THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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IBA Review of the FY 2017 Mid-Year Budget Monitoring Report

OVERVIEW

The Fiscal Year 2017 Mid-Year Budget Monitoring Report (Mid-Year Report) was issued on January 30, 2017, and was presented to the Budget and Government Efficiency Committee (B&GE) on February 2, 2017. The Mid-Year Report describes the current status of revenues and expenditures and their year-end projections based on actual (unaudited) data from July 2016 through November 2016.

The Mid-Year Report reflects projected increased General Fund revenues of approximately $9.5 million at fiscal year-end and projected increased expenditures of $13.6 million, for a total budgetary deficit of $4.2 million. The positive variance in General Fund revenues from the FY 2017 Adopted Budget is primarily due to a projected increase in miscellaneous revenues that reflects the one-time receipt of $13.6 million associated with the annexation of property near the Mount Hope Cemetery approved by Council in December 2016. General Fund expenditures are projected to come in over-budget at year-end largely due to Fire-Rescue and Police Departments' Salaries & Wages expenditures.

Despite the projected year-end deficit of $4.2 million, the Mid-Year Report does not include a request for an appropriation adjustment. Instead, the Financial Management Department (FM) will continue to monitor the budget and request an appropriation if necessary as part of the FY 2017 Year-End Budget Monitoring Report (Third Quarter Report) released in May. Updates to the year-end projections in the Mid-Year Report, including the receipt of a $12.6 million one-time payment from the Chargers due to the early termination of the Qualcomm Stadium contract, will be discussed at that time.

In past years the Mid-Year Report has included the status of revenues and expenditures over six months, July through December, as required by Municipal Code section 22.0229 and Council Policy (CP) 000-02. The FY 2017 Mid-Year Report, however, is based on five months of activity:

from July 2016 through November 2016. FM indicates that staff plans to return to Council with amendments in order to make the change to a five-month reporting period permanent. A review of this and other recent changes to the City's budget monitoring process is discussed in the "Additional Considerations – Quarterly Budget Monitoring Process" section of this report.

The Mid-Year Report includes a 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 the IBA review of the Mid-Year Report is to provide clarification and additional information for items outlined in that report. In our review we also include discussions of vacancy issues, recent and proposed changes to the City's budget monitoring reports, and an analysis of projected year-end expenditures for select departments, reserve goals, and an updated Excess Equity estimate.

The Mid-Year Report requests that the City Council approve three items, none of which affect the General Fund: a $2.0 million increase in the Development Services Enterprise Fund for debt payments for the Accela project; the transfer of $5.9 million of excess reserves in the Public Liability Reserve Fund to the Public Liability Operating Fund; and the appropriation of up to $5.0 million to a new capital project for tenant improvements for 101 Ash Street. Our Office believes that these requests are appropriate and we do not raise any related concerns in this report.

Finally, our review of the Mid-Year includes discussions of three issues for Council's consideration: how and when vacancy information is presented to the City Council, the fiscal impact of Fire-Rescue Department staffing changes, and the type of expenditure and revenue information included in First Quarter Budget Monitoring Reports. These three items are discussed in this report and recommendations for each of these items are included in the conclusion.

FISCAL/POLICY DISCUSSION

Major General Fund Revenues

The Mid-Year Report notes that FY 2017 General Fund revenues are projected to end the year $9.5 million, or 0.7% over-budget, despite an overall decrease in major General Fund revenues from the FY 2017 Adopted Budget and the FY 2017 First Quarter Budget Monitoring Report's (First Quarter Report) year-end projections, as displayed in the table on the following page. Reductions in major General Fund revenues are due to reductions in sales tax, transient occupancy tax (TOT), and major franchise fees that are partially mitigated by increases in property tax and property transfer tax, 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 $14.3 million over-budget primarily due to the receipt of $13.6 million in one-time revenues associated with the annexation of property near the Mount Hope Cemetery which was approved by City Council in December 2016.[2] Increases in miscellaneous and

[1] The miscellaneous revenue category includes a mix of ongoing and one-time revenues that include the following: 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.
[2] The $13.6 million in one-time revenues was transferred to the City from the County and intended to fund storm water maintenance and monitoring expenses in the annexation area over the next 100 years.

department revenues offset the overall decrease in major General Fund revenues, as discussed in detail in the Mid-Year Report.

Our Office has reviewed the year-end projections for property tax, property transfer tax, sales tax, TOT, and franchise fees included in the Mid-Year Report. The following table outlines changes in year-end projections for major General Fund revenues from the FY 2017 Adopted Budget and the First Quarter Report as compared to the Mid-Year Report. Major General Fund revenues are projected to be under-budget by approximately $9.6 million at fiscal year-end, due primarily to a projected $8.7 million reduction in major franchise fees, although this projection is mitigated by a $14.3 million increase in miscellaneous revenues.

