficit of $9.9 million in fiscal year 2017–18. The city got into this tenuous financial position primarily based on three factors: the city council’s decision to enter into a loan in 2014 that restricted the use of much of its general fund cash, a lack of sufficient financial oversight by the city council, and a lack of fiscal transparency by former city management. The biggest part of the city’s general fund reserves deficit is related to this loan, which we discuss later in this report. The remainder is the result of deficit spending not supported by revenue, such as taxes or fees. In fiscal year 2019–20, San Gabriel’s general fund reserves deficit was $8.1 million—$6.4 million of which is due to the collateral requirement of this loan. This lack of general fund reserves and available cash limits the city’s ability to respond to fiscal emergencies and revenue shortfalls, and it could cause the city to have trouble maintaining services to its residents, especially considering the prolonged and uncertain economic impacts of the pandemic.

San Gabriel’s general fund reserves decreased steadily from fiscal years 2014–15 through 2017–18 because the city council did not exert adequate oversight over former city management. During these years, the former finance director and staff developed and presented general fund budgets and staff
reports to the city council that showed that San Gabriel’s revenues were generally covering expenditures and that the general fund had a positive fund balance. In reality, San Gabriel was consistently receiving less revenue than budgeted and frequently spent more than budgeted. Specifically, from fiscal years 2014–15 through 2017–18, actual general fund revenues were $11.4 million lower than budgeted and general fund expenditures were $8.9 million higher than budgeted for a total budget overrun of $20.3 million during these four years.

Former city management did not clearly disclose these revenue shortfalls and expenditure overruns to the city council and the public. The city’s municipal code requires the city’s finance department to prepare and present various reports to the city council with sufficient detail to show the exact financial condition of the city. However, from fiscal years 2014–15 through 2017–18, we did not find—and the city could not provide—documentation showing that the former city manager and former finance director provided to the city council periodic budget updates or that they presented the city’s audited financial statements publicly, even though such information would have shown that the city’s financial condition was in significant decline. Although the former finance director distributed audited financial statements to the city council via interoffice memos, these memos did not include descriptions or explanations of San Gabriel’s revenue shortfalls, expenditure overruns, or declining general fund reserves. Further, the city was unable to provide us with documentation that the city council ever asked for budget updates, formal presentations of the city’s audited financial statements that would include an explanation of the city’s financial concerns, or additional information on the city’s financial condition from the former management.

By failing to exercise the necessary oversight to ensure that city management had fully apprised it of the true financial condition of the city, the city council failed to fulfill its fiduciary responsibility over the city and in overseeing the city’s financial health. The city council adopted unrealistic budgets that overestimated revenues and underestimated expenditures, did not ensure that management held city departments accountable for overspending budget appropriations, and approved spending that depleted the city’s financial reserves.

“The city council failed to fulfill its fiduciary responsibility over the city and in overseeing the city’s financial health.”

The current city manager, who was appointed in February 2018, told us he learned of the city’s dire financial situation around the end of 2018 after its former finance director and its independent auditors informed him of the depleted general fund balance for fiscal year 2017–18. However, the city council should have already known of its declining general fund balance especially since its general fund reserves—the amount of its fund balance that is available to use without restriction—became negative at the end of fiscal year 2015–16. For fiscal year 2016–17, the city’s auditors issued a finding concerning the decline in the general fund balance during the previous two fiscal years. In its response to the audit, city management claimed it would address the situation to avoid further depletion of its general fund balance. However, for fiscal years 2017–18 through 2019–20, the auditors continued to express concern that the city had suffered significant reductions in its general fund balance in the audit opinion and in footnotes to the financial statements. They mentioned further that this condition raised concerns about the impact this would have on future operations of the city. Thus, the city council should have
taken a more active role in overseeing former
city management and in understanding the true
financial condition of the city.

Beginning in fiscal year 2018–19, San Gabriel’s
leadership implemented a number of
improvements to increase transparency and
communication between the city council and city
management and to control department spending.
For example, in May 2019, the city adopted its
fiscal sustainability policy, which requires, among
other things, that city management develop budget
documents that include actual past revenue
and expenditure results, that it disclose and
communicate San Gabriel’s financial condition
in periodic budget updates to the city council
and the public, and that it similarly present the
city’s audited financial statements to the city
council publicly. We found that city management
has generally provided this information since
2019. In addition, the fiscal sustainability policy
established notification and approval requirements
to prevent city departments from exceeding their
approved budget. For example, the policy requires
departments to monitor their budgets and notify
the city manager and finance director of possible
budget overages. According to the city’s audited
financial statements for fiscal years 2018–19 and
2019–20, the city has ceased expenditure overruns.

While these actions are an improvement over
previous city practices, the city continues to have
a significant reserves deficit, and the current
measures in place may not be sufficient to fully
address its financial problems. In October 2019,
to raise revenues, San Gabriel city council put
Measure SG, a 0.75 percent increase in sales tax,
on the ballot for March 2020. Voters approved
this tax, which went into effect on July 1, 2020.
According to the city’s midyear budget update,
the new tax generated $1.3 million in revenue
as of January 2021, which is generally on track
with the $2.8 million the city budgeted for fiscal
year 2020–21. At the time voters approved it, the
city projected that this new tax would generate
$3 million annually in new revenue and would
help rebuild its depleted reserves, but almost
simultaneously with Measure SG’s passage, the
pandemic began to negatively affect San Gabriel’s
economy. Although the pandemic has caused
other city revenues—like the hotel tax revenues
generated by San Gabriel’s hotels—to decline
dramatically by about $1 million for fiscal year
2020–21, the new Measure SG revenue has
mitigated some of these losses. According to
the city manager, this revenue has allowed the
city, at least in the short term, to avoid potential
furloughs, layoffs, and cuts to city services
that might have otherwise occurred. While we
recognize that this tax measure would have
helped the city to reduce its deficit if it had not
been for the pandemic, the city will need to
eliminate its general fund borrowing from other
funds, which we discuss later, before it can build
a reserve.

“While the city’s current
financial policies are
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Because San Gabriel’s general fund reserves
continue to have a deficit balance, the city may
have difficulty sustaining its future operations
because cities that do not have enough reserves to
pay for at least two months of expenditures may
have trouble maintaining service levels in times
of declining revenues or increasing costs. As we
have seen, San Gabriel has had a lack of adequate
reserves for the last five fiscal years and may
experience difficulty maintaining service levels
in the future. With the prolonged and uncertain
economic impact of the pandemic exacerbating
the situation, San Gabriel’s lack of financial
reserves will continue to threaten the city’s
financial health and its ability to provide services
to its residents.
San Gabriel Entered Into a Questionable Loan That Further Exacerbated Its Financial Problems and Restricted Its Available Cash

To pay for capital improvements, San Gabriel entered into two major loans in 2014 and 2015. In December 2014, the city entered into a loan agreement with Citizens Business Bank (Citizens Bank) for $7.8 million to complete the construction of the city’s public works yard (public works loan). As Figure 3 shows, this public works loan required San Gabriel to pledge an amount equal to the borrowed amount that would be held by the bank as collateral for 10 years. The bank charges a relatively low annual interest rate of 1.6 percent on the loan balance and the city earns about 0.6 percent interest on the collateral balance. On the other hand, the city cannot use the pledged amount to support city operations until it pays off the outstanding balance of the loan.

Because the city has used its general fund cash to fulfill the collateral requirement, it has significantly restricted its ability to pay for city services using cash from the general fund. Since fiscal year 2015–16, the city has not had any available cash in its general fund at year-end, yet it continued to overspend for two more years. To pay for this overspending and to adhere to the collateral requirement, the general fund borrowed money from other funds. This agreement to hold a significant portion of the general fund’s cash as collateral is unusual for a local government. The California Debt and Investment Advisory Commission (CDIAC) Debt Financing Guide, which provides guidance on how public agencies can use debt financing in the State, does not mention any loans that require a significant cash collateral requirement. The CDIAC lists many types of public debt, including direct loans, and often these forms of debt are secured through an existing revenue source such as a sales tax or a capital asset, like a building.

Figure 3
San Gabriel Restricted Its Access to Its General Fund Cash When It Collateralized Its Public Works Loan

As of June 2020, San Gabriel still had a significant balance on the loan. According to the city’s audited financial statements, the loan and collateral requirement had decreased from $7.8 million in fiscal year 2014–15 to $6.4 million as of the end of fiscal year 2019–20, as the city has paid down $1.4 million of the loan balance. The city must pay off the remaining balance of $5.4 million, of which $5.2 million is in the form of a balloon payment, in fiscal year 2024–25. This means that, unless the city takes other actions, its general fund cash will continue to be constrained by this loan until then if not longer. In a December 2014 letter, Citizens Bank indicated that San Gabriel has an option to extend the loan for two additional 10-year terms generally under the same terms as the original loan, but the interest rate charged will be based on the 10-year certificate of deposit rate at the date of the agreement plus 1 percent. According to the terms of the extensions, the city must also continue to maintain a cash amount equal to the loan balance as collateral with the bank. If the city chooses the first extension, we estimate it will pay roughly an additional $350,000 in interest over 10 years if the current rate remains the same, and its access to its cash will continue to be restricted until 2035.

The city council and management team at the time failed to adequately evaluate the financial impact of this loan. Although the city had approximately $6 million in its general fund reserves at the end of fiscal year 2013–14, this was below the amount it projected that it needed to fully pay for its public works project. San Gabriel did not have any outstanding third-party debt in fiscal year 2013–14, the year before it entered into the loan, and the current city manager indicated that to his knowledge the city has not had a credit rating from a rating agency, which is used to assess creditworthiness. A credit rating, although not generally required, can be advantageous for issuing bonds.

The city council and management team at the time failed to adequately evaluate the financial impact of this loan. Although the city had approximately $6 million in its general fund reserves at the end of fiscal year 2013–14, this was below the amount it projected that it needed to fully pay for its public works project. San Gabriel did not have any outstanding third-party debt in fiscal year 2013–14, the year before it entered into the loan, and the current city manager indicated that to his knowledge the city has not had a credit rating from a rating agency, which is used to assess creditworthiness. A credit rating, although not generally required, can be advantageous for issuing bonds.

One city council member indicated that the former finance director told the city council that the city had limited financing options because it did not have a credit rating. In a September 2014 staff report, the former finance director informed the city council that the finance department sought financing options from a number of entities, including bond underwriting firms, and that the public works facility loan was the lowest cost and best option. As a result, he recommended that the city council approve the loan.

