THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: June 14, 2018 **IBA Report Number:** 18-18

City Council Date: June 18, 2018

Item Number: 203

Development Services User Fee Adjustments

BACKGROUND

The City Council will be asked to consider adjusting Development Services User Fees on June 18, 2018. These user fees relate to the City's development review and inspection services which are performed by the Development Services Department (DSD) and operated as an Enterprise Fund (the "Development Services Fund") on a 100% cost recovery basis completely independent from the City's General Fund. Typically, the Department reevaluates user fees every five years to account for changes in operating costs, changes in regulations which impact staff time for plan reviews/inspections, and process improvements. Previous adjustments occurred in FY 2010 and FY 2016, increasing user fees by 10% and 13%, respectively. The FY 2016 action also included automatic annual CPI increases (~2-3%) at the start of each fiscal year going forward.

The proposed adjustments under this action primarily consist of increasing DSD user fees in order to recover costs that were not factored into the FY 2016 fee increases. These costs include several large one-time and ongoing expenditures which have caused an imbalance in revenues and expenditures and resulted in a significant depletion of the Development Services Fund's operating reserves. The most significant of these costs are related to the Department's planned relocation to the 101 Ash Street Building and is the focus of this report. Other costs impacting the Fund include salary increases for approved MOUs with labor organizations, pension increases, and the Department's expenses related to the Regional Water Quality Control Board (RWQCB), which staff discusses in their Report to City Council.

Staff is proposing to incrementally phase in the necessary fee increases over three fiscal years: FY 2019 – 6%, FY 2020 – 4.5%, and FY 2021 – 3.5%. The proposed fee increases were presented and discussed at the Budget and Government Efficiency Committee on April 18, 2018. Also presented to the Committee and included in this action is a proposed reduction to the operating reserve target level for the Development Services Fund from 15% to 12%, to be achieved by FY 2023. This revision is not recommended by our Office and was not supported by a majority of Committee members. The Committee forwarded the item to Council without recommendation and requested staff to include a discussion of the extended timeframe necessary to meet the 15% target.

FISCAL/POLICY DISCUSSION

101 Ash Street Related Costs

In October 2016, the City Council approved an agreement to purchase the 101 Ash Street Building. The agreement included an allocation of $5.0 million for the City to pay for renovations and tenant improvements to the building. The $5.0 million was expected to cover the costs for five floors of the building, including the first floor which is to become DSD's new permit center. At the time the City took possession of the building, the expectation was that City Departments, including DSD, would begin relocating to the building beginning July 2017 (FY 2018). Though the relocation did not occur, DSD began paying rent in FY 2018 for its expected share of square footage in the building in the amount of $4.1 million. After completion of space planning, DSD's share of rent was revised down to $4.0 million in the FY 2019 Proposed Budget and is expected to remain at this level through the 20-year lease term for the building. It should be noted that these rental costs are occurring while the Department is also paying rental costs of approximately $600,000 per year for its current location in the City Operations Building.

In addition to the rental costs, the FY 2019 Proposed Budget also included $1.4 million for one-time relocation costs. This amount was also included in the FY 2018 Adopted Budget for the same purpose but was not spent due to the relocation delay.

The final component of the Department's costs related to the 101 Ash relocation are for tenant improvements attributable to the space it will occupy in the building – the most significant of which will be necessary for the first floor to serve as a one-stop DSD permit center. As discussed in our IBA Report No. 18-19 "IBA Review of 101 Ash Project, Proposed CIP Appropriations, and Consideration of Alternative Funding Approach," an informational item on the 101 Ash Street Building proposed tenant improvements was presented to the Infrastructure Committee on May 23, 2018, including four scenarios concerning the extent of improvements to be made to the building. Based on the discussion at Committee, two of the scenarios, both of which include improvements to accommodate DSD's permit center on the first floor, were incorporated into the construction bid solicitation that was released on May 31st: Scenario 3, which limits improvements to five floors (1,2,17,18 and 19); and Scenario 4, which improves all 19 floors. After bids are received and evaluated, staff plans to present their recommendations to Council on which of the two scenarios to proceed with in late-July/early August. *This timing, however, is not ideal given that, unlike the other components discussed above, the actual costs for DSD's share of tenant improvements will not be known to the City Council when this item is considered on June 18th*.