FY 2017 Projected Year-End General Fund Revenue (*$ in millions*)

Revenue Source	Adopted Budget	First Quarter Projection	Mid-Year Projection	Variance: Adopted Budget to Mid-Year	Variance: First Quarter to Mid-Year
Major General Fund Revenues					
Property Tax	$502.0	$505.0	$503.3	$1.3	($1.8)
Sales Tax	272.8	268.7	271.5	(1.3)	2.8
Transient Occupancy Tax	113.3	113.4	112.5	(0.9)	(1.0)
Major Franchise Fees	81.0	80.6	72.3	(8.7)	(8.3)
Sub-Total Major General Fund Revenues:	**969.1**	**967.8**	**959.5**	**(9.6)**	**(8.3)**
Miscellaneous Revenues[1]	70.5	N/A	84.8	14.3	N/A
Property Transfer Tax[1]	9.6	N/A	9.8	0.2	N/A
Department Revenues[1]	280.8	N/A	285.4	4.6	N/A
Total:	**$1,330.0**	**$967.8**	**$1,339.4**	**$9.5**	**($8.3)**

Note: Table may not total due to rounding.

[1]Year-end projections for property transfer tax, miscellaneous, and department revenues were not part of the First Quarter Report and are not available for comparison to the Mid-Year Report.

Since the release of the Mid-Year Report, the City has received a one-time payment of $12.6 million due to the Chargers early termination of their Qualcomm Stadium contract; this payment is not reflected in the table above. Receipt of the Chargers payment increases the year-end projection for miscellaneous revenues to $97.4 million, a $26.8 million increase over the FY 2017 Adopted Budget.

Overall we believe that the projections included in the Mid-Year Report are appropriate based on revenue distributions to date and current economic information, although we note the change in the reporting of property transfer tax. Property transfer tax was included as part of the Mid-Year Report but was omitted from the First Quarter Report this year, meaning that a quarterly comparison of this revenue source is not available. While property transfer tax—budgeted at under $10.0 million for the fiscal year—is not considered a major source of revenue for the City, revenues collected reflect the number of properties sold and therefore can be an important indicator of changes in the real estate market.

Additional details regarding the major General Fund revenues with the largest variance from the First Quarter Report—sales tax and major franchise fees—are discussed in the sections below.

Sales Tax

FY 2017 sales tax revenue in the Mid-Year Report is projected at $271.5 million, which is $1.3 million below revenue included in the Adopted Budget, but $2.8 million higher than the $268.7 million projected in the First Quarter Report. The increase over First Quarter projections is largely due to increased fuel prices and strong business-to-business sales.

The Adopted Budget included a 3.5% growth rate over FY 2016 sales tax revenues; at the time of the First Quarter Report, adjusted sales tax receipts only grew by 2.2%, but the second quarter showed 3.3% growth. The Mid-Year Report therefore includes a 3% projection for the remaining quarters in FY 2017.

Franchise Fees

Franchise fee revenue projections in the Mid-Year Report show a substantial decrease from both the Adopted Budget and the First Quarter Report projections. The FY 2017 Adopted Budget anticipated $81.0 million in General Fund franchise fees, which are received from San Diego Gas & Electric (SDG&E), cable providers, and tip fees at the City's landfill. The Mid-Year Report projects franchise fee receipts at $72.3 million, which is a decrease of $8.7 million from the Adopted Budget.

Decreases are due to a decline in cable franchise fee revenue of $2.0 million (from a total of $18.7 million in the Adopted Budget to $16.7 million in the Mid-Year Report projections), and a decline in SDG&E franchise fee revenue of $7.6 million (from $49.2 million in the Adopted Budget to $41.6 million in the Mid-Year Report projections).

Cable revenues have shown small declines over the past several years, as some consumers shift from television to online services. SDG&E franchise fee revenue has been difficult to project accurately, as energy prices fluctuate rapidly and the City has a limited ability to view the data SDG&E uses to make its own forecasts. Past years have seen substantial single-year declines in SDG&E franchise fee revenue (a decline of 7.4% in FY 2010) and single-year growths (21.1% in FY 2015).

General Fund Expenditures

As discussed in the Mid-Year Report and in our review, projected year-end General Fund expenditures are over-budget largely due to overages in Fire-Rescue and Police Departments' Salaries & Wages. There are projected year-end deficits in Supplies and Contract expenditures as well, despite a request made in the Chief Operating Officer's (COO) November 9, 2016 memorandum, for General Fund departments (and non-General Fund departments with a General Fund impact) to suspend all non-essential discretionary expenditures. While many departments did comply with the COO's request by delaying program expenditures, reducing non-essential expenditures, and lowering training costs, any savings that occurred as a result of these strategies was not enough to reduce projected year-end FY 2017 deficits in General Fund expenditures.