However, it does not appear that the former city management provided the city council complete information on the financial impacts of funding this project through such a loan, nor did it provide other funding options. The city council meeting minutes and documents that city management provided to us do not show any discussion of potential negative effects or risks to the city’s financial condition, like the impact the loan would have on the general fund by tying up most, if not all, of San Gabriel’s general fund cash. Additionally, we did not find evidence that former city management provided to the city council alternatives, such as using its existing reserves to pay for at least part of the project or delaying the project. In 2014 the city council unanimously approved city management’s

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2 A balloon payment is a large payment due at the end of a loan. A balloon loan is set up for a relatively short term, and only a portion of the loan’s principal balance is amortized over the period. The remaining balance is due as a final payment at the end of the loan term. Balloon payment debts are more common in commercial lending than in consumer lending.
recommendation to enter into the loan. According to one city council member, he had concerns about the collateral requirement of the loan, but the former finance director said the city did not have other options and would need to approve the loan to finish the public works yard, which was completed in fiscal year 2016–17.

The collateral requirement of the loan has had a disastrous impact on the city’s finances. At the end of fiscal year 2014–15, the general fund had a $10.2 million reserves balance. As Figure 3 describes, $7.8 million of San Gabriel’s cash was restricted as collateral. As San Gabriel used the loan proceeds during fiscal year 2015–16 on the public works project, it continued to spend more than its revenues, which caused its general fund reserves to fall to a deficit of $4 million. Because the collateralized amount is not available for the city’s use, the general fund has had to borrow from other funds to pay the city’s obligations and maintain the collateral, which creates challenges in stabilizing its finances.

Specifically, the city used money from other city funds to cover general fund shortfalls and maintain the required collateral at the bank—a practice it has employed since fiscal year 2015–16. This practice is problematic because the general fund represents the financial health of the city and is expected to support city services and provide money for other funds as necessary. It should not regularly borrow money from other funds to support city operations. Figure 4 shows that in fiscal year 2019–20, San Gabriel’s general fund borrowed $8.5 million from other funds, including development impact fees and sewer assessments. As the text box describes, these funds generally receive funding through charges and fees paid by users, such as residents, and developers, and these revenues are intended to cover the costs of improvements related to those activities. As of June 2020, the city’s total borrowing from other funds and its outstanding loan balance equated to 49 percent of its general fund revenue in fiscal year 2019–20.

Because the general fund does not have the money to repay the other funds, this situation increases the risk that such borrowing could affect the services for which the other funds were intended, such as future improvements and repairs of San Gabriel’s sewer system. As of fiscal year 2020–21, the city has $5.4 million of funding budgeted for nine sewer system projects but has scheduled spending of only $1.1 million through 2024. The public works director asserted that the city is delaying those projects until it completes its sewer master plan update to avoid spending funds on projects that may no longer be relevant. Nevertheless, if the city’s general fund continues to borrow a significant portion of the sewer fund’s balance, there is a risk that the city will be unable to pay for its current or future sewer improvement projects. As of June 2020, the sewer fund had a balance of $6.5 million, but the city’s general fund borrowed $5 million

San Gabriel’s Special Revenue and Internal Service Funds

- **The Waste Management Special Revenue Fund** accounts for a solid waste surcharge from rate payers and is restricted for financing solid waste management-related programs.
- **The Sewer Assessment Special Revenue Fund** accounts for sewer user fees and is restricted for paying for the maintenance and capital improvements of the sewer system.
- **The Development Impact Fee Special Revenue Fund** accounts for fees from developers and is restricted for financing public facility improvements.
- **The three Self-Insurance Internal Service Funds** are used to account and pay for risk management services related to workers’ compensation and liability claims.

Source: San Gabriel’s adopted budgets and audited financial statements.
of these funds, leaving $1.5 million to use for sewer-related projects. Thus, the city cannot continue to afford to borrow funds dedicated for capital improvements to support its general fund shortfalls.

It is imperative that the city renegotiate or refinance the public works loan to free up its general fund cash, and San Gabriel is actively trying to refinance the loan to improve its liquidity and general fund reserves. Given that the public works loan carries a relatively low interest rate, if San Gabriel refinances the loan, it is probable the city’s new loan will have higher annual debt payments and possibly higher interest costs. We estimate that a 15-year loan with an interest rate of 2.6 percent—1 percent above its current rate—will result in roughly $650,000 in additional interest costs spread over the term of the loan. However, doing so would free up more than $6 million of cash that San Gabriel has currently pledged as collateral. A new loan without the cash collateral requirement would also reduce San Gabriel’s general fund reserves deficit by 78 percent and significantly reduce the need to borrow from other funds. Nevertheless, the general fund reserves would still have a deficit of approximately $1.7 million, based on the city’s fiscal year 2019–20 financial statements. However, when San Gabriel reaches a positive general fund balance, those funds would not be restricted as collateral and generally could be used for other purposes.

Unfortunately, because San Gabriel has had a deficit general fund reserves balance since fiscal year 2015–16, it will likely have difficulty finding willing lenders.

San Gabriel also entered into a second loan, one that the city did not manage appropriately, which resulted in the city paying interest costs for a loan it was not yet using. In May 2015, the city borrowed $3.8 million from the California Infrastructure and Economic Development Impact Fee Special Revenue Fund for 15 years at 3.5 percent interest primarily to help pay

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**Figure 4**

San Gabriel’s General Fund Borrowed Extensively From Other Funds Beginning in Fiscal Year 2015–16

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Amount Borrowed (in Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014–15</td>
<td>$3.8</td>
</tr>
<tr>
<td>2015–16</td>
<td>$1.9</td>
</tr>
<tr>
<td>2016–17</td>
<td>$2.1</td>
</tr>
<tr>
<td>2017–18</td>
<td>$6.3</td>
</tr>
<tr>
<td>2018–19</td>
<td>$10.8</td>
</tr>
<tr>
<td>2019–20</td>
<td>$12.5</td>
</tr>
</tbody>
</table>

for repairs to Del Mar Avenue, a major commercial corridor. Unlike the public works loan, San Gabriel secured this second loan by pledging Measure R revenues to pay the loan debt service. Measure R was a Los Angeles County ordinance that county voters approved effective July 2009 to implement a sales tax in the county for transportation projects. The San Gabriel city council, the board of directors of IBank, and the Los Angeles County Metropolitan Transportation Authority approved the IBank loan. This loan was costly because it required the city to accrue interest on the full balance beginning immediately regardless of when the city received the loan proceeds. Unlike other types of loans in which a lender charges interest as the borrower draws down the funds, the terms of the IBank loan stated that the interest accrues on the entire principal balance, whether or not the funds are disbursed. IBank loans are sometimes structured in this manner.

Given these loan terms, the city should have delayed entering into the loan until it was ready to begin work on the project. Initially the city planned to start the project in the spring of 2016 with completion expected by the fall of 2017, but the city did not finish disbursing these loan proceeds until fiscal year 2019–20—nearly three years later. The city expended only $200,000 of the $3.8 million on the project in fiscal year 2015–16. According to the San Gabriel public works director, the San Gabriel Trench project, which was already in progress, crossed Del Mar Avenue and likely delayed the starting of the project. Consequently, the city paid more than $100,000 in interest costs for a loan it was not then using. Ultimately, the city disbursed the remainder of the funds: $900,000 in fiscal year 2016–17, $525,000 in fiscal year 2017–18, $2.2 million in fiscal year 2018–19, and $211,000 in fiscal year 2019–20. However, the structure and timing of this loan caused the city to incur interest costs on a loan it was not using.

San Gabriel Needs to Consider the Continuing Impact of the Pandemic and Other Key Factors in Its Financial Projections

In its February 2021 midyear budget update, San Gabriel projected that it will continue to experience a negative general fund balance in fiscal year 2020–21, and this deficit will likely linger unless the city makes significant changes. The city manager’s office included a five-year forecast along with its meeting agenda for an October 2020 city council meeting and it has twice provided us updates to this forecast, in December 2020 and February 2021. In its February update, the city projects its general fund balance to steadily increase over the next five years. According to the city’s management specialist, this forecast model is a living document that is intended to be used as a guideline in preparing the city’s budget and as a tool during the year to adjust expenditures if revenues are not meeting projections. We used the city’s model and data from its February update to create our own forecast for the city’s general fund over the next five years.

Although many of the assumptions the city used to develop its projections were reasonable, the city did not consider key factors. For example, as of February 2021, the city projects that it will have around a $6.4 million general fund balance by the end of fiscal year 2025–26; however, potential salary increases and the sustained impact of the pandemic on revenues may prevent the city from increasing its general fund balance from what it is now. Moreover, the city’s projections do not account for the amount the city must set aside as collateral for the public works loan, and thus, they do not reflect the amount the city has available as reserves. Unless the city refinances its public works loan, it will continue to lack access to the cash it pledged as collateral. As Figure 5 shows, considering these factors we project that the city’s general fund will likely continue to have a significant deficit over the next few years, and this effect will appear
even more striking for the city’s general fund reserves when taking its collateralized funds into account.

As they have elsewhere, the economic consequences of the pandemic have had a significant effect on the city’s revenues, particularly hotel transient occupancy taxes (hotel tax). The city projects that it will receive additional revenue in the coming years from a new hotel. However, San Gabriel’s hotel occupancy and the associated tax revenue may recover at a slower pace than the city expects and therefore could be insufficient to address its financial problems. San Gabriel experienced a decline in hotel tax revenue from $3 million in fiscal year 2018–19 to $2.2 million in fiscal

Figure 5
San Gabriel Will Likely Continue to Have a Significant Reserve Deficit Through Fiscal Year 2025–26

Source: Analysis of San Gabriel’s most recent financial forecast.

Note: In March 2021, President Biden signed the American Rescue Plan Act of 2021, which provides money to state and local governments to assist them in recovering from the negative effects of the pandemic. Because this occurred at the end of our fieldwork and was not included in the city’s projections at the time of our review, the impact of these funds is not reflected in our projections. However, we discuss the potential effect these funds will have on the city’s finances on page 16.

* State Auditor’s projections exclude cash that the city must hold as collateral for its public works loan and is thus unavailable for use. This loan contributes between $6.1 million and $4.8 million to the general fund reserves deficit. We also factor a lower growth rate for hotel tax revenue, a modest personnel cost increase, and pension cost increases that will need to be covered by the general fund.
year 2019–20. The city expects a further decline to $1.2 million for fiscal year 2020–21, which is consistent with our projections. The city’s hotel revenue derives primarily from two hotels, and the city anticipates that the third hotel will be built by February 2022. The city expects that this new hotel will contribute significant additional hotel tax revenue and it projects a 108 percent increase in hotel tax revenue for fiscal year 2021–22.

However, we believe that hotel tax revenue will continue to be significantly affected by the pandemic and will recover more slowly. When we asked the city for support for its projected increase, the management specialist said that it was loosely based on educated assumptions and the city’s historical occupancy rates. The city manager stated that the city arrived at its hotel tax projections based on quarterly verbal conversations with the two major hotel operators. According to the agreement between the hotel developer and the city, the new hotel will have 225 rooms and the city anticipates it will have an occupancy of 85 percent, based on the occupancy rates of the two other similarly-sized hotels in San Gabriel; however, the occupancy rate that the city cited was for fiscal year 2018–19, the last pre-pandemic fiscal year.

