THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: February 25, 2016 **IBA Report Number:** 16-04

City Council Docket Date: March 1, 2016

Item Number: TBD

FY 2016 Mid-Year Budget Monitoring

OVERVIEW

The FY 2016 Mid-Year Budget Monitoring Report (Mid-Year Report) was issued on February 12, 2016 along with a citywide vacancy report (Vacancy Report), both of which were presented to the Budget and Government Efficiency Committee (B&GE) on February 24, 2016. The Mid-Year Report describes the current status of revenues and expenditures and their year-end projections based on actual (unaudited) data from July 2015 through December 2015, and the citywide vacancy report analyzes the City's staffing and hiring progress as of January 4, 2016.

The Mid-Year Report reflects projected increased General Fund revenues of $3.7 million as well as projected expenditure savings of $3.9 million, for a total budgetary surplus of $7.6 million. The positive variance in General Fund revenues from the FY 2016 Adopted Budget is primarily due to a projected increase in miscellaneous General Fund revenues, specifically unexpected or increased revenue amounts in motor vehicle license fees, refuse collection business tax, transfers in, and other revenue. The Mid-Year Report also projects year-end over-budget revenue in some of the City's major General Fund revenues: transient occupancy tax (TOT), property transfer tax, and franchise fees, but these increases are mitigated by projected year-end declines in property tax and sales tax. General Fund expenditures are projected to come in under budget at year-end in a number of departments, mostly due to savings in energy and utilities spending.

The Mid-Year Report provides a thorough review of General Fund year-end projections for both revenue and expenditures and provides useful details about major revenues, departmental operations, and other programmatic items. The purpose of our report is to provide clarification or additional information for items outlined in the Mid-Year Report, as well as an analysis of the Mayor's recommended Appropriation Adjustments. We have also included status updates on any changes to policy issues and programmatic budgetary items that were not included in the Mid-Year Report, as well as a discussion on City hiring and vacancies, projected year-end expenditures for select departments, reserve goals, and the Excess Equity estimate.

The Mid-Year Report requests that the City Council approve the following six items:

1. Appropriate $3.3 million in one-time General Fund revenues above FY 2016 Adopted Budget levels that reflects the return to the City of a $3.3 million Community Development Block Grant loan payment
2. Increase General Fund expenditure appropriations in the Citywide Program Expenditures Department by $5.8 million over FY 2016 Adopted Budget levels, to fund a Public Liability Reserve contribution
3. Decrease General Fund expenditure appropriations in the Park & Recreation Department by $2.5 million from FY 2016 Adopted Budget levels
4. Appropriate $4.0 million in the Low Income Housing Lease Revenue Fund for the Homeless Veterans Initiative administered by the San Diego Housing Commission
5. Transfer up to $1.0 million from the SDFD Station Alerting CIP (CIP Contributions from General Fund) to the Police Range Refurbishment CIP
6. Transfer up to $2.0 million from the annual allocation for Watershed CIP to the annual allocation for Drainage Projects ($1.1 million from the PFFA Lease Revenue Bond 2015A Fund and $863,000 from the PFFA Lease Revenue Bond 2015B Fund)

This report includes an analysis of the projected budgetary surplus and Excess Equity, as well as other cost considerations that were not available in the Mid-Year Report, in order to provide additional information for Councilmembers as they consider the Mayor's requests.

FISCAL/POLICY DISCUSSION

General Fund Revenues

FY 2016 General Fund revenues are projected to end the year at $3.7 million, or 0.3% over-budget despite an overall decrease in major General Fund revenues from the FY 2016 Adopted Budget and the year-end projections included in the FY 2016 First Quarter Budget Monitoring Report (First Quarter Report). Reductions in major General Fund revenues are due to reductions in property tax and sales tax that are partially mitigated by increases in TOT, property transfer tax, and franchise fees, and are discussed in greater detail in the "Major General Fund Revenues" section below. The Mid-Year Report notes that miscellaneous General Fund revenues[1] are projected to end the year $5.1 million over-budget due to a one-time return of a $3.3 million Community Development Block Grant loan payment to the General Fund and unexpected or increased revenue amounts in motor vehicle license fees, refuse collector business tax, and transfers in revenues. These increases in miscellaneous revenues offset the overall decrease in major General Fund and departmental revenues, and are part of the Mid-Year General Fund appropriations adjustment request to transfer funds to the Public Liability Reserve.

Projected year-end departmental revenues have decreased overall, and the Mid-Year Report identifies significant projected year-end reductions in revenue in the City Comptroller, Economic Development, Environmental Services, and Transportation & Storm Water departments. These reductions are partially mitigated by projected year-end increases in Fire-Rescue and Police

[1] The miscellaneous revenue category includes the following General Fund revenues: Charges for Current Services, Interest and Dividends, Motor Vehicle License Fees, Other Revenue, Refuse Collector Business Tax, Revenue from Federal and Other Agencies, Revenue from Money and Property, and Transfers In.

revenues. The Mid-Year Report contains details on all of these revenue variances; supplementary information and analyses on additional items to consider are provided in this report in the "Departmental Revenues" section below.