The $13.6 million in over-budget General Fund expenditures projected at Mid-Year (a 1% total variance) is primarily related to over-budget expenditures in Salaries & Wages, Supplies, and

Contracts categories. Those over-budget expenditures are partially offset with under-budget Energy & Utilities, Transfers Out, and Debt category expenditures. Financial Management has provided explanations for many of the budget variances in the Mid-Year Report, and this report supplements that information. This section provides highlights of major variances—a breakdown of variances between the FY 2017 Adopted Budget and year-end projections is included in the table below.[3]

General Fund Mid-Year Expenditures

($ in millions)	**Adopted Budget**	**Mid-Year Projection**	**Variance**	**Variance %**
Personnel Expenditures (PE)				
Salaries & Wages	$ 534.5	$ 546.5	$ (11.9)	-2.2%
Fringe Benefits	376.9	377.7	(0.8)	-0.2%
Sub-Total PE:	$ 911.5	$ 924.2	(12.8)	-1.4%
Non Personnel Expenditures (NPE)				
Contracts	$ 240.2	$ 244.8	$ (4.6)	-1.9%
Energy & Utilities	46.9	44.6	2.3	5.0%
Information Technology	28.8	28.7	0.1	0.4%
Supplies	35.9	38.0	(2.2)	-6.0%
Other	74.7	71.3	3.5	4.6%
Sub-Total NPE:	$ 426.5	$ 427.4	(0.9)	-0.2%
Total:	**$ 1,338.0**	**$ 1,351.6**	**$ (13.6)**	**-1.0%**

Note: Table may not total due to rounding.

The Salaries & Wages mid-year projection is $11.9 million higher than the Adopted Budget. A combination of over-budget and under-budget components net to this $11.9 million. The largest over-budget amounts include:

- Salaries, special pay, overtime, and pay-in-lieu of annual leave for the Fire-Rescue Department, at $2.6 million, $1.0 million, $3.5 million, and $758,000, respectively (Fire-Rescue Salaries & Wages are discussed further in the "Departmental Expenditures – General Fund" section of this report.)
- Overtime and special pay for the Police Department, at $5.0 million and $635,000, respectively
- Overtime for the Transportation & Storm Water (TSW) Department at $1.6 million
- Overtime for other departments, at $1.0 million
- Pay-in-lieu of annual leave in departments other than Fire-Rescue, at $1.5 million
- Termination pay across departments, totaling $875,000

[3] The IBA's review of the mid-year expenditure variances is based on a comparison of projections to the FY 2017 ***Adopted*** Budget, while the Mid-Year Report compares projections to the FY 2017 ***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.

These over-budget amounts are partially offset by $8.1 million in under-budget salaries, due to vacancy savings. The departments with the largest salary savings include:

- Police, at $2.6 million
- Park & Recreation, at $977,000
- Public Works-General Services, at $875,000
- TSW, at $806,000

The Fringe Benefits category is projected to be over-budget by a net $814,000. A number of offsetting components are discussed in the Mid-Year Report, with the largest variances listed below.

- Over-budget fringe expenditures include:
    - $2.8 million in SPSP – largely due to SPSP-H contributions for post-Proposition B Firefighters' overtime
    - $1.3 million in Medicare costs largely due to overtime, termination pay, and pay-in-lieu of annual leave
    - $966,000 due to a shift in fixed Fringe Benefits costs (including the Actuarially Determined Contribution, Other Post-Employment Benefits, and Workers' Compensation) from non-General Funds to the General Fund. (These shifts in costs are based on changes in employee counts and salary amounts from what was originally budgeted.)
- Under-budget fringe expenditures include $4.2 million in flexible benefits projections largely related to higher vacancies than anticipated and changes in employees' health coverage selections during open enrollment.

Total non-personnel expenditures (NPE) are projected to be $888,000 over-budget compared to the FY 2017 Adopted Budget. A combination of over-budget and under-budget components net to this amount. The Mid-Year Report includes a full discussion of these over-budget and under-budget items. Some of the larger items are listed below:

- $3.6 million increase in Citywide Program Expenditures related to the new 101 Ash building's lease-to-own agreement
- $2.7 million increase in TSW NPE, partly related to winter storm emergency work and associated contracts
- $2.5 million increase in the Police Department, primarily for supplies, Fleet motive usage fees, photocopy services, and travel expenses—which are partially offset with a $1.2 million decrease in anticipated Energy & Utilities expenditures
- $1.5 million decrease in the Real Estate Assets Department related to delays in the modification of Civic Center Plaza – which is partially offset with a $600,000 increase related to DeAnza mobile home park management
- $3.0 million decrease in Contracts for departments other than Citywide Program Expenditures, TSW, Police, and Real Estate Assets

- $919,000 decrease in anticipated Energy & Utilities expenditures for the Fire-Rescue Department

Additional expenditure information and analysis is included in the "Departmental Expenditures – General Fund" section of this report.

Departmental Vacancies

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 turnover, including leaves of absence and instances when newly hired employees fill vacancies at lower salaries than budgeted.

Currently projected FY 2017 General Fund vacancy savings are approximately $4.4 million in excess of the $30.4 million Adopted Budget amount. This $4.4 million in over-budget vacancy savings is a net amount. The total over-budget vacancy savings is $8.1 million, which is offset with $3.6 million in over-budget salaries, including $2.6 million for the Fire-Rescue Department.

Savings garnered through a higher level of vacancies are offset by other types of Salaries & Wages expenditures. For instance, overtime projected for FY 2017 exceeds the Adopted Budget by approximately $11.1 million (this includes $5.0 million and $3.5 million for the Police and Fire-Rescue Departments, respectively). Additionally, other Salaries & Wages categories (including special pay, termination pay, and pay-in-lieu of annual leave) are projected to be $5.2 million over budget. The net effect of combining these overages with the $4.4 million vacancy savings produces over-budget Salaries & Wages of $11.9 million. The City will need to consider these spending trends, as well as historical trends, when developing the FY 2018 budget. We will be monitoring these spending categories as part of our review during the FY 2018 budget process.