Conversely, forecasts by tourism and hotel industry-focused organizations predict that hotel occupancy rates and hotel revenue will grow far more slowly. One such organization—Visit California—projects that occupancy rates for hotels in the Los Angeles region will increase to about 68 percent by 2023, which is below the 2019 rate of 78 percent. Another organization predicts that the Los Angeles area will not return to 2019 occupancy levels until mid-2024. Using revenue growth forecasts from Visit California and because the new hotel is not expected to open until at least February 2022, we believe a conservative projection of $1.6 million—a 33 percent increase from fiscal year 2020–21—is more reasonable than the city’s projection of $2.5 million (a 108 percent increase) for fiscal year 2021–22. Further, the city has an agreement to repay the hotel developer for offsite improvements, in part, with 50 percent of hotel tax receipts from the new hotel for up to 12 years. If the new hotel opens fully in March 2022, we estimate that the city would repay the developer between $100,000 to $150,000 through the end of fiscal year 2021–22, which would cause its net hotel tax revenue for 2021–22 to fall as low as $1.5 million.

Additionally, while San Gabriel has recently forgone increases to some personnel costs for city employees, future adjustments may have a considerable impact on the city’s general fund if savings are not found elsewhere. The city manager indicated that the city has deferred salary increases for certain employee groups. For example, as of January 2021, the city has current memorandums of understanding in place with two of its four collective bargaining units that include only minor benefit increases and do not include salary increases through fiscal year 2020–21. However, if we add a modest cost-of-living adjustment of 1 percent for city employees from the general fund, the city’s total personnel costs between fiscal years 2021–22 and 2025–26 would increase by more than $2 million. Although any future salary increases will depend on negotiations...
between the city and its labor groups, even small increases will have a significant effect on the city finances.

Moreover, the city’s projections likely understate the amount its general fund must pay in future years to cover its rising retirement costs. As we discuss in the Introduction, San Gabriel receives revenue from a property tax to pay for the city’s share of CalPERS retirement costs. Although the city includes the required pension contributions for the next five years in its model, we project that the city’s retirement fund will not be able to completely pay for retirement costs in future years and that the general fund will have to make up any shortfalls. We estimate that the general fund may have to provide more than $2 million total to meet the retirement costs between fiscal years 2022–23 and 2025–26, as we discuss further in the next section.

Further, the city’s current financial projections fail to account for the balloon payment that will be due in January 2025 for its public works loan, which will likely have an outstanding balance of $5.2 million at that point unless the city renegotiates its loan agreement. Even if the city has a positive general fund balance in fiscal year 2024–25, a balloon payment of $5.2 million would have a profound effect on the city’s finances.

The city manager told us that the city believes its projections of its revenues and expenditures are reasonable and that the city has made an effort to be conservative in the assumptions in its model. For example, it included a 4 percent increase for property tax revenues even though the city’s property tax revenue has trended higher. However, we believe that the city could improve its projections. According to the Government Finance Officers Association (GFOA), it is a budgeting best practice to analyze major revenue sources to identify forecasting assumptions and whether potential trends are likely to continue. This analysis is useful beyond creating budgetary projections by also enabling a city to uncover potential issues in advance and develop options so as to take action in a timely manner. By delaying an in-depth analysis of key revenue sources and future costs, including factors that are unusual, such as the pandemic and the effect of the loan collateral on its general fund reserves, San Gabriel may miss opportunities to help build a positive general fund balance.

The federal government has recently provided a substantial boost to San Gabriel’s financial condition. In March 2021, President Joe Biden signed the American Rescue Plan Act of 2021. This act provides money to state and local governments to assist them in recovering from the negative effects of the pandemic. Specifically, San Gabriel is allotted more than $7.5 million over two years. The city will receive up to $3.75 million each year in fiscal years 2020–21 and 2021–22. These recovery funds will assist the city in reducing its general fund reserve deficit and likely reduce the amount it borrows from other city funds. We estimate that San Gabriel could reduce the city’s reserves deficit balance to $2.8 million for fiscal year 2020–21. Likewise, with the second infusion of federal stimulus funds it could further reduce its general fund reserves deficit to $177,000 for fiscal year 2021–22. According to the city manager, the city intends to use the bulk of the stimulus funds to reduce its general fund deficit. However, these are specific appropriations of federal funds, and the city will not be able to rely on them for future ongoing expenditures. Further, because of the public works loan, the city will likely continue to have insufficient reserves for the next few years.

“We believe that the city could improve its projections.”
Therefore, to meet its financial obligations, the city must develop a comprehensive plan to guide its financial recovery in the long term, including how it will handle this loan, reduce expenditures, and increase revenues.

San Gabriel Has Not Implemented a Comprehensive Financial Recovery Plan

Although San Gabriel has adopted and implemented several stand-alone policies aimed at improving the city’s long-term financial health, the city lacks a formal, comprehensive, long-term financial recovery plan. The city finance department developed a long-term financial plan that finance staff presented to the city council in January 2019. However, the city council did not formally adopt the plan, and the current city manager indicated that the city has not used this plan. According to the current city manager, the city only used the January 2019 plan to identify options for creating additional revenue sources to aid in its recovery. The city eventually arrived at the need to adopt a new sales tax, which voters approved in March 2020.

The city has taken some steps to strengthen some of its financial policies. In May 2019, city management recommended and the city council adopted a fiscal sustainability policy that established guidelines for San Gabriel’s overall fiscal planning and management. Some of the guidelines in the policy include requirements that the city fund current operating expenditures only with current operating revenues, place one-time revenues in reserves and not use them for operating expenses, and establish user fees and charges for services to achieve full cost recovery.

San Gabriel leadership also adopted a fund balance reserves policy (reserves policy) in May 2019 that requires that the city maintain a minimum general fund reserves balance of 17 percent of its annual operating expenditures. This threshold represents the equivalent of two months of reserves—the minimum amount the GFOA recommends.

In this policy, San Gabriel also established a seven-year schedule for reaching its reserves requirement, and it requires the city manager to develop a plan for replenishing the reserves in a reasonable time frame should the reserves fall below the required minimum level in the future. Furthermore, the city has developed a five-year forecast that, according to the current city manager, allows the city to gauge its progress in building its general fund reserves following the schedule set in its reserves policy.

Although these policies, practices, and forecasts are important, they lack specific actions for how the city will achieve its financial goals. When we asked the city manager why San Gabriel has not developed and adopted a formal financial recovery plan, he disagreed that it did not have one, stating that San Gabriel’s fiscal sustainability policy, fund balance reserves policy, and five-year forecast, taken together, serve as its long-term financial plan although it is not in a single formal document. The city manager also told us that implementing the new Measure SG sales tax, monitoring revenues for shortfalls and expenditures for overruns, and deferring salary increases for city employees is evidence that the city has a long-term recovery plan to rebuild the city’s general fund reserves and is following it. We verified that the city has taken action or plans to take action on each of these items. However, as previously discussed, the city needs to consider the ongoing impact of the pandemic and other key factors in its five-year forecast, and these policies do not outline specific recovery strategies or actions for how the city will rebuild its general fund reserves and address other significant financial challenges, such as its large unfunded pension and OPEB obligations. The lack of a comprehensive plan addressing all the city’s areas of financial risk could affect its financial recovery. The city should develop a more robust plan that specifies, both in the short term and long term, how the city will rebuild its general fund reserves, and it should address...
the city’s lack of general fund liquidity, its unfunded pension and OPEB obligations, and refinancing of the public works loan.

Developing this comprehensive and detailed plan will help city leadership focus its direction, identify key recovery strategies, and articulate the specific actions needed for the city to reach financial sustainability. The GFOA notes several essential elements of a financial recovery plan. As Table 2 shows, San Gabriel’s current policies are lacking in specific recovery strategies or an operational action plan for how the city will achieve these goals in both the short and long term. By developing a comprehensive financial recovery plan that includes these elements city leadership can introduce more accountability into the financial recovery process and more consistency into the actions of the city should there be future turnover of city council members or members of the management staff. A comprehensive and formal financial recovery plan will also provide the public an additional benchmark with which to gauge the progress of the city’s financial recovery and the performance of city leadership in achieving that recovery.

Recommendations to Address This Risk:

• To ensure efficacy and accountability in its financial recovery process, city management should develop and the city council should formally adopt a comprehensive financial recovery plan by October 2021, that includes the following:
  » Descriptions of short-term and long-term goals.
  » A description of financial challenges the city faces, such as low reserves.

Table 2
San Gabriel’s Policies Lack Key Elements of a Comprehensive Financial Recovery Plan

<table>
<thead>
<tr>
<th>RECOVERY PLAN ELEMENTS AS OUTLINED BY THE GFOA</th>
<th>DESCRIPTION OF ELEMENT</th>
<th>SAN GABRIEL POLICIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description of goal</td>
<td>Description of short- and long-term financial goals.</td>
<td>✓</td>
</tr>
<tr>
<td>Financial projections</td>
<td>Projections of both current and future revenues and expenditures.</td>
<td>✓</td>
</tr>
<tr>
<td>Recovery strategies</td>
<td>Specific strategies to be undertaken to preserve an entity and to remain financially viable.</td>
<td>✗</td>
</tr>
<tr>
<td>External environmental analysis</td>
<td>A process to identify all the external elements that can affect an organization’s performance.</td>
<td>✗</td>
</tr>
<tr>
<td>Budget process analysis</td>
<td>An analysis of where improvements in the budgeting process can be made.</td>
<td>✓</td>
</tr>
<tr>
<td>Budget reform plan</td>
<td>Changes to how the government collects and spends money.</td>
<td>✓</td>
</tr>
<tr>
<td>Operational analysis</td>
<td>A systematic analysis to determine whether each area of the organization is contributing effectively to overall performance and the furthering of the organization’s strategic goals.</td>
<td>✗</td>
</tr>
<tr>
<td>Operational action plan</td>
<td>A highly detailed plan of how a team or department will contribute to the organization’s goals.</td>
<td>✗</td>
</tr>
<tr>
<td>Risk assessment</td>
<td>An identification of hazards that could negatively impact an organization’s ability to conduct business.</td>
<td>✗</td>
</tr>
</tbody>
</table>

Source: Analysis of current San Gabriel’s financial policies, GFOA best practices, and financial industry publications and websites.
» An analysis of the external and internal elements that may affect the city’s ability to reach its goals.

» Strategies to build and preserve its general fund balance, including building and maintaining general fund reserves sufficient to fund at least two months of expenditures.

» Actions that the city plans to take to address its challenges and a timeline for completing those actions.