Major General Fund Revenues

Our Office has reviewed the year-end projections for property tax, sales tax, TOT, and franchise fees included in the Mid-Year Report. The information included in the Mid-Year Report for these revenue sources provides details about the overall major General Fund revenue decreases in year-end projections from budgeted levels, as well as a newly added "Economic Uncertainties" section that provides context to major General Fund growth rates and a sensitivity analysis for each of the major General Fund revenues. These analyses are welcome additions to the Mid-Year Report, especially in years such as this one when Council is asked to approve or modify a mayoral proposal to increase appropriations, or when revenues are projected to come in at, or below, budget. In the latter case, any change to the economy at the mid-point of the year could affect the City's ability to realize budgeted revenue levels or support its budgeted expenditures.

The following table outlines changes in year-end projections for major General Fund revenues from the FY 2016 Adopted Budget and the First Quarter Report as compared to the Mid-Year Report. While individual revenues are projected to vary up to approximately $3.9 million from the FY 2016 Adopted Budget at fiscal year-end, overall the major General Fund revenues are only projected to be under-budget by $204,000.

FY 2016 Projected Year-End Revenue (*$ in millions*)

Major General Fund Revenue	Adopted Budget	First Quarter Projection	Mid-Year Projection	Variance: Adopted Budget to Mid-Year	Variance: First Quarter to Mid-Year
Property Tax	$470.1	$470.4	$467.8	($2.3)	($2.6)
Property Transfer Tax	8.4	9.2	9.4	1.0	0.2
Sales Tax	285.8	284.3	282.5	(3.2)	(1.8)
Transient Occupancy Tax	102.2	104.1	106.0	3.9	2.0
Major Franchise Fees	79.4	79.5	79.8	0.4	0.3
Total:	**$945.8**	**$947.5**	**$945.6**	**($0.2)**	**($2.0)**

Table may not total due to rounding

Overall, we believe the projections included in the Mid-Year Report are appropriate based on revenue distributions to date and current economic information. Additional items of interest regarding property tax, property transfer tax, sales tax, and TOT are discussed in the sections below.

Property Tax and Property Transfer Tax

Property Tax. The First Quarter Report projected an approximately $0.3 million increase in property tax revenue over the FY 2016 Adopted Budget, although our Office had cautioned in our review of that report that that number was likely overstated. The Mid-Year Report has revised that projection to $2.3 million below budgeted property tax revenue, due to a $7.2 million decrease in the residual distribution from the Redevelopment Property Tax Trust Fund (RPTTF). This decrease is partially mitigated by increases in the 1% property tax base bolstered by the current growth in home sales and prices, the Motor Vehicle License Fee (MVLF) backfill payment, and the projected RPTTF tax sharing pass-through payments.

The Mid-Year Report projects a decrease in residual RPTTF payments of $7.2 million. As our Office noted in our review of the First Quarter Report and the Mayor's Five-Year Financial Outlook, RPTTF revenue projections in the First Quarter Report did not include the addition of reinstated recognized obligations on the City's Recognized Obligation Payment Schedule (ROPS) submittals that are allowed by the passage of SB 107. Increases in ROPS distributions reduce the remaining residual amount of RPTTF funding available for local cities.

In the most recent ROPS – ROPS 10 – submitted to the State, several reinstated loan agreements and new line items were included. While ROPS 10 covers funding for obligations that will occur in FY 2017, a portion of the actual residual distribution occurs in FY 2016, and the associated decline in Residual RPTTF is therefore recognized in this fiscal year.

Property Transfer Tax. The Mid-Year Report projects property transfer tax to be approximately $9.4 million at year-end, an increase of $1.0 million over the FY 2016 Adopted Budget, and a $220,000 increase from the First Quarter Report. The City receives $0.55 per $1,000 of the sale price of residential and commercial real estate through the property transfer tax collected by the County. The projected year-end increase in property transfer tax revenue reflects expected annual property sales based on actual receipts received.

Sales Tax

The Mid-Year Report projects sales tax revenue to be $3.2 million below the FY 2016 Adopted Budget, and $1.8 million below First-Quarter projections. This decline in projections is almost entirely due to decreased fuel prices. As noted in the Mid-Year report, taxable sales of all other goods have increased over those in FY 2015 year. We believe the decrease in projections is appropriate. It will continue to be important to monitor sales tax receipts throughout the year; as the decline in fuel prices began midway through FY 2015, year-over-year growth in the third and fourth quarter of FY 2016 may be less impacted than the first two quarters.

Transient Occupancy Tax

TOT revenues are projected to end the year approximately $3.9 million over budget in the Mid-Year Report, an increase of $1.9 million from the First Quarter Report. The Mid-Year Report notes that this variance is due to increases in occupancy and room rates, as well as to additional overnight visitors to San Diego during calendar year 2015. In order to better capture the continued strength of the City's tourism trends reflected in TOT receipts and as forecast by the San Diego Tourism Authority, Financial Management has increased the TOT growth rate from 6% to 7% for the remainder of this fiscal year only. Our Office believes that this growth rate increase is appropriate, as it reflects the ongoing current growth in TOT while maintaining an awareness of the potential for unanticipated social or economic changes that could affect local tourism in the next fiscal year.