In prior years, as part of the budget monitoring process, the City Council has requested detailed vacancy status reports. These reports listed departments' vacant positions and sometimes indicated whether positions were intended to be filled, as well as the estimated timeframes for hiring. Financial Management has noted that they are looking to the Personnel Department to communicate to Council information regarding City vacancies.

This information has been important to Council in terms of the budget monitoring process, as well as evaluating how City services are being fulfilled, and monitoring what progress has been made with respect to filling newly budgeted positions that are part of enhanced service levels. We recommend that Council clarify the type of vacancy information it would like to receive to assist them in understanding how City services are being fulfilled.

We note that the Mid-Year Report includes the numbers of new positions, by department, which were added to the FY 2017 Adopted Budget. This information also shows how many positions have been filled. The Mid-Year Report notes that as of January 20, 2017, 68% or 213.83 of the 314.40 new full-time equivalent (FTE) positions have been filled.

Departmental Expenditures – General Fund

Fire-Rescue Department – Personnel Expenditures

The Fire-Rescue Department is projected to exceed budgeted expenditures by a net $13.8 million, which is the largest General Fund expenditure variance in the Mid-Year Report. The primary cause of the over-budget projection is an increase of $14.6 million in personnel expenditures (including fringe). The Department's expenditures in excess of levels set by Council in the Adopted Budget are significant and are cause for concern. While the Mid-Year Report gives a detailed description of the factors driving increased personnel expenditures (summarized below for reference), it does not explain why these expenditures were not funded in the FY 2017 Adopted Budget, why the overages were not identified in the First Quarter Report, or how they will be mitigated in the upcoming FY 2018 Proposed Budget.

The Mid-Year Report identifies several components of the $14.6 million over-budget personnel expenditure projection for the Fire-Rescue Department, which are listed below for reference and analyzed later in further detail:

- $8.3 million in Salaries & Wages, including:
    - $2.6 million in salaries due to expanding three fire academies from 36 to 48 recruits without funding to support new hires
    - $1.0 million in special pay, largely associated with overtime expenditures
    - $3.5 million in overtime, including:
        - $1.2 million due to a Local 145 memorandum of understanding (MOU) provision that led to increased employee usage of annual leave
        - $980,000 to support a new Fast Response Squad (FRS) in the San Pasqual Valley
        - $580,000 in storm-related staffing
        - $390,000 in Lifeguard Division overtime
    - $758,000 in pay-in-lieu of annual leave related to the Local 145 MOU
- $6.3 million in fringe benefit increases, largely related to overtime and increases for new employees

The following sections discuss areas of concern identified by our office regarding the Fire-Rescue Department's significant over-budget personnel expenditures projected in FY 2017, including recommendations for Council consideration in the FY 2018 budget process.

The First Quarter Report Did Not Fully Analyze Personnel Expenditures

In a departure from recent past practice, the FY 2017 First Quarter Budget Monitoring Report did not fully analyze departments' personnel expenditures (as discussed in the "Additional Considerations – Quarterly Budget Monitoring Process" section of this report). In the case of the Fire-Rescue Department, a review of overtime projections was provided instead. The First Quarter Report projected Fire-Rescue overtime to exceed budget by $2.7 million by fiscal year-end. Had a full analysis of other personnel expenditures been included in the Report, the Council could have been made aware of projected increases earlier in the Fiscal Year and steps to control further overages could potentially have been considered.

A New FRS was Established without Explicit Approval by Council

As noted in the Mid-Year Report, the Fire-Rescue Department is projected to expend $980,000 in unbudgeted overtime to support the operation of a new, third FRS in the San Pasqual Valley in partnership with the San Diego County Fire Authority. The County has provided the necessary apparatus and equipment while the City has provided personnel to staff the FRS. The Department has indicated that additional service was provided to the San Pasqual Valley on a 12-hour basis from July 2016 through January 2017, and that the service is currently being provided on a 24-hour basis as a formal FRS unit.

The San Pasqual FRS was not identified as a new program in the FY 2017 Adopted Budget, nor was it called out as a new program in the First Quarter Report (the report instead noted $540,000 in unbudgeted overtime for general coverage in the San Pasqual Valley area). In contrast, when the City's first two FRS units were implemented in Encanto and South University City (in FY 2015 and FY 2016, respectively), related funding was requested and approved by the Council during the annual budget process. This did not occur for the third FRS. Should the Department wish to continue operating the San Pasqual FRS in FY 2018, funding should be identified in the FY 2018 Proposed Budget for Council consideration.