» Identification of individuals or departments responsible for monitoring and reporting the city’s progress to the city council.

• To ensure that San Gabriel has relevant information for making decisions, it should update its financial projections to include in-depth analysis of key revenue sources and future costs, including factors such as the pandemic and the effect of the loan collateral on its general fund reserves, among other factors.

• To eliminate the general fund’s need to borrow from other funds, San Gabriel should develop a plan by October 2021 to renegotiate or refinance the public works loan to free up its general fund cash. In making its decision, it should consider the short- and long-term impact of its financing choice on its general fund and on the operations of the city.

• San Gabriel should create a policy by October 2021, that describes options and considerations it will evaluate and present to its city council when entering into debt, including the following:
  » An analysis of alternative methods of financing.
  » The impact on city finances, in both the short term and long term.
Blank page inserted for reproduction purposes only.
San Gabriel Needs to Consider Additional Expenditure Reductions and Revenue Increases

San Gabriel Needs to Address Its Rising Employee Retirement Costs

San Gabriel’s growing retirement benefit costs will likely put additional pressure on its general fund. The text box summarizes key terms related to the city’s retirement costs. San Gabriel, like other California cities, is experiencing high pension costs and a large unfunded pension liability in part because of these reasons:

- CalPERS experienced large decreases in the market value of the investments it held on the city’s behalf to cover the cost of these pension obligations during the financial crisis in fiscal year 2008–09.

- CalPERS decreased its expected rate of return on its investments.

- The population of retirees has tended to live longer and draw upon pension assets for a longer duration than initially anticipated.

Pension Benefits

San Gabriel had a total pension liability of $229.8 million as of June 2020. However, the city has only set aside funding to pay for a portion of those pension benefits that its employees have already earned. As of June 2020, the city had a pension funded ratio of 69 percent, meaning that the city has funded only $158.6 million of these benefits, leaving an unfunded balance of $71.2 million. We consider cities with a funded ratio below 70 percent to be at high risk. Because San Gabriel has not fully funded the pension benefits already earned by its employees, CalPERS projects that San Gabriel’s annual required pension payment will increase by about 25 percent, or $1.9 million, by fiscal year 2024–25.

Although it has a special property tax to help pay the retirement costs of city employees (retirement tax), the city may need to find additional sources of funding to pay for its increasing pension costs. San Gabriel voters originally approved the retirement tax in 1948. Since at least fiscal year 2015–16, the city council has annually approved a tax rate intended to generate revenue not to exceed the amount needed to meet the city’s pension obligations. Currently the city

Retirement Cost Terms

Pension liability: The total cost of pension benefits a city’s employees and retirees have earned that the city is obligated to pay.

Unfunded pension liability: The difference between an entity’s total pension liability and the assets that it has invested in its pension fund.

Normal payment: A city’s annual payment to CalPERS to cover the cost of pension benefits earned by its employees that year, calculated as a percentage of the city’s payroll.

Unfunded liability payment: An additional annual payment a city makes to CalPERS to decrease its unfunded pension liability.

Source: CalPERS annual valuation reports.
has set the tax rate at 14 cents per $100 of assessed property value. The city manager noted that the retirement tax has kept pace with growth in the city’s normal payments and annual unfunded liability payments, and we verified that the tax revenue was greater than the city’s total retirement costs for fiscal years 2016–17 through 2019–20. By continuing to pay the annual required pension payments to CalPERS, the city is projected to pay down its current unfunded pension liability by fiscal year 2045–46. However, if CalPERS achieves lower than expected or negative returns on its investment portfolio, the value of the investments that it holds on San Gabriel’s behalf will decrease, creating more unfunded liability and in turn increasing the city’s annual payments.

In the event that the city’s total retirement payments exceed the retirement tax revenue, the city will either have to cover the shortfall with general fund revenue or request an increase in the retirement tax rate through the voters. We estimate that the revenue generated by the retirement tax will likely be insufficient to cover its annual required pension payment from fiscal years 2020–21 through 2024–25 by an average of about $230,000 annually. Therefore, the city may benefit from temporarily increasing the tax rate or issuing pension obligation bonds (pension bonds), as we discuss below. However, as Table 3 shows, these options are not without risks.

Although raising sufficient additional tax revenue to pay for increasing retirement costs is an option, the city would need to obtain voter approval. By our estimate, an increase from the current 14 cents to 15 cents per $100 of assessed property value would likely generate enough revenue to cover the city’s annual required pension payment through fiscal year 2024–25. San Gabriel’s city manager noted that the city cannot increase the current rate without voter approval. State law generally prohibits a local government from increasing a tax unless its voters approve the increase. If the city’s voters gave

Table 3
San Gabriel Should Weigh the Benefits and Risks of Its Options to Secure Funding for Its Retirement Costs

<table>
<thead>
<tr>
<th>PENSION FUNDING STRATEGY</th>
<th>BENEFITS</th>
<th>RISKS</th>
</tr>
</thead>
</table>
| Temporarily Increase the Retirement Tax Rate | • Adjusting the retirement tax rate would give the city greater flexibility to secure funding for retirement costs without needing to use general fund revenue.  
• An increase from 14 cents to 15 cents per $100 of assessed property value could be sufficient to fully cover the city’s increasing annual pension costs in certain fiscal years. | San Gabriel’s voters may reject a tax increase measure. |
| Issue Pension Bonds | The city could transfer the proceeds to CalPERS, resulting in significantly lowered annual unfunded liability payments. | • The city would be required to make annual debt payments.  
• The city could use up its limited debt capacity, reducing its ability to take on debt for other purposes, such as infrastructure improvements.  
• If CalPERS does not achieve its expected rate of return on plan assets or achieves negative returns, the city would have to pay both annual debt payments and higher unfunded liability payments. |

Source: Analysis of San Gabriel’s financial statements, CalPERS reports, and GFOA guidance.
the city council the ability to increase the tax rate as needed, the city would have greater flexibility to secure funding for its retirement costs without needing to use general fund dollars. However, San Gabriel’s voters could reject such an initiative, or the city council could opt not to increase the rate even if the initiative did pass. Therefore, the city would benefit from proactively identifying additional sources of potential funding to guard against years in which its retirement costs will be greater than its retirement tax revenue.

Alternatively, or in conjunction with increasing the retirement tax rate, the city could issue pension bonds to reduce the annual cost of its unfunded pension liability. By issuing pension bonds, the city could transfer the bond proceeds to CalPERS to reduce its unfunded pension liability and potentially lower its annual unfunded liability payments. The city manager stated that the city is exploring the possibility of issuing pension bonds and plans to present an analysis to the city council. However, the city could still have difficulties issuing pension bonds because of its general fund deficit. The city manager indicated that although he is not inclined to recommend that the city issue further debt, favorable market interest rates make issuing pension bonds an option worth considering. He added that the retirement tax as a dedicated revenue source could mitigate creditor’s concerns over the city’s poor financial condition.

Pension bonds do carry considerable risks. The city’s unfunded pension liability could still increase if CalPERS experiences lower than expected investment returns or negative returns, in which case the city would need to identify revenues to cover both its debt payments and any increase in the cost of its unfunded liability payments. Further, the GFOA warns that issuing pension bonds reduces a city’s ability to take on debt for other purposes, such as infrastructure improvements. To ensure that it can continue funding its increasing retirement costs without using general fund revenue, the city should assess the extent to which it can increase its retirement tax rate and weigh the benefits and risks of issuing pension bonds.

Other Post-Employment Benefits

San Gabriel’s total net obligation for OPEB, which includes other benefit costs such as retiree health care, has also increased in recent years in part because the city has paid less than the amount needed to fully fund the costs of those benefits. From June 2018 to June 2020, San Gabriel’s accumulated unfunded OPEB liability increased from $24 million to $46 million, nearly doubling in only two years in part because the expected rate of return on the investment of the plan’s assets was lowered in fiscal year 2017–18 and because the city has stopped prefunding these costs. As of June 2020, the city has set aside only 11 percent—about $5.9 million—of the funds needed to pay for OPEB costs for benefits already earned by employees.

As the city’s unfunded OPEB liability increases, its annual payments to CalPERS also increase. Over the next five years, the city’s annual OPEB payments are projected to increase from $1.8 million to $2.4 million—more than 31 percent. This is problematic, in part because the city does not require its employees to contribute toward their OPEB costs. The city also currently does not prefund its OPEB costs by contributing to its OPEB trust, which includes money set aside to pay for anticipated OPEB costs. Instead the city uses the pay as you go method, only covering the annual cost of the benefits for current retirees but not making payments to proactively fund the health benefits it will be obligated to pay for its current and future employees when they retire. Although the city previously contributed to an OPEB trust—for example, allocating $113,000 in fiscal year 2017–18—the city stopped contributing to its
OPEB costs in fiscal year 2018–19 because of the city’s increasing pension costs and poor financial condition.3

However, if the city does not address its unfunded OPEB liability, the liability will continue to grow and put further pressure on its general fund. For example, if the city were to negotiate with its employee unions and its employees agreed to contribute 3.5 percent of their salaries to fund OPEB costs—the rate normally paid by state employees represented by the Service Employees International Union—that contribution would enable the city to pay an additional amount of approximately $500,000 annually toward its total OPEB liability. According to the city manager, the city will consider these benefit costs during its negotiations with its employee unions and will pursue employee contributions with them. The city should also develop a long-term plan for fully funding OPEB obligations.

3 Beginning in fiscal year 2008–09 San Gabriel established a trust with CalPERS—specifically, the California Employers’ Retiree Benefit Trust—for OPEB.

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Figure 6
Mission Playhouse Operating Expenditures Have Significantly Exceeded Operating Revenues Since at Least Fiscal Year 2014–15

Note: Revenue amounts here do not include funding to the playhouse from San Gabriel’s general fund or retirement fund.
San Gabriel’s Mission Playhouse’s Operating Deficits Contribute Significantly to the City’s Ongoing General Fund Deficit

The city owns and operates the Mission Playhouse—a community center that hosts various events, such as theater and music performances and public meetings. Its main sources of revenue are rental and service fees that clients pay to use the playhouse and funding that the city provides to the playhouse to help cover its costs.

Since at least fiscal year 2014–15, the playhouse’s operating expenditures have exceeded operating revenues. As Figure 6 shows, playhouse operating expenditures have exceeded operating revenues by amounts ranging from approximately $500,000 in fiscal year 2014–15 to more than $1.1 million in fiscal year 2016–17.