Departmental Revenues

Police AB 109 Revenue

The Mid-Year Report notes a $390,000 increase in revenue associated with Assembly Bill 109 Public Safety Realignment (AB 109), which supports Police Department overtime for monitoring out-of-custody offenders. We note that this amount is the net surplus of Department revenue from other agencies, including but not limited to AB 109. Revenue attributed solely to AB 109 in FY 2016 is approximately $600,000. At the February 2016 Public Safety and Livable Neighborhoods Committee meeting, the Police Department reported that AB 109 revenue of $600,000 in FY 2016 represented a significant decrease from FY 2015 revenue, which was $1.1 million. Because the Department limits AB 109 overtime expenditures to the corresponding amount of revenue received from the State, the revenue decrease does not have an impact to the General Fund. However, some Committee members expressed interest in exploring the possibility of subsidizing the Police Department's monitoring of parolees in excess of AB 109 revenue in the future.

General Fund Expenditures

The $3.9 million in under-budget General Fund expenditures projected at Mid-Year (less than 1% total variance) is primarily related to under-budget energy and utilities and transfers out (in the "Other" category) expenditures. Those under-budget expenditures are partially offset with over-budget contracts, supplies, and fringe benefits expenditures. A breakdown of variances between the FY 2016 Adopted Budget and year-end projections is included in the table below.[2]

General Fund Mid-Year Expenditures (*$ in millions*)

	Adopted Budget	Mid-Year Projection	Variance	Variance %
Personnel Expenditures				
Salaries & Wages	$ 522.4	$ 522.4	$ (0.0)	0.0%
Fringe Benefits	356.3	357.5	(1.2)	-0.3%
Sub-Total	$ 878.7	$ 879.9	$ (1.2)	-0.1%
Non Personnel Expenditures				
Contracts	$ 220.3	$ 223.4	$ (3.0)	-1.4%
Energy & Utilities	47.1	38.7	8.4	17.8%
Information Technology	26.8	26.2	0.7	2.5%
Supplies	28.7	31.8	(3.2)	-11.0%
Other	86.4	84.1	2.3	2.6%
Sub-Total	$ 409.4	$ 404.2	$ 5.1	1.3%
TOTAL GENERAL FUND	$ 1,288.0	$ 1,284.1	$ 3.9	0.3%

Table may not total due to rounding.

[2] The IBA's review of the mid-year expenditure variances is based on a comparison of projections to the FY 2016 ***Adopted*** Budget, while the Mid-Year Report compares projections to the FY 2016 ***Current*** Budget. Although the Current Budget figures match the Adopted Budget figures in total, adjustments have been made among departmental budgets and expenditure categories. These adjustments cause differences between the variance amounts reported in the Mid-Year Report and variances discussed in this report.

The salaries and wages category shows no variance between the Adopted Budget and the Mid-Year projection; however, a combination of over-budget and under-budget components net to zero. There is $12.3 million in projected under-budget salaries, including:

- Police Department - $5.7 million
- Transportation & Storm Water (TSW) Department - $2.0 million
- Park & Recreation Department - $915,000
- Library - $642,000
- General Services - $623,000

These under-budget salaries are offset by the following over-budget expenditures:

- $9.0 million in overtime, including $6.0 million, $1.6 million, and $631,000 for Police, TSW, and Fire-Rescue departments, respectively
- Overages of $1.7 million in pay-in-lieu of annual leave and $1.1 million in termination pay, spread over a number of departments
- $487,000 overage in hourly pay, largely due to Park & Recreation's $426,000 overage

The net $1.2 million in projected over-budget fringe benefits also includes a number of offsetting components, some of which are listed below.

- Over-budget fringe expenditures, due in part to the following:
  - $4.7 million increase in workers' compensation costs due to increases in operating costs and increased reserve needs as described in the "Risk Management Reserves" section of this report
  - $906,000 increase in Medicare costs
  - $467,000 increase in SPSP-H
- Under-budget fringe expenditures include:
  - $3.6 million in flexible benefits projections
  - $1.5 million from the reduced General Fund allocation of the Actuarially Determined Contribution (ADC) pension payment

Total non-personnel expenditures are projected to be $5.1 million under-budget compared with the FY 2016 Adopted Budget. Specific variances include the following:

- Contracts are over-budget by $3.0 million due to a number of relatively small over-budget variances that more than offset under-budget variances of a similar magnitude. The largest contracts variances include the following:
  - $3.4 million over-budget Citywide contracts, largely due to increased Public Liability fund operational needs
  - $3.8 million in TSW over-budget contracts expenditures largely due to recent storms (although this is mostly offset with $1.7 million that was originally budgeted in capital expenditures and $1.6 million in under-budget transfers out)
  - $1.8 million reduction in Park & Recreation contracts expenditures budget that was moved to the other expenditures category (transfers out)
  - $917,000 in under-budget Economic Development contract expenditures

- Energy & utilities includes $8.4 million in under-budget expenditures across departments. The largest under-budget variance is $4.6 million in Park & Recreation, of which $3.5 million is due to savings from water conservation efforts. The Police and Environmental Services departments are also under-budget by $1.3 million and $797,000, respectively.