Fiscal Impacts of MOU Implementation Were Not Fully Identified in the FY 2017 Adopted Budget

A provision of the most recent Local 145 MOU requires mandatory payments to members in order to reduce their annual leave balances. Additionally, because Fire-Rescue employs a constant-staffing model, when a firefighter uses annual leave and does not work a shift, another firefighter is assigned to cover that shift on a backfill overtime basis. While the MOU provision is intended to reduce the City's liability for large banks of annual leave, effects on overtime were not anticipated or budgeted in FY 2017. The Mid-Year Report projects $1.2 million in increased overtime and $758,000 in increased pay-in-lieu of annual leave due to the new MOU provision. Financial Management and Fire-Rescue should work together in the FY 2018 budget development process to project the potential continued effects of MOU implementation.

Expanded Fire Academies Were Authorized without Sufficient Funding for New Hires

The FY 2017 Adopted Budget included the addition of $487,000 (added at the May Revision) in personnel and non-personnel expenditures to increase the number of fire academy participants from 36 to 48 per academy in FY 2017. In total, three expanded fire academies are expected to graduate in FY 2017. While the Adopted Budget included funding to conduct the academies, it did not include a sufficient corresponding increase in salaries to support the new graduates. As noted in the Mid-Year Report, vacancy savings were over-estimated in the Adopted Budget. This is the primary cause of the Department's $2.6 million over-budget salaries projection. Financial Management and Fire-Rescue should work together in the FY 2018 budget development process to more accurately predict fire suppression staffing levels and related funding needs.

Significant Changes to Staffing Policy Require Further Analysis and Should Be Vetted Separately by Council

At the meeting of the Budget and Government Efficiency Committee on February 2, 2017, the Fire-Rescue Department indicated that it intends to reach full fire suppression staffing by the end of FY 2017, and that it may even find itself in the position of being overstaffed in the near future. Because the Department employs a constant staffing model, changes to staffing levels directly impact the balance of different types of personnel expenditures in the Department's budget.

The Fire-Rescue Department utilizes constant staffing to fill all required operational fire suppression posts throughout the City. A "post" is a seat on an in-service fire apparatus that must be staffed by a firefighter at any given point in time. This is different from a "position," which is a budgeted personnel count that may be funded or unfunded. Whereas a post must always be staffed, a position may be filled or left vacant. As firefighter absences at posts occur (either due to utilization of leave time or short-staffing due to vacancies), other firefighters are assigned to staff these posts (or backfill them) on an overtime basis. Generally, the constant staffing model aims to offset these overtime expenditures with budgeted vacancy savings.

For the past several years, the Department has been understaffed and has relied heavily on overtime to fill required operational posts. Since FY 2015, the Mayor and Council have invested in additional and expanded fire academies to increase hiring. Due to those efforts and the expanded fire academies discussed earlier in this report, Fire-Rescue is now projected to approach full staffing by fiscal year-end. In this case, full staffing means that the number of filled firefighter positions is equal to the number of required operational posts in the Department.

According to the constant staffing model, full staffing should result in increased salary costs offset by decreased overtime costs. Depending on a variety of factors, this balance may increase, decrease, or have no significant effect on net personnel costs. A 2014 performance audit by the Office of the City Auditor found that post-Proposition B firefighters' overtime costs are higher than pre-Proposition B firefighters due to changes in fringe rates. The audit also found that as the Department gains more post-Proposition B firefighters and loses more of their pre-Proposition B counterparts, it would be more cost effective to increase fire suppression staffing while decreasing overtime. According to the Fire-Rescue Department, approximately 76% of firefighter positions are currently filled by post-Proposition B employees.

In past reports, our Office has supported efforts to increase firefighter staffing in order to improve service delivery and decrease reliance on overtime. We have also noted that further analysis is required to determine the net fiscal impact of recent Fire-Rescue Department staffing shifts. As noted previously, as the Fire-Rescue Department has filled more positions, expenditures on salaries are projected to exceed budget by $2.6 million. In theory, overtime should decrease as a result of these higher staffing levels. In practice, however, the Mid-Year Report projects over-budget overtime expenditures of $3.5 million. It may be the case that overtime on regular fire suppression operations has in fact decreased while the projected overtime increases are due to wholly outside factors.

> A thorough analysis of staffing levels will be required to properly budget personnel expenditures in the FY 2018 budget process. If in fact Fire-Rescue is on track to be potentially overstaffed by fiscal year-end, it may not be prudent to continue to run expanded fire academies in FY 2018. Too little information is available on the impact of full staffing, let alone overstaffing, to justify further major changes to the Department's staffing model at this time.

We recommend that the Fire-Rescue Department work with Financial Management to analyze the fiscal impacts of potential staffing model changes, including moving from full staffing to overstaffing, prior to the release of the FY 2018 Proposed Budget.

Library Department

The Library Department projects excess expenditures of approximately $510,000 for contracts over the FY 2017 Adopted Budget, primarily driven by excess expenditures of $360,000 for security services for library facilities including the Central Library. The Library Department is the largest user of the citywide contract for security services and requires additional security coverage due to the expansion of operational hours at all the library facilities since the original contract was approved in FY 2014. The Library Department requested additional funding for security services in the FY 2018–2022 Five-Year Financial Outlook and anticipates bringing an adjustment to the contract amount to the City Council for consideration by late FY 2017. The adjustment is expected to address: the additional needs for current operating hours at library facilities, an increased number of events at the Central Library, and adjustments to labors costs since FY 2014. While increasing operating hours at library facilities has been a priority of the City Council, auxiliary services necessary to support the increased service levels need to be considered as well.

