



The Centurion COUNSELOR

Vol. 11, No. 1, October 2004

PAGE 1

UNDERVALUED SECTORS

(CONSIDER!)

- **LARGE CAP VALUE**
- **DIVIDEND STOCKS**
- **CONSUMER DEFENSE**

OVERVALUED SECTORS

(AVOID!)

- **SMALL CAP ENERGY**
- **CALIFORNIA
MUNICIPAL BONDS**
- **CHINA**

In the past several years we have written several times about Municipals bonds and why we are not fans of them. In this issue we bring you two more stories that show some of the hidden perils and how difficult it is to reform the finances of state and local governments. Our first story deals with the State of California's well known budget problems and how much waste has been built into the system over the years. The second story deals with a lesser known, but much deeper, problem; the City of San Diego's pension budget.

Soft Job

During the recent recall election, candidate Schwarzenegger promised to perform a review of all of California's operations. One of the more fascinating aspects of the Governor's California Performance Review report is the list of state boards and commissions. The staff who wrote the report note that they are not confident they identified all the boards and commissions in state government because there is no comprehensive list and as they went looking, they found more and more. Ultimately, they found 339 such bodies and they are recommending the elimination of 117 of them. All of their duties will be assigned to a state agency in the new, hopefully reorganized and streamlined government. To give you some scope of the enormity of the review process, as well as the implied enormity of the scope of a state government out of control and desperately in need of fixing, we have listed a sample of the 117 bodies to be eliminated on the following page.

As you look at the list, consider the testimony that is being given to the 21 commissioners assigned by the Governor to listen to public comment on the CPR recommendations. What they hear runs something like this: "We acknowledge that state government is an inefficient mess and needs to be fixed. We support that concept. However, [insert name of particular board, commission or entity here] is not part of the problem. Indeed, our [repeat name here] is actually very important and even self-sustaining. We provide an important regulatory function without which disaster would strike. [Insert example of imminent death or destruction.]"

List of Boards and Committees to be Eliminated by the State of California

Architects Board and Landscape Architects Technical Committee;
Banking Advisory Council;
Board of Barbering and Cosmetology;
Board of Registration for Professional Engineers and Land Surveyors;
Bureau of Hearing Aid Dispensers Advisory Committee;
California Horse Racing Board;
Contractors State Licensing Board;
Court Reporters Board;
Credit Union Advisory Committee;
Electronic Commerce Advisory Council;
Inspection and Maintenance Review Committee (in Bureau of Automotive Repair);
New Motor Vehicle Board;
Board of Pilot Commissioners of the Bays of San Francisco, San Pablo and Suisun;
Private Security Disciplinary Review Committee (North/South) and Alarm Company Disciplinary Review;
Real Estate Advisory Commission;
Service Agency Advisory Committee;
Speech-Language Pathology and Audiology Board.
Agricultural and Cooperative Bargaining Advisory Committee;
Apprenticeship Council;
Commission of the Californians;
Commission for Economic Development;
Commission on Health and Safety and Workers' Compensation;
Committee for the Employment of People with Disabilities; Employment Training Panel;
Fair Employment and Housing Commission;
Industrial Welfare Commission;
Occupational Safety and Health Appeals Board;
Occupational Safety and Health Standards Board;
Rehabilitation Appeals Board;
Small Business Board;
Small Business Reform Task Force;
Unemployment Insurance Appeals Board and Workers' Compensation Appeals Board.
Alternative Energy and Advanced Transportation Financing Authority;
Board of Reclamation;
Building Standards Commission;
California Transportation Commission;
California Water Commission;
Consumer Power and Conservation Financing Authority;
Departmental Transportation Advisory Commission;
Electricity Oversight Board;
Energy Commission;
High Speed Rail Authority;
Low Income Oversight Board;
Public Library Construction and Renovation Board;
Public Works Board;
Seismic Safety Commission;
State Allocation Board;
and the Tax Credit Allocation Committee.

Most citizens only have a vague idea what some of these boards do. Meanwhile, some of the appointees to these bodies have salaries of more than \$100,000 per annum, even though they meet only a few times per year. And even though some of these are ostensibly oversight bodies, there is no line of accountability to elected officials for their work.

Enron By The Sea

Newspaper articles have called the city of San Diego, California “Enron by the Sea,” this about a city that boasts on its website of being “the most efficiently run big city in California. Today San Diego is on the verge of Bankruptcy facing a \$1.2 Billion pension shortfall and a \$545 million deficit in retiree medical benefits. Standard and Poor’s, the bond rating service, has suspended its ratings of San Diego saying “it can no longer vouch for the cities creditworthiness while an audit of 2003 remains unpublished.” Investigators from the FBI, the U.S. attorney’s office and the Securities and Exchange Commission are probing whether charges should be brought for the non-disclosure of its true financial picture in the prospectus for a municipal sewer-bond offering. How did San Diego get in this mess and why has it received so little attention?