As a result of the significant and consistent operating deficits, the city has had to provide funding for the playhouse to remain solvent. Between fiscal years 2014–15 and 2019–20, the city used the general fund to give the playhouse more than $4.2 million—an average of $700,000 a year—despite the poor financial condition of the city. In fiscal year 2020–21, San Gabriel limited the amount of funding it will contribute to the playhouse to $250,000. The city manager also indicated that the city is only planning to contribute between $250,000 and $350,000 for every fiscal year thereafter. According to the city manager, the city anticipates that these amounts should be enough to cover the costs of the playhouse going forward because the city has attracted nontraditional sources of revenue for the playhouse, such as socially distanced video-streamed dance contests. In addition, the city revised its playhouse fee structure in late 2019 to generate more revenue, and the city manager anticipates that the city will not need to increase transfer amounts to the playhouse once activity ramps back up to pre-pandemic levels.

The city hired a consultant to conduct an evaluation of the playhouse and its operations, which was presented to the city council in August 2020. The report noted that the playhouse had been scheduled for use only 45 percent of the days in fiscal year 2017–18 and 57 percent of the days in fiscal year 2018–19. The consultant observed—among other items—that increasing the use of the facility, especially on weekdays, to maximize revenue should be a critical goal. However, the city manager explained that due to the pandemic, the city has not implemented many of the report’s recommendations, which included creating a Mission Playhouse Advisory Committee, developing a strategic plan for the playhouse, and creating a pool of volunteers for playhouse events.

Because of pandemic-related closures, the Mission Playhouse has been operating in a limited capacity with reduced revenue and expenditures, a situation that may be prolonged as the economic effects of the pandemic continue. Although the city has limited the funding it plans to contribute, the playhouse will continue to burden the city’s general fund if the city does not ensure that the playhouse reduces ongoing expenditures or raises additional revenue to fully support its operations. According to the city manager, once the playhouse is open again to live audiences, the city intends to work with the city council and the community to implement the consultant’s recommendations and—should fiscal expectations not be met—to evaluate the playhouse’s revenues and expenditures and work with the city council to determine what actions to take.

San Gabriel May Have Forgone Additional Revenue Because It Has Not Updated Its Fees for Certain City Services

By not periodically updating its fees, San Gabriel has not ensured that it collected much-needed revenue that could help relieve
the financial burden on the city’s general fund. Under state law, the city may establish its fees at levels that allow it to recoup the full cost of the services it provides as long as it does not exceed the reasonable costs of providing those services—a concept referred to as full cost recovery. Most of San Gabriel’s fees help pay for services such as recreation programs, public safety, and public works, and they include fee types covering services such as facility rentals, building permits, and waste management services. However, city management has not evaluated whether the fees it charges for services align with the full cost of those services since 2016. Although the city contracted for a comprehensive review of all city fees in 2016, the city did not fully implement recommendations in the fee study. According to its fiscal year 2019–20 fee schedule, although it updated some fees based on the 2016 fee study, the city has not adjusted the majority of its fees in the last four years, and some have not been updated since 2002.

The cost of providing the majority of the fee services is primarily paid through the general fund; the city uses the general fund to pay for costs incurred as a result of a service, and the fees the city collects for the service are intended to help reimburse the general fund for that cost. By not periodically assessing the cost of providing these services and increasing the fees to cover them, San Gabriel is continuing to miss an opportunity to minimize the burden on its general fund. Moreover, state law defines a charge for a service that exceeds the reasonable price of providing the service as a tax, which is then subject to the State’s requirements for imposing taxes, including a requirement that the city submit and obtain voter approval in order to implement the tax. Thus, because the city has not evaluated the full cost of services and the fees to cover those services since 2016, it risks both undercharging and overcharging fees for those services. If it undercharges, the city further subsidizes those services from the general fund. However, if it overcharges, the city exposes itself to taxpayer lawsuits for imposing a tax in violation of state law.

Because the city has not assessed whether its fees were fully recovering costs since 2016 and because it was undergoing a new contracted fee study during our audit, we were unable to determine the total revenue it has forgone by charging less than full cost recovery. However, using a conservative approach, we estimated that if the city increased just half of its general fund revenues from fees to keep pace with inflation, it may have been able to collect more than $300,000 over four years—additional revenue that could have helped reimburse its general fund for the cost of providing these services.

The city presented to the city council the results of its latest fee study in early April 2021 and it plans to update its fees as part of the budget adoption in June 2021. The new fee study could provide the city with information regarding charges for services and help ensure that it is recovering costs.

Recommendations to Address This Risk:

- To ensure that its rising pension costs do not create a burden on the general fund, San Gabriel should identify and develop an analysis of the benefits and risks of alternative methods of paying for these rising costs, such as increasing the retirement tax or issuing pension obligation bonds.

- To limit costs related to employee retirement benefits, San Gabriel should negotiate with its unions for employees to contribute a reasonable portion of their salaries to fund their future OPEB benefits.

- San Gabriel should develop a long-term funding plan to address its OPEB liability. The plan should include
actions necessary to ensure that the city will be able to meet its obligations to its employees and retirees.

- To reduce the negative impact of the Mission Playhouse on the city’s financial condition, San Gabriel should implement recommendations from its consultant reports including developing a strategic plan that maximizes the use of volunteers and pursuing other measures that reduce expenditures and increase revenue.

- To ensure that the fees it charges for services align with costs, San Gabriel should develop and implement policies and procedures to require it to do the following:
  » Develop methodologies for determining the full cost of those services to ensure that it is not overcharging or undercharging for services.
  » Reevaluate the costs of its fee-funded services at least every three years. It should develop a plan to adjust its fees to fully recover costs, including a phased-in approach for large increases.
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Gaps in San Gabriel’s Management Controls Increase the Risk of Inefficiency and Waste

San Gabriel Does Not Monitor Contract Costs or Ensure That It Receives the Best Value for Its Procurements

**Competitive Bidding**

San Gabriel has not always adhered to its policies requiring competitive bidding of contracts. Specifically, of the eight contracts we reviewed, we identified one instance in which the city council approved contract amendments that extended the terms of the original contract over several decades and another instance when the city council approved new contracts for different services with the same vendor without seeking competitive bids. As a result, the city contracted exclusively with certain vendors for many years without seeking competitive bids from other firms to evaluate their services and costs. The city’s purchasing policy requires a formal competitive bid process for contracts worth more than $15,000 and notes that contracts should generally have a maximum term of three years. The *State Contracting Manual* (SCM)—which provides guidance for managing contracts to state agencies and identifies government contracting best practices—also recommends that contracts for services should generally not exceed three years unless the contracting entity can provide a written justification for a longer term for business reasons. For example, in the event that a contractor for the city needs to acquire financing to purchase equipment necessary to provide the service, the required loan repayment may be for a period of longer than three years. The SCM also notes that entities should not use amendments to circumvent the competitive bidding process.

Through repeated use of contract amendments, the city has not competitively bid its waste collection contract for more than 70 years. Figure 7 shows that the city initially executed two contracts in 1948 and 1951 with a waste collection firm and then amended those contracts a total of 16 times and substantively revised the terms of those contracts two times, once in 1957 and again in 2000. Nine of those contracts and amendments increased the duration of the contract, ranging from an additional three years to an additional 25 years. In 2000 the city executed a substantially rewritten, amended, and restated agreement with its then-current contractor, again without competitive bidding. That amendment was effectively a newly rewritten contract, intended to consolidate the terms of all of the amendments the city had previously executed. The most recent amendment, from 2020, extended the contract term to an ongoing service period of 25 years with an automatic one-year extension each year, referred to as an *evergreen period*. If the city subsequently decides to terminate its waste collection contract, the one-year term would not automatically renew, but the city would still be obligated to remain in the contract for 25 years from the termination date. The city manager noted that it is not unusual for cities to have such evergreen terms in their waste collection contracts.

Nevertheless, by failing to seek competitive bids from other waste collection companies to evaluate proposed collection rates, the city cannot ensure that its residents and businesses are paying competitive rates. Although the city itself does not make any payments under this contract, the contractor collects fees directly from San Gabriel’s residents and local businesses.
By forgoing a competitive bidding process and systematically extending the contract’s term, the city has committed its residents to paying the contractor’s rates without verifying that the contract is providing the best value to them. Consequently, the city residents and businesses may be overpaying for these services.

By not procuring waste collection services through a competitive bidding process, the city also likely missed opportunities to obtain franchise fee revenue for more than 60 years. A franchise fee is a fee paid by a contractor providing a utility—such as waste collection—for the right to provide that service in a city and to use the city’s streets. The original contract from 1948 stipulated that the waste contractor pay the city 25 percent of its gross annual receipts from the contract. However, a substantively revised contract executed in 1957 removed that term and the contractor was allowed to keep the whole of the amount it collected from its customers. Thereafter, the city did not collect any fees from the contractor until 1992, when the city council adopted an additional waste management fee that the contractor collects directly from its customers and remits to the city.

Nevertheless, the city did not charge a separate franchise fee until 2020. In 2019 the city conducted a survey of 10 other cities in Los Angeles County and found that seven of those cities charged a franchise fee to their waste collection contractors, including three cities that used the same waste collection company as San Gabriel. According to the city manager, the results of the survey provided

Figure 7
The City Has Not Conducted a Competitive Bid for Waste Collection for More Than 70 Years

Source: San Gabriel contract documents and city council meeting minutes.
San Gabriel with information that it used to negotiate with its contractor, which ultimately led to the city’s 2020 amendment requiring the contractor to make an annual payment to the city of $350,000 that will increase each year in alignment with the Consumer Price Index (CPI). Had the city previously charged such a franchise fee that increased in alignment with the CPI, it could have collected a total of $3.4 million in revenue from fiscal years 2009–10 through 2019–20. The city’s failure to solicit proposals from multiple waste collection companies likely contributed to its failure to secure such a revenue opportunity at an earlier date.

In another instance, the city did not competitively bid two architectural service contracts for different phases of a project but instead re-awarded them to the same company, even though long delays in construction paused the project for a total of 17 years. The city executed three separate contracts with the company, each for a specific phase of the project: a needs assessment phase, a schematic design phase, and a design refinement and construction requirements phase. In 2000 the city competitively bid a needs assessment contract for a new police facility and executed a contract with a vendor. Upon completion of that first phase of the project, the city executed a new contract with the same company in 2001 without rebidding. The police chief, city attorney, and city council at the time asserted that consistency was in the city’s best interest. However, the city delayed the project for nine years, citing design changes, relocation, and budget constraints, so the contractor did not complete the second phase until 2010. The city then awarded a third contract to the same vendor in 2010 totaling $1.7 million, again without a rebidding process. The city again delayed the project for eight years, citing similar reasons, before finally entering the construction phase in 2018.

Despite spending this money, this project was not completed and the city cancelled its contract with the company in fiscal year 2019–20. The assistant finance director stated that the city has removed the incomplete project from its capital improvement program. Nevertheless, the city has had multiple contracts with the same vendor for nearly 20 years without competitive bidding despite executing three separate contracts for distinct project phases for a facility that was ultimately not built. Although the delays may have been unrelated to the contractor’s performance, the city could have requested proposals from a variety of vendors before executing a new contract to ensure that it was receiving the best value instead of continuing to rely on the results of the original competitive bid from 17 years before.