Police Department

The Police Department continues to experience vacancies in excess of budget, which has contributed to a year-end projection of $2.6 million in salary savings. Although the Department has made progress in hiring new officers by holding expanded police academies, sworn attrition continues to be persistently high. As of January 30, 2017, the Department was experiencing the departure of 14 sworn officers per month, and reported a sworn strength of 1,838 filled positions out of 2,039 budgeted positions. The Department's staffing challenges have contributed to an increase in salary savings, an increase in 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 $5.0 million, for a total of $26.0 million in FY 2017. This projection remains unchanged from the First Quarter Report. Of the $5.0 million overtime projection in excess of budget, the Department attributes $1.4 million to extension-of-shift overtime[4] and $400,000 to Communications Division staffing. Both of these types of overtime negatively impact the General Fund, as these expenditures will not be reimbursed.

[4] The Police Department has attributed the need for extension-of-shift overtime to a number of factors, including training new officers, increased neighborhood policing efforts, calls taking longer to resolve, and issues related to understaffing.

Other contributing factors to Police Department over-budget overtime, including $1.4 million in grant and task force related overtime, $1.0 million in special events overtime, and $600,000 in unbudgeted AB 109 overtime, are largely reimbursed. As a result, these expenditures are offset by corresponding unbudgeted revenue and have little to no net impact on the General Fund. However, as our Office has noted in several past reports, including both expenditures and revenue related to these types of overtime in the Adopted Budget, rather than adjusting them at mid-year, would add transparency to the Department's budget.

For additional context, we have analyzed Police overtime expenditures from the last five years, as described in the table below. On a year-over-year basis, Police overtime expenditures have increased significantly since FY 2014 and have exceeded budget since FY 2012.

Police Overtime - Historical Budget vs. Actual (*$ in millions*)

Fiscal Year	Adopted Budget	Actuals	Variance: Adopted Budget to Actual
FY 2017	$21.0	$26.0*	$5.0
FY 2016	18.0	25.0	7.0
FY 2015	11.1	23.1	12.0
FY 2014	11.8	17.8	6.0
FY 2013	17.1	19.7	2.6
FY 2012	17.1	19.3	2.2

*Projected

As shown in the table above, the FY 2017 Adopted Budget included the addition of $3.0 million in overtime expenditures to support extension-of-shift work and to better align budgeted overtime with historical expenditures. Despite this budget increase, overtime continues to exceed current budget and is projected to exceed FY 2016 levels. Police overtime expenditures will require continued close monitoring in the current fiscal year. For FY 2018, Financial Management has indicated it will work with the Police Department to conduct a zero-based review of overtime expenditures as part of the budget development process.

Public Works-General Services

The Mid-Year Report notes that the Facilities Division of the General Services branch of the Public Works Department was given authority to fill 25.00 new FTE positions in FY 2017, but has only filled eight of those positions. These positions consist of skilled trade positions such as electricians, HVAC repair technicians, and carpenters. At the time of the adoption of the FY 2017 budget, Public Works anticipated that half of those positions would be filled by the mid-year, with the remaining half to be filled by the end of the fiscal year.

Public Works reports that it continues to encounter significant competition for these positions from the private sector, which continues to have a high demand for skilled trade positions. The delay in hiring contributes to $875,000 in reduced personnel costs projected in the Mid-Year Report; Public Works does still anticipate filling the majority of the positions by the end of FY 2017.

Real Estate Assets Department

The Mid-Year Report includes a number of adjustments associated with Real Estate Assets Department (READ) expenditures. The Mid-Year Report shows a net reduction of $1.2 million in READ expenditures largely due to $600,000 in increased expenses associated with management of the DeAnza mobile home park, which are offset by a delay in expending $1.5 million for the reconfiguration of the Civic Center Plaza (CCP) building. The City entered into a lease-to-purchase agreement for the CCP building in January 2015 that required the City to assume the responsibility for capital improvements and space reconfigurations.

We also note that the City entered into a lease-to-purchase agreement for the 101 Ash Street building in October 2016; FY 2017 leasing costs associated with that agreement total $3.6 million, and are recognized in the Mid-Year Report as an increase in Citywide Program Expenditures. That agreement required the building's current owner to make a payment of $5.0 million to the City to allow for capital upgrades and repairs; the Mid-Year Report recommends moving this $5.0 million into a CIP project for this purpose.

General Fund and Risk Management Reserves[5]

The following sections discuss the General Fund Reserve (including Excess Equity), and the Risk Management Reserves (including the Public Liability, Workers' Compensation, and Long-Term Disability Reserves).

General Fund Reserve

The City's General Fund Reserve requirement is based on the past three fiscal years' audited General Fund operating revenues; it is the product of the three-year average revenues and the target percentage for the applicable year. For FY 2017, the target percentage is 14.75%, and the Reserve requirement is $173.8 million. When the Reserve requirement is met there may be additional monies remaining, which, per the Reserve Policy, are known as "Excess Equity." The Reserve Policy defines Excess Equity as "Unassigned Fund Balance that is not otherwise designated as General Fund Reserves and is available for appropriation."