- Supplies are projected at $3.2 million in over-budget expenditures, including the following:
  - $1.6 million in over-budget TSW supplies expenditures, largely related to recent storms
  - $862,000 and $612,000 in over-budget Police and Fire-Rescue supplies, respectively

- Other expenditures are projected to be $2.3 million under-budget, including the following variances:
  - $1.6 million in under-budget TSW transfers out as mentioned above
  - $1.8 million in under-budget TSW capital expenditures, largely due to moving this budget to the contracts category
  - $1.5 million in over-budget Park & Recreation transfers out, although there is an offsetting under-budget amount in contracts, as mentioned above

A discussion of notable budget variances can be found in the Mid-Year Report produced by the Financial Management Department. Additional expenditure information and analysis is included in the "Departmental Expenditures" section of this report.

Departmental Vacancies

The Vacancy Report indicates that as of January 4, 2016 there were approximately 1,047.25 full time equivalent (FTE) vacancies citywide. Vacancies are constantly changing, and the January listing is only a snapshot in time. The number of citywide vacancies has decreased by 65.25 FTE between the November 27, 2015 snapshot of 1,112.50 FTE and January 4, 2016, a little over a month's time. Department vacancy issues are discussed in the Mid-Year Report and are included in the "Departmental Expenditures" section of this report.

As part of the normal budget cycle, positions that become vacant during the year are anticipated to generate vacancy savings. Vacancy savings have been estimated in the budget for normal turnover, including leaves of absence and instances when newly hired employees fill vacancies at lower salaries than budgeted.

However, currently projected General Fund salary savings are approximately $12.3 million in excess of the FY 2016 Adopted Budget, $5.7 million of which is related to the Police Department. Our Office notes that salary savings is the largest budget variance, and that if the remaining vacancies that are planned to be filled by year end are not filled as projected, there could be additional vacancy savings at year-end. During the budget process, it should be carefully considered whether it is reasonable to anticipate that new positions added to a budget will be filled for the full fiscal year. If not, the budget should reflect only partial year funding, as appropriate.

Savings garnered through a higher level of vacancies are offset by other personnel expenditures, including termination pay, pay-in-lieu of annual leave, and overtime. Overtime projected for FY

2016 exceeds the adopted budget by approximately $9.0 million (this includes $6.0 million for the Police Department); termination pay and pay-in-lieu of annual leave are projected to be $2.8 million over budget.

Departmental Expenditures – General Fund

Fire-Rescue Department

The Fire-Rescue Department is projected to exceed budgeted overtime expenditures by approximately $631,000, for total overtime expenditures of $30.6 million. The Mid-Year overtime projection represents a $261,000 increase from the projection previously provided at the First Quarter. The Department has indicated that over-budget overtime is due primarily to $1.6 million in expenditures for strike team and other emergency suppression deployments. As strike teams are deployed during a given fiscal year, the Fire-Rescue Department incurs overtime expenditures as a result of the related backfill of positions. The Department generally receives reimbursement for these costs in either the same or the following fiscal year. In FY 2016, the Department is projected to receive unbudgeted revenue of approximately $1.3 million as reimbursement from the California Office of Emergency Services for current-year strike team deployments.

Apart from overtime related to strike team deployments, Fire-Rescue Department overtime for regular operations is projected to remain within budget. However, the Department is currently experiencing overtime savings of approximately $1.0 million due to the delayed implementation of three expanded programs in FY 2016: Skyline Temporary Fire Station, East Mission Valley Fire Station, and the University City Fast Response Squad. Had these programs been operational for the full fiscal year as was anticipated in the FY 2016 Adopted Budget, the Department's overtime expenditures related to regular operations would likely still have remained within budget. Overall overtime expenditures, however, would have exceeded budget due to strike team deployments. Rather than account for unbudgeted strike team revenue and expenditures during the mid-year budget monitoring process, the Department should consider including these amounts in the annual budget development process.

Park & Recreation Department

The Mid-Year Report projects $3.5 million in savings from water and sewer expenses for the Park & Recreation Department from the FY 2016 Adopted Budget allocations. On April 1, 2015, Governor Brown mandated substantial water use reductions across the State. To comply with the mandate, the Department enacted multiple water conservation efforts such as reducing watering areas and times, turf replacement programs, and limited use of water fountains. The effectiveness of these programs have resulted in lower than projected water usage, and associated savings. Additionally, the Department has indicated that the savings from less water use takes into consideration the rate increase which became effective in January 2016.

Police Department

The Police Department continues to experience a high number of vacancies in excess of budget, which has contributed to a projection of $5.7 million in salary savings. Although the Department has made significant progress in hiring new officers by holding expanded police academies, attrition continues to exceed budgeted assumptions at a rate of approximately 13 sworn departures per month, compared to the attrition rate of nine sworn departures per month assumed in the FY 2016 Adopted Budget. The continued higher-than-anticipated attrition has contributed to an increase in vacancy savings, an increase in extension-of-shift overtime, and an increase in termination pay as noted in the Mid-Year Report.