**Contract Management**

We also found that San Gabriel does not have a centralized system for monitoring its current contracts, which compromises its ability to prevent departments from overspending the amount of their contractual service budgets. Because of its insufficient contract tracking system, the city cannot track the total costs associated with each of its contracts over multiple years, and city management cannot determine total citywide annual contract costs. This increases the risk of cost overruns and decreases the city’s ability to oversee its departments’ spending, likely contributing to some city programs routinely exceeding their contractual expenditure budgets. In fiscal year 2017–18, for example, San Gabriel exceeded its total citywide budget for contractual service expenditures by $468,000, or 19 percent.

Because the city does not have a central system to identify all of its current contracts, city officials were unable to provide us with a comprehensive list of its contracts. In response to our request for an updated list
of all of the city’s contracts, the city provided information from two different sources: the chief city clerk provided a spreadsheet used to track contract expiration dates, and the city’s management specialist prepared a list of contracts based on vendors in the city’s accounting system. However, the two lists do not agree, and neither is complete as each is missing several contracts. By generating expenditure reports from the city’s accounting system and using the account code designated for recording expenditures pertaining to contract services, the management specialist was able to determine the amount the city paid to vendors providing contracted goods and services. In doing so, she was able to create a list of the city’s existing contracts. However, this method identifies only those contracts against which the city has made payments, so it would overlook other contracts without payment activity, including newer contracts for which the city had not yet received invoices for goods or services provided. Thus, the city cannot rely on the accounting system to manage its contracts.

The city is unable to account for all of its current contracts and their associated costs in part because it has not consistently followed its contract management policies. The city’s municipal code designates the City Clerk’s Department (city clerk) as the custodian of the city’s contract documentation, though the department does not have a contract oversight role. To ensure that executed contracts are provided to the city clerk, the city’s purchasing policy requires departments to receive signatures from vendors before presenting the contracts to the city council for its approval. This policy gives the city the ability to fully execute a contract upon city council approval and send the final document to the city clerk directly, instead of needing to return to the vendor for its signature. However, the city does not consistently follow its policy: of the seven contracts we reviewed that required city council approval, we verified that only two were signed by the vendor first. The city’s failure to follow this policy contributed to the city clerk not having complete contract documentation—such as fully executed contracts and bid documents—and in turn hampered its ability to account for all of its contracts.

The city also does not sufficiently monitor the performance of its contracts. The city’s purchasing policy requires department heads to provide documentation annually to the city manager indicating that they have completed a review of the services associated with each contract that has a term of more than one year and to make recommendations for any changes to the contract. However, the city has not followed this policy. The only monitoring effort that the city has undertaken is to prepare a biennial summary of on-call professional service contracts for the city council in which departments identify vendors, services provided, contract lengths, and recommendations for continuing their use. However, this summary includes only certain professional service contracts that are not project specific and excludes contracts associated with capital projects and contracts that do not require the city to make payments, such as the waste collection contract. Of the eight contracts we reviewed, only two appeared in any of the past three biennial summaries. Consequently, the city does not ensure that it monitors all of its current contracts.

**Recommendations to Address This Risk:**

- To ensure that it consistently receives the best terms and value for services, the city should strengthen its purchasing policies to require the following:
  - Departments to competitively bid services at least every three years or to document a justification for services that require a longer contract duration.
Departments to justify in writing reasons for amending contracts that extend the term or alter the services of the original contract instead of using a competitive bidding process. The city council should approve these justifications.

- To ensure that it is able to track its costs related to its contracts citywide, the city should do the following:
  - Develop a centralized depository with information on all current contracts, including the payments to date, full contract value, and the status of the performance of services.
  - Develop and implement procedures to monitor and update that centralized depository and to use this information to ensure that departments do not exceed their budgeted contractual service costs.
  - Develop and implement a process to ensure the enforcement of the city’s policy to submit all executed contracts, including supporting documents, to the city clerk.

To ensure that its waste collection contract represents the best value for the city, its residents, and its other community members, before the next automatic extension on October 17, 2021, San Gabriel should do the following:

- Negotiate with its waste collection company to revise key terms of its contract, including the contract’s duration and the city’s right to terminate the agreement.
- Conduct annual surveys of comparable cities to identify their waste collection franchise fees to ensure that it is receiving a competitive fee from its contractor.
- Solicit information on rates that residents and businesses in other cities are paying for waste collection services to ensure that it negotiates fair rates for its residents and businesses.

We conducted this audit under the authority vested in the California State Auditor by Government Code section 8543 et seq. and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle, CPA
California State Auditor

April 27, 2021
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Appendix A

Scope and Methodology

In February 2020, the Audit Committee approved a proposal by the State Auditor to perform an audit of San Gabriel under the local high risk program. We conducted an initial assessment of San Gabriel in December 2019, in which we reviewed the city’s financial and operating conditions to determine whether it demonstrated characteristics of high risk pertaining to the following six risk factors specified in state regulations:

- The local government agency’s financial condition has the potential to impair its ability to efficiently deliver services or to meet its financial or legal obligations.
- The local government agency’s ability to maintain or restore its financial stability is impaired.
- The local government agency’s financial reporting does not follow generally accepted government accounting principles.
- Prior audits reported findings related to financial or performance issues, and the local government agency has not taken adequate corrective action.
- The local government agency uses an ineffective system to monitor and track state and local funds it receives and spends.
- An aspect of the local government agency’s operation or management is ineffective or inefficient; presents the risk for waste, fraud, or abuse; or does not provide the intended level of public service.

Based on our initial assessment, we identified concerns about San Gabriel’s financial condition and financial stability as well as aspects of its operations that were ineffective or inefficient. The table lists the objectives that the Audit Committee approved and the methods we used to address them.
### Table

#### Audit Objectives and the Methods Used to Address Them

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<th>AUDIT OBJECTIVE</th>
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<tbody>
<tr>
<td>1</td>
<td>Review and evaluate the laws, rules, and regulations significant to the audit objectives. Reviewed relevant state laws, regulations, municipal code, and other background materials applicable to the city.</td>
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| 2               | - Developed and analyzed trends of revenues, expenditures, liquidity, and other relevant financial risk indicators from fiscal years 2014–15 through 2019–20.  
- Evaluated San Gabriel’s funding sources (general fund, special revenue funds) that paid for services relevant to our audit objectives.  
- Assessed the city’s financial condition and ability to meet its obligations by reviewing audited financial statements and budget reports.  
- Obtained the perspective of management and other relevant staff regarding our findings. |
| 3               | - Assessed whether the city complied with state law and best practices when it acquired two loans.  
- Evaluated the decision-making process for both loans to ensure that the city followed its policies.  
- Interviewed staff and city council members to review the loan approval process and the reasons the city entered into the loan that restricts its cash.  
- Reviewed loan documents and city council approval minutes related to the two loans.  
- Evaluated the impact of the loan terms on the city’s financial condition and the city’s plans to restructure or refinance the loans.  
- Evaluated the latest information on expenditures and revenues, including the amount and timing of revenue from the recently approved tax measure.  
- Reviewed projections for revenues and expenditures in the fiscal year 2020–21 budget and five-year forecast to determine whether the city has the financial resources to meet its financial obligations. |
| 4               | - Evaluated the policies, processes, and practices the city used to develop its budgets compared with applicable criteria and GFOA best practices. Interviewed relevant staff to obtain an understanding of the budget process.  
- Evaluated whether changes to the budgeting process since 2019 have led to balanced budgets and more accurate financial forecasts by doing the following:  
  – Analyzing the city’s budgets from fiscal years 2014–15 through 2020–21.  
  – Analyzing the forecasts for the next five years. We also reviewed the city’s assumptions related to the financial impacts of the pandemic.  
  – Interviewed staff to obtain the city’s perspective regarding the results of our audit. |
| 5               | - Interviewed staff to obtain an understanding of the city’s policies, processes, and practices for setting fees.  
- Reviewed the city’s fee schedule adopted in fiscal year 2019–20, evaluated the city’s process to ensure that fees cover its costs of providing services, and determined the extent to which the city adjusted its fees.  
- Estimated the amount of revenue the city failed to collect by not increasing half of its general fund fees to keep pace with the average rate of inflation between fiscal years 2016–17 and 2019–20. |
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| 6 Evaluate the information about San Gabriel’s financial condition that city management presented to the city council and residents, and determine whether that information accurately depicted the city’s financial condition. | • Evaluated whether the city’s financial position was, and is, accurately communicated to the city council and its residents by doing the following:  
  – Comparing meeting documents presented to the city council and the public with actual financial reports, budgets, and other relevant data.  
  – Interviewing city council members and obtaining their perspective on the financial condition of the city, and what their role is in ensuring that management provides adequate and accurate information.  
• Determined whether city management fully disclosed, presented, or communicated relevant financial/budget information to the city council by reviewing the information provided to the city council and the information that city council members requested from city management. |
| 7 Examine San Gabriel’s efforts to fill key management positions and maintain organizational and leadership continuity within city operations. | Interviewed staff and reviewed succession plans, personnel records, and staff reports to identify turnover in key management positions and efforts to fill vacancies. We found that the city’s efforts to maintain continuity were generally appropriate. |
| 8 Review San Gabriel’s policies and practices for overseeing and approving contracts and expenditures and determine whether they are in compliance with relevant laws, policies, and best practices. | • Reviewed San Gabriel’s purchasing policies and practices and evaluated compliance with relevant laws and best practices related to effective contracting, competitive bidding, and other relevant practices.  
• Reviewed contract lists created by city staff and payment records to identify contracts. Although we found the lists to be incomplete, we used other sources to inform our selection of contracts for testing. Judgmentally selected eight contracts based on size, contracting department, and type of work. Determined the extent to which the city complied with its contracting and competitive bidding policies.  
• Reviewed the city’s payment records and staff reports to identify expenditures. Judgmentally selected 12 expenditures based on size and type of expenditure from the city’s accounting system, which we determined to be complete for our purpose. Assessed the extent to which the city complied with its purchasing policies and identified no reportable issues.  
• Interviewed city staff to determine how the city performs oversight of contracts and purchases. |
| 9 Review and evaluate San Gabriel’s hiring process. At a minimum, determine the extent to which hiring policies and practices for key management positions include appropriate levels of screening and evaluation to ensure that individuals hired meet the minimum job requirements and qualifications for the positions. | • Interviewed the human resources director and other personnel responsible for hiring staff to get an understanding of the hiring process, the process for determining qualifications or hiring criteria, and the process for determining whether someone meets the qualifications or criteria.  
• Evaluated the hiring and performance review policies and practices and determined whether they complied with relevant laws and best practices.  
• Reviewed job qualifications and salaries for seven key management positions and compared those to similar positions at comparable cities. We found that the qualifications and salaries were generally comparable with those in other cities.  
• Reviewed files of six (total) past and current key management positions based on the city’s organizational chart to determine whether the positions were advertised and individuals were hired through an appropriate screening and evaluation process to ensure that they met minimum qualifications. Additionally, reviewed personnel files to determine whether individuals received periodic performance reviews. We determined that the hiring and performance review practices were generally appropriate. |
| 10 Review and assess any other issues that are significant to the audit. | We did not identify any additional issues that are significant to the audit. |