The calculation of FY 2017 estimated year-end Excess Equity is displayed in the following table. As shown in the table, adjustments are made to the FY 2016 ending Reserve yielding the FY 2017 projected Reserve of $197.4 million. As stated above, $173.8 million is needed in FY 2017 to meet the City's 14.75% Reserve requirement. This leaves $23.6 million in estimated Excess Equity.

[5] The City's Reserve Policy is Council Policy 100-20 (last updated April 28, 2016).

FY 2017 Year-End Excess Equity Estimate *($ in millions)*	
Ending FY 2016 Reserve Balance	$ 192.4
FY 2017 Budgeted Use of Excess Equity	(8.0)
FY 2017 Projected Additional Use of Excess Equity per the Mid-Year Report	(4.2)
FY 2017 Receipt of Chargers Termination Fee[1]	12.6
FY 2017 Budgeted General Fund Reserve Contribution[2]	7.6
Adjustment for FY 2015 Accrued Low Flow Diversion Capacity Charges	(3.0)
FY 2017 Year-End Reserve Estimate	***197.4***
FY 2017 14.75% Reserve Requirement (*includes FY 2017 General Fund Reserve contribution*)[2]	(173.8)
FY 2017 Year-End Excess Equity Estimate[1]	**$ 23.6**

[1]The Mid-Year Report's Excess Equity projection was calculated prior to the City's receipt of the $12.6 million Charger's termination fee, which accounts for the difference between the Excess Equity estimate displayed here and the estimate provided in the Mid-Year Report.

[2]The budgeted General Fund Reserve Contribution is added back, as it is part of the $173.8 million reduction for the FY 2017 14.75% Reserve requirement.

The City could consider the use of any available Excess Equity in order to accommodate unfunded one-time costs. FY 2017 activity will continue to be monitored, and projections will be updated in the Third Quarter Report.

Risk Management Reserves

Public Liability Reserve

The Public Liability (PL) Fund supports costs to the City related to claims against the General Fund. The goal for PL Reserve, per the City Reserve Policy, is that the overall reserve target of 50% of the outstanding actuarial liability be reached by FY 2019. The outstanding liability is based on the average value of annual actuarial liabilities for the three fiscal years ending in 2016, which is approximately $78.2 million. The overall 50% target amount (to be achieved by FY 2019) is $39.1 million. Note that the PL Reserve is paid entirely from General Fund contributions.

The FY 2017 target level is 43%, which equates to $33.6 million. During our review of the Five-Year Outlook, the FY 2017 PL Reserve was estimated to be $39.5 million, leaving an estimated excess of $5.9 million. At that time, we suggested that the City could consider using a portion of the excess PL Reserve funds for one-time needs. However, since that time Financial Management has determined that the $5.9 million is currently needed to support various claims that may require settlements or judgement payments in FY 2017. They have requested authority to transfer the $5.9 million from the PL Reserve Fund to the PL Operating Fund, and have indicated that they will continue to monitor claims and provide an update in the Third Quarter Report.

Workers' Compensation Reserve

The City Reserve Policy currently requires a Workers' Compensation (WC) Reserve target of 25% of the outstanding actuarial liability. Like the PL Reserve, the outstanding liability is based on the average value of annual actuarial liabilities for the three fiscal years ending in 2016, which is approximately $234.8 million. The 25% target amount for FY 2017 is $58.7 million. The $58.7 million target has increased from the $57.0 million that was originally estimated during the preparation of the FY 2017 Adopted Budget, as the three-year average for WC outstanding liabilities increased upon receipt of the FY 2016 actuarial valuation in September.

On January 23, 2017, Report to Council #17-011 was released, which includes a proposal to modify the WC Reserve Policy.[6] The proposed modification would reduce the WC Reserve target from 25% to 12%, or approximately one year's worth of operating expenses. Implementation of this change in the WC Reserve requirement would produce an excess WC Reserve amount approximating $28.5 million ($23.2 million for the General Fund portion). However, if the Reserve target remains at 25%, it is estimated that the City will need to contribute an additional $2.2 million ($1.7 million General Fund) to the WC Reserve to bring it from the $56.5 million projected balance to the $58.7 million target balance for FY 2017.

Long-Term Disability Reserve

The Long-Term Disability Reserve (LTD) overall target level is 100% of the outstanding liability for LTD. As for the other Risk Management Reserves, the outstanding liability is based on the average of the annual actuarial liabilities for the most recent three fiscal years. For FY 2017, that liability is $11.0 million (based on the average of liabilities for FY 2014 through FY 2016).

With the projected FY 2017 Reserve balance at approximately $17.4 million, the target is projected to be exceeded by $6.4 million. During our review of the Five-Year Outlook, we suggested that the City could consider using a portion of the excess LTD Reserve funds for one-time needs. The General Fund portion of the $6.4 million excess is approximately $4.3 million. We note, however, that the City is currently negotiating with its recognized employee organizations regarding a death and disability benefit for employees who were hired on or after July 20, 2012, and, per the parameters of Proposition B (passed by the voters in June 2012), are not eligible for the defined benefit pension. Excess LTD Reserve amounts have been anticipated as a funding source for the new death and disability benefit.