The Police Department is projected to exceed budgeted overtime expenditures by $6.0 million, for a total of $24.0 million in overtime expenditures. This represents a $1.0 million increase from the FY 2016 First Quarter Report. Of the $6.0 million overtime projection in excess of budget, the Department attributes $4.0 million to extension-of-shift related overtime, $1.4 million to grant and task force related overtime, and $600,000 to unbudgeted AB 109 overtime. The increase from the First Quarter to the Mid-Year Report is due to an increase in extension-of-shift overtime. The Police Department has indicated that its expanded use of this type of overtime is due to increased neighborhood policing efforts, increased training that includes more experienced officers working alongside new officers, backfilling to meet recommended staffing levels, and calls taking longer to resolve. The impact of this type of overtime to the General Fund is of concern as these expenditures will not be reimbursed.

Strategic Initiatives – General Fund

The Mid-Year Report provides updates on some of the projects, programs, and services that received additional funding in the FY 2016 Adopted Budget, as well as other items of interest. In the sections below, our Office provides additional information on storm-related expenditures and the Mayor’s streets repair goals, as well as updates on two Public Safety initiatives.

Mayor’s Streets Repair Goal

The Mid-Year Report includes an update on the Mayor’s initiative to repair 1,000 miles of city streets over the next five years. Initial plans called on the City to repair approximately 300 miles in FY 2016.

To date, 90 miles of repairs have been completed, 127 miles of repairs have been initiated but not yet completed, and an additional 91 miles of repair are expected to be initiated this fiscal year. $74.0 million in funding from TransNet, Gas Tax, lease revenue bonds, and the General Fund were allocated to this effort in FY 2016, in the following amounts:

Street Repair Goal Funding Sources (*$ in millions*)	
Prop 42	$ 27.0
Gas Tax	$ 7.5
Lease Revenue Bonds	$ 30.0
TransNet	$ 8.5
General Fund	$ 1.0

It would be appropriate for Council to receive periodic updates on miles repaired and funding expended on this goal throughout the remainder of the fiscal year, as well as updated information on the streets Overall Condition Indicator (OCI).

Police Department

Police CAD Replacement Project. The City Council approved a contract with Intergraph Corporation for the Police Department Computer-Aided Dispatch (CAD) replacement project on December 8, 2015. The Department has indicated that planning for initial software installation and configuration is currently underway, and that hardware installation is planned to begin in March 2016. The project is estimated to be complete by December 2017.

Feasibility Study for Police Traffic Division Facility. The Police Department contracts projections include $250,000 to fund a feasibility study to replace the Traffic Division facility located on Aero Drive. The facility, originally built in 1999, is composed of a series of trailers joined together to form a temporary modular building. The Police Department has indicated that the building lacks the functionality necessary to meet its operational needs. During the FY 2016 budget process, a majority of City Councilmembers requested in their budget modification memoranda that funding be provided for the design of a permanent replacement facility. Ultimately, funding was not provided for this purpose in the FY 2016 Adopted Budget.

At the request of the Chair of the Public Safety and Livable Neighborhoods Committee, our Office conducted further analysis of the facilities needs at Traffic Division and released IBA Report 15-37, "Police Department Traffic Division Facility Needs." In that report, we proposed funding a feasibility study for a permanent facility to allow Public Works to work with the Police Department to analyze property issues, operational needs, and desired facility conditions. After a hearing at the Public Safety and Livable Neighborhoods Committee in October 2015, the City Council approved a resolution in December 2015 requesting that the Mayor include $250,000 in funding for the feasibility study in the FY 2016 Mid-Year Budget Adjustments. The Public Works has indicated that the study will take 9-12 months to complete.

Storm-related Expenditures

The Mid-Year Report projects $8.5 million in expenditures beyond what was budgeted, resulting from the City's emergency response to the recent winter storms. These costs are largely non-personnel expenses related to emergency capital improvement projects and pump-station maintenance needs, though they do include a total of $260,000 in overtime for expenses incurred in the Transportation & Storm Water and Fire-Rescue departments.

As winter forecasts continue to predict chances of significant rainfall due to an El Niño year, these expenses should be monitored closely throughout the remainder of the year to ensure that any additional storm-related expenses are provided for.

Departmental Expenditures – Non-General Funds

Low Income Housing Lease Revenue Fund

During the annual State of the City address in January 2016, the Mayor announced the Homeless Veterans Initiative to provide housing opportunities for up to 1,000 homeless veterans in the City within one year. The City and the San Diego Housing Commission (SDHC) are partnering to achieve this goal. The Homeless Veterans Initiative is to be comprised of multiple programs with a total projected cost of approximately $12.5 million. The SDHC has identified approximately $5.5 million in federal resources, $4.0 million in contributions from the City, and $3.0 million in SDHC resources to address the projected cost of $12.5 million.