Source: Analysis of documents, interviews, and data obtained from San Gabriel.
Assessment of Data Reliability

The U.S. Government Accountability Office, whose standards we are statutorily obligated to follow, requires us to assess the sufficiency and appropriateness of the computer-processed information we use to support our findings, conclusions, or recommendations. In performing this audit, we obtained data from San Gabriel's financial accounting system to review its expenditures for fiscal years 2015–16 through 2019–20. To evaluate San Gabriel's data, we reviewed existing information about the data, interviewed staff knowledgeable about the data, and performed electronic testing and compared the data to other sources. We found these data to be sufficiently reliable for our purposes.
Appendix B

The State Auditor’s Local High Risk Program

Government Code section 8546.10 authorizes the State Auditor to establish a local high risk program to identify local government agencies that are at high risk for potential waste, fraud, abuse, or mismanagement, or that have major challenges associated with their economy, efficiency, or effectiveness. Regulations that define high risk and describe the workings of the local high risk program became effective on July 1, 2015. Both statute and regulations require that the State Auditor seek approval from the Audit Committee to conduct high risk audits of local entities.

To identify local entities that may be at high risk, we analyzed audited financial statements and pension-related information for more than 470 California cities. This detailed review included using the financial data to calculate indicators that may be indicative of a city’s fiscal stress. These indicators enabled us to assess each city’s ability to pay its bills in both the short and long term. Specifically, the indicators measure each city’s financial reserves, debt burden, cash position or liquidity, revenue trends, and ability to pay for employee retirement benefits. In most instances, the financial indicators determined in 2019 rely on information for fiscal year 2016–17.4

Based on our analysis from 2019, we identified several cities, including San Gabriel, which appeared to meet the criteria for being at high risk. We visited each of these cities and conducted an initial assessment to determine the city’s awareness of and responses to these issues, as well as to identify any other ongoing issues that could affect our determination of whether the city was at high risk. After conducting our initial assessment, we concluded that San Gabriel’s circumstances warranted an audit. In February 2020, we sought and obtained approval from the Audit Committee to conduct an audit of San Gabriel.

If the local agency is designated as high risk as a result of the audit, it must submit a corrective action plan. If it is unable to provide its corrective action plan in time for inclusion in the audit report, it must provide the plan no later than 60 days after the report’s publication. It must then provide written updates every six months after the audit report is issued regarding its progress in implementing the corrective action plan. This corrective action plan must outline the specific actions the local agency will perform to address the conditions causing us to designate it as high risk and the proposed timing for undertaking those actions. We will remove the high risk designation when we conclude that the agency has taken satisfactory corrective action.

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4 As we describe earlier in Appendix A, we conducted our initial assessment of San Gabriel in December 2019 based on this detailed review. In November 2020, we updated our financial indicators to include information through fiscal year 2018–19.
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April 7, 2021

Elaine Howle, CPA
California State Auditor
621 Capitol Mall, STE 1200
Sacramento, CA 95814

Dear Ms. Howle:

The City Council and City Management is fully committed to the responsible and wise financial stewardship of the City of San Gabriel. We have demonstrated this clearly through the actions that the City has taken in response to its precarious fiscal position. We welcome your report as another tool that the City can use in its ongoing mission of self-improvement.

In late 2018, it became clear that the City of San Gabriel had a negative general fund balance. When the current City Council was made aware of the situation, they felt misled by former management and that former management failed to live up to their professional and fiduciary responsibilities to the City as a whole and the City Council. The City Council felt that the former City Management failed in at least three critical ways during that period of time: (1) former City Management failed to disclose to and advise the City Council that projected revenues were not being realized and budgeted expenditures were being exceeded; (2) former City Management failed to disclose to and advise the City Council that the $7.8 million being pledged as collateral for the public works loan would result in a direct dollar-for-dollar decrease in the City’s unreserved general fund balance; and (3) former City Management failed to deploy the proceeds of the I-Bank loan in a timely manner and failed to disclose to and advise the City Council of the years-long delays in the deployment of such funding. As a result of these failures, the City Council was not apprised of the true financial condition of the City and was therefore denied the opportunity to take corrective action.

However, once these failures were discovered and the City Council was properly informed about the financial condition of the City, they immediately directed staff to carefully review the City’s finances to provide short and long term solutions to restore its financial health. Because of that direction, staff discovered many of the issues later presented in the audit and presented them to the City Council.

The City Council responded to these challenges without hesitation, and took multiple actions to improve the oversight of City resources as well as to ensure the continued quality service provided to the people of San Gabriel. Throughout the process, the City engaged the public and made them aware of the problem through increased transparency and frequent fiscal reporting.
Additional information was also made available through the City’s public information channels and staff has continued to regularly update this information.

Specifically, the City Council adopted a fiscal sustainability policy in May 2019 that implemented a comprehensive framework for budget, economic development, risk management, financial reporting, cash management, and debt management. We improved transparency with a new policy that requires regular presentations of our comprehensive annual financial reports to the City Council with an independent auditor present. We improved accountability by having each director take direct responsibility for their department’s operational revenue and expenditures. We improved our budget tracking by presenting actual real-time revenue and expenditures as a critical part of our ongoing budget process. Though adopted prior to our initial contact with the State Auditor’s office, much of what is contained in the new policies addresses concerns brought up in the Audit by providing a financial recovery plan. These policies will be combined into a single document to become the framework of a comprehensive financial recovery plan as recommended by the audit.

Through our revised budgeting process and consistent financial updates to the City Council, in late 2018 through June 30, 2019, the City generated a positive change in fund balance of $756,719. These actions produced a near-30% improvement to the City’s fund balance, illustrating that with keen oversight, the process improvements were working.

In the following fiscal year, beginning July 1, 2019, the City Council and current City Management continued the diligent practices by adopting a general fund budget with a projected surplus. However, in March 2020, our regional economy began experiencing the devastating impacts of the COVID-19 pandemic as a result of the safer-at-home orders issued by the State and the County. Despite these ongoing difficult financial conditions, the City was able to generate a positive change of $84,611 in our fund balance through constant communication between the City Council and City Management. This further improved the overall financial health of the City’s general fund.

Lastly, for the current fiscal year ending June 30, 2021, the City is projecting a positive change in fund balance of over $400,000. The results provided by the City over the last three fiscal years -- despite difficult economic circumstances -- demonstrates the City Council’s and current City Management’s commitment to the wise and diligent stewardship of City resources.

Although the City’s financial health has improved, there is much more work left to accomplish and the City continues to strive to be better. An important part of this process is critically analyzing actions taken in the past and correcting them where appropriate. The City’s initial discovery of the problems and the public outreach that followed, coupled with the State’s Audit, are important steps in this process. The process of self-evaluation and correction will continue even after all the recommendations made in the Audit have been implemented.
Ms. Elaine Howle  
April 7, 2021  
Page 3

The City welcomes the recommendations provided in the Audit report as validation that the City is on the right track. Attached is the City’s detailed response to each of the recommendations noted in the Audit. You will see that the City is very much in alignment with the recommendations and even began the process of implementing similar improvements prior to the report.

If you have any questions related to this response, please do not hesitate to contact me at your convenience.

Respectfully,

[Signature]