The potential cost of DSD's share of tenant improvements could vary considerably depending on which scenario is chosen and the actual construction bids received. As provided in Table 1 below, we summarize the likely range of bid outcomes for each scenario. Using staff's assumptions in their analysis comparing all four scenarios[1], DSD's share of costs under Scenario 4 is assumed to

[1] See Exhibit E (101 Ash Street Comparative Estimated Costing) to Staff Report titled "101 Ash Street Building Lease and Proposed Tenant Improvements," dated May 17, 2018.

be $12 million. This equates to an amortized cost of approximately $1.0 million annually in debt service beginning in FY 2021 once the initial use of General Fund Commercial Paper is restructured with a 15-year long-term bond (based on current rates). Staff has indicated that this $12 million assumption was intended to be somewhat conservative and we generally agree, especially considering that DSD's allocation of the $5.0 million included in the lease agreement for tenant improvements, estimated to be $2.0 million based on space planning, is not factored into this assumption. Once included, the actual financed amount could be closer to $9.5 million (or approximately $800,000 in debt service annually). Conversely, on the high end of potential outcomes, we do not believe construction bids would exceed the bids that were previously received requiring a 24/7 work schedule. DSD's share of costs under the previous bid was estimated to be approximately $14 million after factoring in its $2.0 million allocation for tenant improvements included in the lease agreement. This equates to approximately $1.2 million in annual debt service costs once restructured into a 15-year bond.

Utilizing a similar approach for Scenario 3, we estimate the cost (financed amount after including DSD's tenant improvement allocation) to be between $3-7 million and debt service costs to be between $300,000 and $600,000 annually.

Table 1 – Estimated Potential Range of DSD's Share of Tenant Improvement Costs

	Scenario 3 - Improve Five Floors		**Scenario 4 – Improve All Floors**	
	Financed Amount	Annual D/S (15-Year Bond)	Financed Amount	Annual D/S (15-Year Bond)
Low	$3 M	$0.3 M	$9.5 M	$0.8 M
Staff Assumption	$5 M	$0.4 M	$12 M	$1.0 M
High	$7 M	$0.6 M	$14 M	$1.2 M
Range	**$3 – 7 M**	**$0.3 – 0.6 M**(1)	**$9.5 – 14 M**	**$0.8 - 1.2 M**(1)

(1) Represents the annual debt service costs beginning in FY 2021 after the initial use of General Fund Commercial Paper is restructured into a 15-year long-term bond (based on current rates). Commercial Paper costs in FY 2019 and FY 2020 are estimated to be as follows: Scenario 3 - $0.1-0.2M; Scenario 4 - $0.2-0.4M.

Note that the analysis in this report is based on staff's proposed approach of utilizing Commercial Paper as an interim financing. While we are generally supportive of the use of Commercial Paper, our Office offers an alternative through the use of proceeds generated from the January 2018 restructuring of the Tobacco Settlement Revenue Bonds. More information can be found in IBA Report 18-19 referenced above.

<u>Proposed Fee Increase</u>

The Department engaged MGT Consulting Group (MGT), the same consultant who conducted the user fee study in 2016, to update their analysis to incorporate the cost increases discussed above. MGT determined that a 17% rate increase is necessary to fully recover these costs. To mitigate the impact on its customers, the Department is proposing to phase in the fee increases, which are in addition to automatic annual CPI increases, over three fiscal years up to the following levels: FY 2019 – 6%, FY 2020 – 4.5%, and FY 2021 – 3.5%. While these percentages represent maximum increases (not including CPI increases), it should be noted that the 6% increase for FY 2019 is the actual increase that would go into effect 60 days after passage of the Resolution, if approved by City Council. After FY 2019, the Department will set the actual fee increase rates for FY 2020 and FY 2021 during the budget development process for each respective fiscal year. Council's only role at this point will be limited to their consideration of the Development Services Fund's proposed budget.

Given that the fee increases will be phased in, the Development Services Fund will still project to end FY 2019 in a deficit after the 6% increase with expenditures exceeding revenues by $3.7 million, as illustrated in Table 2 below. This projected deficit would be funded through the use of remaining reserves resulting in a projected fund balance of approximately $200,000. Beginning in FY 2020, the Fund would normalize with a projected surplus of $900,000 at fiscal year-end which would begin replenishing reserves. This assumes the maximum fee increases and CPI adjustments occur.