Although negotiations for the new death and disability benefit have not concluded, and the City's cost to fund the benefit is uncertain, there may be interest in utilizing all, or a portion of, the LTD excess Reserve for one-time needs in FY 2018. One suggestion would be to use a portion of the excess Reserve, e.g. $3.4 million ($2.3 million General Fund), to mitigate future deficits.

Mid-Year Budget Adjustments

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 mid-year projection to the City Council, and make a recommendation for addressing the deficit or surplus. As noted in the Municipal Code, "[t]he City Council may approve the Mayor's recommendation or modify such recommendation in whole or in part, up to the total amount recommended by the Mayor."

The FY 2017 Mid-Year Report is projecting a General Fund year-end deficit of approximately $4.2 million, but there is no recommendation to address this deficit at this time. With no

[6] See IBA Report 17-03 for additional information on the proposed Reserve Policy changes.

recommendation from the Mayor, the Council is not able to make changes to General Fund allocations. Instead, staff is recommending that any adjustments wait until the release of the Third Quarter Report, scheduled for May 16, 2017. Our Office notes that since the release of the Mid-Year Report, the City has received a one-time payment of $12.6 million as a result of the Charger's early termination of their Qualcomm Stadium lease, effectively eliminating the projected year-end deficit.

Although the City Council is not being asked to make changes to the General Fund at this time, they are being asked to approve changes in allocations to the Development Services Fund, Public Liability Operating Fund, Public Liability Reserve Fund, and approve the appropriation of $5.0 million to a new capital project for the 101 Ash Street building.

Additional Considerations – Quarterly Budget Monitoring Process

The Mid-Year Report includes a projected $14.6 million increase in Fire-Rescue Department personnel expenditures over the Adopted Budget. This increase was unanticipated—the First Quarter Report had noted a projected $2.7 million increase in overtime (now projected in the Mid-Year Report to be $3.5 million) but did not discuss other Salaries & Wages or fringe expenditures. This information was not included in the First Quarter Report because of a change in first quarter budget monitoring processes in FY 2016. At that time FM implemented two budget monitoring streamlining measures:

- The removal of departmental revenue and expenditures projections (by revenue and expenditure category) from the First Quarter Report while retaining: major General Fund revenue projections, the status of new positions added in the current year's budget, public safety overtime projections, updates on strategic initiatives, updates to the General Fund reserves, and updates to the Risk Management reserves.
- Creation of the Year-End Financial Performance Report that provides the City Council and the public a comparison of actual (unaudited) revenue and expenditures compared to the year-end projections included in the Third Quarter Report.

Two additional changes to the budget monitoring process were put in place in FY 2017:

- The First Quarter Report was heard at the Budget and Government Efficiency Committee only, not by the City Council as in prior years.
- The Mid-Year Report was issued a month earlier than in prior years, and is based on five months of actual activity as opposed to six months as required by the Municipal Code. FM notes that this change in timing allows departments to complete their mid-year budget monitoring work before they develop their proposed budgets for the upcoming fiscal year. They are planning on returning to the City Council with updates to the Municipal Code and Council Policy 000-02 (Budget Policy) in order to make this timing change permanent.

While we support streamlining of processes where possible, we would like to see a review of significant revenue and expenditure variations restored to the First Quarter Report, as well as see the First Quarter Report presented at full Council (in addition to Committee) in the future. Per the Budget Policy, quarterly budget monitoring reports are intended to "explain significant revenue and expenditure variances and indicate trends that may require remediation."[7] If the significant overage in Fire-Rescue Department personnel expenditures had been projected and discussed as part of the First Quarter Report, steps could potentially have been taken to address and control further overages. Our Office recommends that significant variances in expenditures and revenues be reinstated in the First Quarter Report, and that this information be presented to the full City Council for review.

CONCLUSION

The Office of the IBA has reviewed the Mid-Year Report and we believe that the projections included in the Report are appropriate, as are the requested appropriation adjustments. We raise concerns, however, about the timeliness of budget monitoring information—including how and when this information is presented to the City Council, as well as the magnitude of the projected over-budget Fire-Rescue Department personnel expenditures, and the availability of citywide vacancy information. In order to address these concerns we offer three recommendations for Council's consideration:

1. That the City Council clarify the type of vacancy information it would like to receive that would assist them in understanding how City services are being fulfilled.
2. That the Fire-Rescue Department work with Financial Management to analyze the fiscal impacts of potential staffing model changes, including moving from full staffing to overstaffing, prior to the release of the FY 2018 Proposed Budget.
3. That significant variances in expenditures and revenues be reinstated in the First Quarter Report, and that this information be presented to the full City Council for review.

Updates to projected year-end revenues and expenditures will be available in the Third Quarter Report, scheduled to be released in May and reviewed by the City Council on June 5, 2017.

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[7] Council Policy 000-02 *Budget Policies* page 9, updated June 22, 2016.