Mark Lazzaretto  
City Manager

Attachment
# City of San Gabriel, California

## Response to Recommendations of the California State Auditor

April 7, 2021

<table>
<thead>
<tr>
<th>No.</th>
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<tr>
<td>6</td>
<td>Financial Management</td>
<td>To ensure efficacy and accountability in its financial recovery process, city management should develop and city council should adopt a comprehensive financial recovery plan by October 30, 2021.</td>
<td>The City has been implementing a financial recovery plan to revive the City’s financial condition since 2018. The plan has included passing a local sales tax measure, generating operating general fund surpluses, adopting annual budgets with general fund surpluses, adjusting budgets as external environments change, providing monthly, quarterly and semi-annually financial updates to the City Council, exploring options and offers to refinance the public works loan, adjusting fees charged to residents, contemplating options to address the City’s pension and OPEB liabilities, and tightening the operations at the Mission Playhouse. The City will continue the implementation process of the financial recovery plans mentioned above, along with constantly updating the plans as circumstances change. In response to the State Auditor’s recommendation, the City will bring a formal financial recovery plan by October 30, 2021 to the City Council that will identify the specific area for improvement along with the potential courses of action to take, and measureable goals.</td>
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<td>7</td>
<td>Financial Management</td>
<td>To ensure San Gabriel has relevant information for making decisions, it should update its financial projections to include in-depth analysis of key revenue sources and future costs, including factors such as the pandemic and the effect of the loan collateral on its general fund reserves, among other factors.</td>
<td>The City has developed a five-year forecast for revenues and expenditures. The forecast is developed by making projections on what will happen in future years and they offer the opportunity to run operating scenarios. The five-year forecast is frequently revised to incorporate new information, changes in the City’s operating environment and updates to our future. As the Audit suggests, the City will incorporate the loan collateral into the forecasts, as well as into the formal financial plan.</td>
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<td>7</td>
<td>Financial Management</td>
<td>To eliminate the general fund’s need to borrow from other funds, San Gabriel should develop a plan by October 30, 2021 to renegotiate or refinance the public works loan to free up its general fund cash. In making its decision, it should consider the short and long-term impact of its financing choice on its general fund and on the operations of the city.</td>
<td>The City has reached out to potential lenders to refinance the public works loan. The City has had discussions with the bank holding the loan, but the bank was unwilling to modify the terms of the loan. The current economic environment due to COVID-19 and the City’s current financial condition are creating challenges for the City to refinance the loan. However, with the City’s constantly improving financial condition and with the forthcoming American Rescue Plan funds, the City anticipates that it will be able to receive an offer that will allow it to prudently refinance the public works loan. In the meantime, the City will evaluate and incorporate alternate scenarios as part of the financial plan and present them to the City Council by October 30, 2021.</td>
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<tr>
<td>7</td>
<td>Financial Management</td>
<td>San Gabriel should adopt a policy by October 30, 2021, that describes options and considerations it will evaluate and present to its city council when entering into any future debt, including: an analysis of alternative methods of financing; impact on city finances, both short term and long term.</td>
<td>A standard practice for professional staff in the preparation of City Council agenda reports is to fully analyze the agenda item that is up for consideration by the City Council. The City recognizes that the agenda report presented by former management to the City Council lacked key analysis such as the impact to the general fund’s fund balance. In line with the Auditor’s recommendations, the City’s debt policy can be updated to instruct staff to include key information in regards to debt financing and will be done so by October 30, 2021.</td>
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<td>To ensure that its rising pension costs do not create a burden on the general fund, San Gabriel should identify and develop an analysis of the benefits and risks of alternative methods of paying for these rising costs, such as increasing the retirement tax or issuing pension obligations bonds.</td>
<td>The City is addressing its pension liability. Like nearly every city in California, pension liability is a burden that San Gabriel faces. The City has engaged a fiscal advisor and is analyzing the merits of using Pension Obligation Bonds to reduce its future pension outlays. The fiscal advisor will be presenting potential solutions to the City Council on April 20, 2021. Other potential solutions to improve the financial condition of the pension liability, such as raising the City’s retirement tax, are also being vetted.</td>
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<td>2</td>
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<td>To limit costs related to employee retirement benefits, San Gabriel should negotiate with its unions for employees to contribute a reasonable portion of their salaries to fund their OPEB benefits.</td>
<td>In regards to the OPEB liability, there are many options to consider, one of which could include the possibility of requiring employees to contribute a portion of their salary to offset the benefit. The City will contemplate its options to improve the OPEB liability, taking into account short-term and long-term impacts on the organization’s finances and the ability to provide services to the community. Any changes to the employee benefit formula would need to be negotiated with the employee bargaining units.</td>
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<td>San Gabriel should develop a long-term funding plan to address its OPEB liability. The plan should include actions necessary to ensure that the city will be able to meet its obligations to its employees and retirees.</td>
<td>A prudent financial plan will include, at the minimum, the acknowledgement of future liabilities. The City recognizes the need to fund the OPEB liability trust to some level. As each financial challenge is overcome by the City, the City’s ability to fund the OPEB trust will become more clear.</td>
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<td>II</td>
<td>Expenditure Reductions and Revenue Increases</td>
<td>To reduce the negative impact of the Mission Playhouse on the city’s financial condition, San Gabriel should implement recommendations from its consultant reports including developing a strategic plan that maximizes the use of volunteers and pursuing other measures that reduce expenditures and increase revenue.</td>
<td>The Mission Playhouse has been part of the City since 1927 and provides many cultural experiences to the residents of San Gabriel and to the region. The City has reduced the level of funding the Mission Playhouse receives from the general fund by over $550,000 per year. Further illustrating the City's commitment to reducing costs and raising revenues, during the COVID pandemic where businesses and entertainment venues have been shuttered, the Mission Playhouse has remained open for alternative programming and has required an allocation from the general fund of only $250,000. The City is contemplating all options to reduce the financial impact on the City's general fund including an increased reliance on volunteers and exploring methods to raise revenue and lower expenses, as recommended in the Audit.</td>
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<td>To ensure that the fees it charges for services align with cost, San Gabriel should develop and implement policies and procedures to require it to: a) develop methodologies for determining the full cost of those services to ensure that it is not overcharging or undercharging for services; b) reevaluate the costs of its fee-funded services at least every three years. It should develop a plan to adjust its fees to fully recover costs, including a phased-in approach for large increases.</td>
<td>The City has already completed a study to update City fees with the results of the study presented to the City Council on April 1, 2021. The fees will be updated for the fiscal year beginning July 1, 2021, and regular updates will be performed.</td>
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### Contract Management

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<td>9</td>
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<td>To ensure that it is able to track its costs related to its contracts citywide the city should: develop a centralized depository, develop and implement procedures to monitor and update the centralized depository, and develop and implement a process to ensure the enforcement of the city’s policy to submit all executed contracts to the city clerk.</td>
<td>The City agrees with the importance of a central repository for documentation and monitoring of all City contracts. The City will further refine and finish implementing a solution to accurately track and monitor contracts. The City expects a robust contract management system to be in place by the end of the year.</td>
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<td>10</td>
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<td>San Gabriel should negotiate with its waste collection company to revise key terms of its contract, including the contract’s duration and the city’s right to terminate the agreement. San Gabriel should also annually survey comparable cities waste collection franchise fees to ensure it is receiving a competitive fee from its contractor. Finally, San Gabriel should also solicit information on rates that residents and business in other cities are paying for waste collection services to ensure it negotiates fair rates for its residents.</td>
<td>The industry standard for waste hauling contracts is to have a long-term agreement with a waste hauler. The cost to acquire several expensive waste hauling vehicles, to set up a database for tracking and billing several thousand customers, and to design efficient collection routes is extremely expensive. Amortizing these costs over a long term contract ensures that the lowest fees are secured for the City’s residents and businesses. On the contrary, should these contracts be rebid or renegotiated on a short term basis, these costs would need to be spread over a short payback period, thus resulting in high costs to the end customer. The contract with the solid waste collection provider was thoroughly contemplated and negotiated. An ad hoc solid waste committee was established and met with the solid waste provider in several meetings over a two year period to determine the best option for the City. A regional survey was performed and the results found that the contract terms were in line with other cities in the area. The City also surveyed the waste fees for surrounding cities and determined that San Gabriel’s rates are in line with what customers pay in the region. Finally, as part of the renegotiations and contract extension, the City was able to procure an annual payment from the solid waste provider of $350,000, increased annually by CPI, which improves the City’s general fund ongoing revenue structure.</td>
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Comments

CALIFORNIA STATE AUDITOR’S COMMENTS ON THE RESPONSE FROM THE CITY OF SAN GABRIEL

To provide clarity and perspective, we are commenting on San Gabriel’s response to our audit. The numbers below correspond to the numbers we have placed in the margin of San Gabriel’s response.

Although we acknowledge that the city has improved its financial policies and practices, the city continues to have a significant financial reserves deficit, and the current measures in place may not be sufficient to fully address its financial problems, as we state on page 8. Thus, the city needs to take further steps to address its poor financial condition, such as developing a comprehensive financial recovery plan that includes strategies for building its reserves, renegotiating or refinancing a loan that restricts its available cash, and identifying opportunities to increase revenues and reduce expenditures.

Although we agree that former management did not clearly disclose to the city council revenue shortfalls, expenditure overruns, and other key financial information, the city was unable to demonstrate that the city council ever asked for budget updates, formal presentations of the city’s audited financial statements, or additional information on the city’s financial condition as we discuss on page 7. Such information would have shown that the city’s financial condition was in significant decline. By failing to exercise the necessary oversight to ensure that city management had fully apprised it of the true financial condition of the city, the city council failed to fulfill its fiduciary responsibility over the city and in overseeing the city’s financial health.

We disagree with the city’s claim that much of what is contained in its new policies addresses the concerns of our audit. As we state on page 17, although the city has adopted and implemented several stand-alone financial policies, these policies lack specific actions for how the city will achieve its financial goals. In addition, as we show in Table 2 on page 18, San Gabriel’s policies lack key elements of a comprehensive financial recovery plan. As we recommended, the city should develop a more robust plan that specifies, both in the short term and long term, how it will rebuild its general fund reserves, and it should address the city’s lack of general fund cash, its unfunded pension and OPEB obligations, and how it will refinance its public works loan.
While we recognize that the city has stopped its overspending in recent years, it will need to do more to eliminate its substantial general fund reserves deficit, which was $8.1 million as of June 30, 2020. Therefore, it is critical that the city implement our recommendations to improve its financial health, including renegotiating or refinancing its public works loan that restricts its access to its general fund cash.

We look forward to receiving San Gabriel’s complete plan for addressing the risks described in our report and each of our recommendations. As we describe on page 39, San Gabriel is required to submit a corrective action plan within 60 days of this report’s publication. The corrective action plan must outline the specific actions the city will perform to address the conditions causing us to designate it as high risk and the proposed timing for undertaking those actions. The city must then provide written updates every six months after the audit report is issued regarding its progress in implementing its corrective action plan. We will remove the high risk designation when the city has taken satisfactory corrective action.

The financial recovery plan that the city asserts it has been implementing since 2018 is San Gabriel’s fiscal sustainability policy, fund balance reserves policy, and five-year forecast, as we discuss on page 17. Although these policies are an improvement over previous city practices, they do not outline specific recovery strategies or actions for how the city will rebuild its general fund reserves or address other significant financial challenges, such as its large unfunded pension and OPEB obligations. Without a comprehensive financial recovery plan, the city lacks an adequate blueprint for improving its financial condition. We look forward to receiving the city’s comprehensive financial recovery plan when it provides an update on its progress toward implementing our recommendations.

In addition to incorporating the effect of the loan collateral into its financial forecast, we also recommend that the city include an in-depth analysis of key revenue sources and future costs, such as the ongoing effects of the pandemic and other factors we discuss on page 13.

The city did not present the results of its new fee study to the city council until after we provided it with a draft copy of our report. We look forward to receiving this study when the city provides its 60-day update on its progress in implementing this recommendation, including documentation of its plan to adjust its fees to fully recover costs.
Although the city has a policy requiring that it competitively bid contracts, it has not always done so. As we discuss on page 29, we identified one instance in which the city council approved contract amendments that extended the terms of the original contract over several decades, and another instance in which the city council approved new contracts for different services with the same vendor without seeking competitive bids. Therefore, the city must strengthen its current policies and practices to ensure that it receives the best value when procuring goods and services, including requiring departments to competitively bid services at least every three years.

Although the city states that it conducted thorough negotiations with the solid waste collection provider and surveyed other cities, it conducted those negotiations with just its current vendor. Specifically, it amended the contract in 2020 to extend the contract term to an ongoing service period of 25 years—more than double the duration of the previous term without competitively bidding this contract. By substantially extending the contract’s term, the city committed its residents to paying the contractor’s rates for at least 25 years without verifying that the contract is providing the best value to them. The city also points out that it was able to procure an annual payment from the solid waste provider of $350,000. However, as we state on page 31, if it had done so sooner, the city could have collected a total of $3.4 million in additional revenue from fiscal years 2009–10 through 2019–20.

Although the city noted that it performed a regional survey to aid in its negotiations for the most recent amendment, as we discuss on page 29, the city did not seek proposals from multiple waste collection companies in previous years. Therefore, to ensure that its waste collection contract represents the best value for the city and its residents and given the city’s long history of renewing contracts with its waste collection provider without competitively bidding, before the next automatic extension in October 2021, San Gabriel should renegotiate with its waste collection company to revise key terms of its contract, including the contract’s duration and the city’s right to terminate the agreement. We also recommend that the city annually conduct such a survey of comparable cities to identify their waste collection franchise fees to ensure that it is receiving a competitive fee from its contractor. In addition, it should solicit information on rates that residents and businesses in other cities are paying for waste collection services to ensure that it negotiates fair rates for its residents and businesses.