Table 2 – Financial Projections with Proposed Fee Adjustment ($ millions)*

	FY 2018 YE Proj.	FY 2019 Forecast	FY 2020 Forecast	FY 2021 Forecast	FY 2022 Forecast	FY 2023 Forecast
Beginning Reserves	$ 11.3	$ 3.8	$ 0.2	$ 1.1	$ 2.8	$ 6.1
Projected Revenues	64.3	68.0	72.1	75.2	76.5	77.8
Projected Expenditures	71.8	71.7	71.2	73.6	73.1	74.7
Net	**(7.5)**	**(3.7)**	**0.9**	**1.7**	**3.4**	**3.1**
Ending Reserves	$ 3.8	$ 0.2	$ 1.1	$ 2.8	$ 6.1	$ 9.3

*May not add due to rounding.
Source: Development Services Department

The projections in Table 2 above are based on MGT's updated analysis which assumed the annual debt service costs for DSD's tenant improvement costs to be $500,000 in FY 2019 and $1.2 million in FY 2020 and beyond. This most closely matches our "High" estimate for Scenario 4 (see Table 1). However, as discussed above, these costs could vary considerably depending on which scenario is chosen and the actual construction bids received. To illustrate the impact this could have on the rate increases to be set in FY 2020 and FY 2021, it can be roughly assumed that for every $600,000 in reduced debt service costs, the necessary fee increase could be reduced by 1%. For example, given our "Low" estimate for Scenario 3, the debt service amount is projected to be $300,000 once the Commercial Paper is restricted into a long-term bond. This represents a $900,000 difference from MGT's assumption of $1.2 million which would equate to a 1.5% reduction in the required fee increase. *Note that this example is purely intended to illustrate the potential impact this cost component could have on rate setting decisions, assuming all other factors are held constant. These other factors, which most notably includes the level of building permit/development activity, could potentially play a more significant role when rates are set for FY 2020 and FY 2021.* **In order to keep Council informed of the rate setting process, we recommend that the Department submit a memorandum to City Council outlining the revenue and expenditure analysis used to determine the actual fee increase proposed for FY 2020 and FY 2021 prior to Council's review of each proposed budget.**

<u>Operating Reserve</u>

Included in the proposed actions for this item, is a revision to Council Policy 100-20, "Reserve Policy," which would reduce the Development Services Fund's Operating Reserve target from 15% to 12% to be achieved by FY 2023. Our Office does not recommend this revision and it was

not supported by a majority of Committee members at the April 18, 2018 Budget and Government Efficiency Committee. Maintaining the current 15% reserve target level is prudent considering the significant impact unforeseen costs can have on this enterprise fund which operates on a full cost recovery basis. This is evidenced by the current situation where several large expenditures have combined over a short period of time to nearly deplete current reserves. As noted above, staff's proposal is to reach a target level of 12% by FY 2023. **We recommend extending this timeframe beyond FY 2023 to reach a target level of 15%. It is estimated that that would require an additional two years to FY 2025.** The proposed reserve replenishment schedule is provided in Figure 3 below.
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Figure 3 – Operating Reserve Targets

Target Date	Target %	Projected Target $
June 30, 2018	9.5%	$5.3 million
June 30, 2019	10.0%	$6.3 million
June 30, 2020	10.5%	$7.3 million
June 30, 2021	11.0%	$7.9 million
June 30, 2022	11.5%	$8.3 million
June 30, 2023	12.0%	$8.7 million
June 30, 2024	13.5%	$10.0 million
June 30, 2025	15.0%	$11.2 million

CONCLUSION

The proposed adjustments under this action primarily consist of increasing DSD user fees in order to recover costs that were not factored into the FY 2016 fee increases. If this action is approved by Council, the fee increase will be 6% in FY 2019 and go into effect after 60 days. After FY 2019, the Department will set the actual fee increase rates for FY 2020 (up to 4.5%) and FY 2021 (up to 3.5%) during the budget development process for each respective fiscal year. We recommend that the Department submit a memorandum to City Council outlining the revenue and expenditure analysis used to determine the actual fee increase proposed for FY 2020 and FY 2021 so that they may be better informed prior to reviewing of each proposed budget.

With respect to the funding plan to replenish reserves, we do not recommend approving the proposed action to reduce the Development Services Fund's Operating Reserve target from 15% to 12% to be reached by FY 2023. We recommend maintaining the existing 15% target level and extending staff's proposed replenishment schedule by two years to reach a target level of 15% by FY 2025.

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