The Mid-Year Report is proposing to appropriate $4.0 million to the Homeless Veterans Initiative from the Low Income Housing Lease Revenue Fund. The Low Income Housing Lease Revenue Fund was established to collect lease revenues from City-owned properties for low and moderate income housing and transfer the funds to the Housing Authority for use by the SDHC for the purpose of increasing the supply of low and moderate income housing. With the appropriation of $4.0 million from this fund, the remaining balance in this fund would be approximately $1.9 million. Per the SDHC, the allocation of $4.0 million from this fund will not impact any currently planned programs.

Public Utilities Department – Pure Water Program

The Mid-Year Report includes an update on the City's Pure Water program that will provide for the potable reuse of wastewater. The FY 2016 Adopted Budget included $15.0 million in expenditures to support this program, however, the Mid-Year Report notes that only $1.2 million has been expended to date. The Public Utilities Department states that actual expenditures and encumbrances to date have been $13.6 million, and that it expects that the full $15.0 million will be expended or encumbered by the end of the fiscal year.

Status of Reserves and General Fund Mid-Year Budget Adjustments

The following sections discuss the overall General Fund Reserve requirement, Risk Management Reserves, available fund balance in the General Fund above the Reserve requirement ("Excess Equity"), and recommended mid-year budget adjustments which, if approved by Council, would reduce Excess Equity.

General Fund Reserve Requirement

The Mid-Year Report provides a breakdown of the current total General Fund reserve balance, how much of this reserve balance is required to be utilized for the City's emergency and stability reserves, and the resulting projected Excess Equity after these requirements are met.

The City's Reserve Policy requires that the combined emergency and stability reserves equal 14% of the last three fiscal years' average of audited General Fund operating revenues. The 14% reserve requirement in FY 2016 is $159.0 million, as shown in the table below. Note that in future years, the City's required emergency and stability reserve amounts are anticipated to increase as revenues increase.

$ in millions	FY 2015 Reserve Requirement	FY 2016 Reserve Requirement
FY 2015 Audited Revenues		$ 1,144.5
FY 2014 Audited Revenues	$ 1,171.7	1,171.7
FY 2013 Audited Revenues	1,092.0	1,092.0
FY 2012 Audited Revenues	1,108.4	
3 Year Average Revenues	$ 1,124.0	$ 1,136.1
14% of Average Revenues	$ 157.4	$ 159.0

In response to Council direction at the January 25, 2016 City Council meeting, the Chief Financial Officer (CFO) is working to revise the City's Reserve Policy for presentation to B&GE this March. Substantive revisions will include increasing the General Fund Reserve target from 14% to 16.7% of operating revenues and establishing the new Pension Payment Stabilization Reserve.

Rating Agencies' References to City Reserves

Earlier this month, two of the major rating agencies acknowledged the City's growing reserves and policy targets in reaffirming their credit ratings for the City. On February 2, 2016, Fitch Ratings reaffirmed the City's 'AA-' rating and revised their rating outlook for the City from stable to positive. In reaffirming the rating, Fitch praised the City's recent efforts to increase reserves (General Fund Reserve increase to 16.7% and intention to achieve Public Liability and Workers' Compensation reserve policy goals) and create a pension payment stabilization reserve. On February 12, 2016, Moody's Investor Services reaffirmed the City's 'Aa2' rating citing "a strong and improving financial position market by growing reserves and policy targets."

Risk Management Reserves

Public Liability Reserve

The goal for the Public Liability Reserve, per the City Reserve Policy, is that the overall reserve target of 50% of the outstanding actuarial liability be reached by FY 2019. Presently, this estimate is based on the average value of annual actuarial liabilities for the three fiscal years ending in 2015, which equals $91.8 million. The target amount of 50% of this actuarial liability amount is $45.9 million.

For FY 2016, the Reserve Policy target is 40% of the actuarial liability, or $36.7 million. The current Reserve balance is $22.9 million, which is $13.8 million below the target. The Mid-Year Report is recommending that $5.8 million be contributed to the Public Liability Reserve, utilizing a $2.5 million transfer of Park & Recreation Department expenditure savings, combined with a $3.3 million increased General Fund expenditures appropriation. Contributing $5.8 million to the

Public Liability Reserve will utilize all but $1.8 million of the mid-year budgetary surplus, and it will bring the Reserve to 31% of the target amount. Our Office believes that this action is prudent.

The goal for FY 2016 to meet the 40% target, after making the $5.8 million recommended Mid-Year contribution, will require an additional $8.0 million contribution. We also concur with adhering to the goal of achieving the 40% target for FY 2016. The Year-End Budget Monitoring Report will include updates on the budget needs of the following reserves: Public Liability, Worker's Compensation, General Fund, and Pension Payment Stabilization. The funding needs for all of these reserves will likely exceed $30.0 million, and could, by themselves, utilize the entirety of the projected General Fund Excess Equity.

As noted above, the CFO is working to revise the City's Reserve Policy for presentation to B&GE this March. Substantive revisions are expected to include increasing the General Fund Reserve target to 16.7% of operating revenues and establishing the new Pension Payment Stabilization Reserve.