The problem did not happen suddenly but took many years of mismanagement and raiding of funds earmarked for pensions. As of June 30, 2003 the actuarial value of the pension plan’s assets stood at \$2.375 billion or \$1.16 billion less than the amount needed to cover promised benefits. The New York Times reported that according to a report issued by Richard Carl Sauer, a former official of the Securities and Exchange Commission and Paul Maco a former S.E.C. lawyer who oversaw the agency’s work on the Orange County Bankruptcy, that for years the city has spent monies from pension fund earnings. “Year after year pension fund earnings that exceeded projections” were used to “pay for a variety of local projects ranging from expenses associated with playing host to the 1996 Republican Convention to paying health insurance premiums for retired teachers and firefighters.” On top of taking funds from the plan the city sweetened benefits including a deferred retirement option which lets an employee delay retirement and create a special account earning 8 percent interest and a 2 percent annual cost-of-living adjustment in their pension. Under this plan high-paid employees could receive nearly \$1 million on retirement.

Today San Diego is faced with several choices none of which are pleasant. The city could file for bankruptcy, borrow more money to reduce the pension debt, cut city services, raise taxes or force a roll-back of benefits to city workers. Is it possible that holders of San Diego bonds will lose some or all of their monies? In our opinion, it is unlikely that the bond holders will lose all of their money, but we do believe the odds are greater than 50/50 the city will need to file for bankruptcy in the next several years. We also believe that a bankruptcy filing could reduce the interest rate on those bonds outstanding.

The real problem is the lack of disclosure required in the municipal bond marketplace. A public corporation could not be almost a year late in filing its financial statements. San Diego’s own review stated that “the city’s financial disclosures exhibit significant inaccuracies and omissions” Under current law in California, cities are allowed to remove “excess” funds from pension plans, something that corporations have not been able to do for at least 20 years.

Continued From Page 4

These two articles illustrate just a few of the challenges facing all state and local governments. While we believe that California and some of its cities are closer to the cliff, the problem is not isolated to California. The municipal bond market needs the same level of disclosure that corporations face, to do any less only puts off the inevitable failure of a large city or state.

QUOTE OF THE QUARTER

“Even a casual review of the list of officers, boards, bureaus and commissions, made in the light of their duties as here stated, will serve to convince the observant reader that numerous duplications and overlapping of function exist and that administrative centralization is sadly lacking. The presence of great numbers of independent boards, bureaus, commissions, and officers indicates an undue overhead expense; but where it is shown that two or more bodies perform all or parts of functions that could be performed by one, the absence of efficient organization and the certainty of needlessly high expense become still more readily apparent. A general reorganization of the state government, involving the establishment of a few centralized departments should be undertaken by the 1919 legislature.”

Taxpayer’s Association of California, “Expenses and Outlays of California State Government,” June 1918.

The Death Of OPEC

The Organization of Petroleum Exporting Countries (OPEC) was started in 1960 and was originally made up of 13 countries that controlled 80% of the world’s oil reserves. As OPEC got stronger and better organized in the 1970’s, it used its power to raise oil prices and increase member countries revenue. The “oil shocks” of the 70’s led to long lines at gas stations and to high prices for everything from gasoline to cars and houses. It caused inflation, economies to weaken, people to lose jobs and a recession. Today OPEC controls about one-third of the world’s oil supply but its best days may be behind it.

As the price of oil continues to spiral higher, energy companies are encouraged to spend more on exploration and production, which is increasing production outside of OPEC. Production in Russia and in the Caspian region is poised to increase dramatically in the next twenty-four months. In 2000, OPEC produced 42% of the world’s oil and by 2010 it will produce less than 25%. The high price is also resulting in new production and seismic technologies. Today oil can be produced for less than \$10.00 per barrel. In spite of the problems in oil producing countries, the laws of economics can not be repealed over the long term. Any product with a 400% margin over the cost to produce will entice competition to enter the market. Not only will more production come online but alternative forms of energy become increasingly more competitive as the price rises.

This week General Electric announced two new projects that use alternative sources of power. The first takes advantage of the United States ample supply of coal, with GE and Bechtel Corp. forming an alliance to offer a standardized power plant that burns coal more cleanly than conventional coal-fired plants. They plan to work on North American plants with integrated combined-cycle gasification systems, which converts coal into a synthetic gas that can eventually be used as the primary fuel for a gas turbine. These plants currently cost 20 percent more to build versus the traditional pulverized coal-fired plants, but can reduce harmful emissions by 50 percent. Coal-fired power plants generate about half of the nation's electricity supplies, but few new plants have been built in the past 10 years because of uncertainty over federal clean air standards. GE said it expects to be able to lower the cost of building the plants in the future as it integrates its gasification technology business. The second announcement has GE Energy being selected to supply up to 660 wind turbines, totaling 990 megawatts of wind-generated electricity, for eight projects in Quebec to be placed on line between years 2006 and 2012. This project is the largest single award for new wind generation capacity in the history of the global wind energy industry. Once again new technology becomes competitive courtesy of high oil prices.

We still believe fundamentally, oil prices should be in high \$20s and eventually should decline into the low \$20s as oil inventories rise based on our assessment of supply/demand economics and current inventory levels. We think 3 factors could put pressure on oil prices - continued rise in inventories, absence of supply shock, and excessive speculation. The longer oil prices stay high the bleaker the future for oil becomes. In our opinion, if OPEC does not want to return to a Bedouin lifestyle in the next generation or two, they must lower oil prices.



CENTURION

COUNSEL, INCORPORATED

**Centurion Counsel Wishes You
Continued Prosperity in 2004!**