Workers' Compensation Reserve

For FY 2015, the Workers' Compensation (WC) Reserve had met the overall target level of 25% of the outstanding liability for WC. The outstanding liability is based on the average of the annual actuarial liabilities for the most recent three fiscal years. For FY 2015, that liability was $193.7 million (based on the average of liabilities for FY 2012 through 2014). The corresponding 25% target was $48.4 million.

With the June 30, 2015 valuation completed, the average of the outstanding liabilities for the three fiscal years 2013 through 2015 increased to $218.1 million, increasing the WC 25% target to $54.5 million. The current reserve balance is approximately $48.4 million, or $6.1 million less than the target.

The Mid-Year Report indicates that the City will increase FY 2016 contributions to the WC Reserve, by $3.1 million. Although the remaining $3.0 million needed to reach the 25% target is not recommended for funding in the Mid-Year, the goal is still to reach the target by year-end. As stated previously, the funding needs for a number of City reserves will be reviewed again with the release of the Year-End Budget Monitoring Report. We support adhering to the goal of achieving the 25% WC Reserve target in FY 2016.

Long-Term Disability Reserve

For FY 2015, the Long-Term Disability Reserve (LTD) had also met the overall target level, which is 100% of the outstanding liability for LTD. The outstanding liability is based on the average of the annual actuarial liabilities for the most recent three fiscal years. For FY 2015, that liability was $18.3 million, based on the average of liabilities for FY 2012 through 2014.

With the June 30, 2015 valuation completed, the average of the outstanding LTD liabilities for the three fiscal years 2013 through 2015 decreased by $3.4 million, to $14.9 million. The current reserve balance of approximately $18.4 million exceeds that target.

Initial Excess Equity Estimate

The estimated FY 2016 beginning reserve balance for the General Fund is $196.5 million. As displayed in the table below, there is $39.9 million in projected Excess Equity based on the current 14% reserve requirement of $159.0 million, and before any future expenditures are removed.

Initial Excess Equity Calculation ($ in millions)		
FY 2016 Beginning Reserve Balance	$	196.5
FY 2016 Projected Surplus		1.5
Adjust for FY 2015 Accrued Low Flow Diversion Capacity Charges		1.0
Subtotal − FY 2016 Year-End Reserve Estimate	$	199.0
14% Reserve Requirement		159.0
FY 2016 ENDING EXCESS EQUITY ESTIMATE	**$**	**39.9**

Table may not total due to rounding.

The next section discusses recommended mid-year budget adjustments which, if approved, would impact the Excess Equity estimate.

Mid-Year Budget Adjustments

The amount that can be recommended for budgetary use at mid-year is based upon projected **budgetary surplus**. The Mid-Year Ordinance, codified in Municipal Code section 22.0229, requires the Mayor to report any budgetary deficit or surplus in the General Fund projection to the City Council and make a recommendation for addressing the deficit or surplus. In the case of a surplus, such as projected for the current year, the ordinance then requires:

- The Mayor may recommend budgeting all, none, or any portion of projected surplus; and
- The City Council may approve the Mayor's recommendation or modify such recommendation in whole or in part.

The table below displays the components of the $7.6 million in estimated budgetary surplus for FY 2016, based on mid-year projections. The components include the following:

- $6.2 million Excess Equity used to balance the budget – the FY 2016 Adopted Budget was originally balanced using $6.2 million in excess equity, as budgeted revenues were lower than budgeted expenditures. This resource is not needed based on mid-year projections.
- $1.5 million projected surplus – mid-year projected revenues minus projected expenditures yield a surplus of $1.5 million

$ in millions	Adopted Budget	Year-End Projection	Budgetary Surplus/(Deficit)
Revenue	$ 1,281.9	$ 1,285.6	$ 3.7
Expenditures	$ (1,288.0)	$ (1,284.1)	$ 3.9
USE OF EXCESS EQUITY	$ (6.2)	$ 1.5	$ 7.6

Table may not total due to rounding.

The Mayor is recommending that $5.8 million of the projected $7.6 million in General Fund budgetary surplus be spent to fund the FY 2016 Public Liability Reserve. If Council approves the recommendation for using the $5.8 million in budgetary surplus, the remaining budgetary surplus would be $1.8 million. This surplus can be used to fund the estimated $1.0 million required for the FY 2017 Community Projects, Programs, and Services (CPPS) budgets, as well as any unanticipated expenditures such as those which may result from the effects of El Niño.

Based on the identified budget surplus and recommended use, Council options are as follows:

- Accept the Mayor's budget recommendations in full and fund the Public Liability Fund in the amount of $5.8 million, using a $3.3 million additional expenditure appropriation, combined with the transfer of budget related to $2.5 million in Park & Recreation expenditure savings
- Modify the Mayor's recommendations as desired for any amount less than or equal to $5.8 million

Adjusted Excess Equity

The Mid-Year Report reduces the initial $39.9 million Excess Equity estimate (discussed earlier) to $38.9 million after adjusting for $1.0 million in estimated City Council budgetary savings to be re-budgeted as CPPS in FY 2017.

Further, if Council approves the Mid-Year recommended $5.8 million contribution to the Public Liability Reserve, Excess Equity would be reduced to $33.1 million.

Adjusted Excess Equity ($ in millions)	
FY 2016 Ending Excess Equity Estimate	$ 39.9
FY 2016 Estimated Council Savings for FY 2017 CPPS	(1.0)
Subtotal − Adjusted Excess Equity	$ 38.9
Mid-Year Recommended Public Liability Reserve Contribution	(5.8)
FY 2016 ADJUSTED EXCESS EQUITY ESTIMATE	**$ 33.1**

A number of items may impact the year-end projections. First, the funding needs for City reserves supported by the General Fund could potentially utilize the entirety of the projected General Fund Excess Equity.

- Public Liability and WC reserves are not projected to be fully funded to their target levels in the Mid-Year Report. The Public Liability and WC reserves are currently projected to be $8.0 million and $3.0 million short of targeted funding, respectively. To fund these reserves to their FY 2016 target levels, the General Fund would be responsible for contributing the full $8.0 million for Public Liability and $2.5 million for WC.
- As mentioned previously, the revised City Reserve Policy is anticipated to be presented to B&GE in March 2016. Increasing the General Fund Reserve from 14% to 16.7% of operating revenues would cost approximately $30.7 million, if fully funded immediately. The most likely approach would be to phase-in the increased funding requirement over several years.
- The City Reserve Policy revisions will also include the addition of a Pension Payment Stabilization Reserve. The Mayor had originally requested $15.0 million in General Funds for the Pension Reserve.

Additionally, the City Council is considering whether to place as many as 10 separate ballot measures on the June 2016 ballot. Based on their best estimate of the election service costs associated with the City's June ballot measures and candidate races, the County Registrar of Voters will bill the City for those costs early in May 2016. Approximately $4.2 million was appropriated in the FY 2016 Adopted Budget for the June election; however, the current projected cost for the June 2016 Primary, assuming that all 10 measures are approved, is approximately $5.2 million. If the Council decides to place all 10 measures on the ballot, the City will need to identify approximately $1.0 million of available funds for these additional election costs.

Financial Management plans to further update projections and Excess Equity estimates for the Year-End Report, as well as provide recommendations for funding the Public Liability and WC reserves. Currently, these reserves are only funded at 31% and 23.6%, respectively, while their FY 2016 targets are 40% and 25%, respectively. The intention per the Mid-Year Report is to fully fund Public Liability and WC reserves to their FY 2016 reserve targets, which would require $8.0 million and $2.5 million, respectively. Our Office supports achieving these targets and, as stated above, notes that the CFO will be bringing recommendations for funding the new Pension Payment Stabilization Reserve and increasing the General Fund Reserve requirement to B&GE in March.

The Mid-Year Report does not address a funding plan for meeting all current policy goals for reserves; however it notes that the Mayor is focused on funding all reserve policy goals for FY 2017, which would include the new Pension Payment Stabilization Reserve and an increased General Fund Reserve. Specific funding levels for these are to be determined in the Mayor's FY 2017 Proposed Budget. With the receipt of the revised City Reserve Policy in March and the updated year-end projections in April, the City will be better able to make informed decisions on funding all of its reserves.

We also note for Council reference that the $5.0 million that had been set aside for the Bayside Fire Station in FY 2016 has been earmarked as General Fund revenue for FY 2017 in the most recent Five-Year Outlook. The FY 2016 Adopted Budget included $5.0 million from the General Fund to fund the Bayside Fire Station CIP project. After the budget was adopted, however, other eligible funding from previously unallocated bond proceeds was identified for the Bayside Fire Station CIP as part of the Semi-Annual Capital Improvements Program Monitoring Report and CIP Budget Revisions item approved by Council on December 14, 2015. The original $5.0 million contribution from the General Fund to the Bayside Fire Station has been de-appropriated from the CIP and remains unallocated in Fund 400265, CIP contributions from General Fund.

CONCLUSION

The Office of the IBA has reviewed the Mid-Year Report and we believe that the projections included in the Report are appropriate. Our Office notes that the requested Appropriation Adjustments: to increase General Fund appropriations in order to fund the Public Liability Reserve, to appropriate $4.0 million in the Low Income Housing Lease Revenue Fund for the Homeless Veterans Initiative, and to transfer funds between CIP projects, are all prudent requests. There will be, however, additional requests for General Fund dollars before the end of the fiscal year such as increased costs associated with the June 2016 election and additional funding needs to meet Public Liability and WC Reserve targets. Our Office notes that at this time there is no revenue source to support these requests outside of Excess Equity.

Christiana Gauger
Fiscal & Policy Analyst

Charles E. Modica, Jr.
Fiscal & Policy Analyst

Chris Ojeda
Fiscal & Policy Analyst

Chris Olsen
Fiscal & Policy Analyst

Lisa Byrne
Fiscal & Policy Analyst

Jeff Kawar
Deputy Director

Andrea Tevlin
Independent Budget Analyst