



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Second Amendment Between the City of San Diego & the Tourism Marketing District Corporation

BACKGROUND

The San Diego Tourism Marketing District (TMD) was established on January 1, 2008 and expired on December 31, 2012 after its initial term of five years. City Council approved their intent to renew the TMD and its associated assessments on September 25, 2012, which initiated the process where hoteliers could vote in favor of or protest its renewal. On November 26, 2012, votes were tabulated and there was no majority protest to the TMD's renewal. Following the report on the hoteliers' vote, the City Council approved the following:

- Resolution of renewal for the TMD and its associated assessment for a period of 39 ½ years, through June 30, 2052.
- Operating Agreement between the City and the San Diego Tourism Marketing District Corporation (SDTMD) for the administration of the TMD funds.

Then Mayor Jerry Sanders subsequently signed the resolution of formation for the TMD, but did not sign the Operating Agreement prior to leaving office. On March 28, 2013 the City entered into a five year Operating Agreement with the SDTMD which was subsequently amended on April 15, 2013 (First Amendment). This amended Operating Agreement between the City and SDTMD was signed by then Mayor Bob Filner and enacted the following significant changes:

- The five year Operating Agreement between the City and SDTMD would expire November 25, 2017;
- The requirement that the City will only distribute assessments collected from hotels that have signed both an indemnification agreement holding the City harmless and a waiver forgoing any rights they may have to seek reimbursement or payment from the City should the SDTMD be invalidated in a court of law;

- Establishing a liability reserve of up to \$2.3 million to defend the TMD against any lawsuits; and
- Provide 10% of total assessments to Balboa Park Centennial, Inc. (Centennial, Inc.) for the 2015 Balboa Park centennial celebration (up to \$6.0 million).

Based on the number of indemnifications and waivers received, approximately 18% of available funding is currently being distributed. Given this reduced level of funding and the potential negative impacts on tourism in the City, a Second Amendment to the Operating Agreement (Second Amendment) is now being proposed for Council consideration, which would implement the following:

- Rescind the First Amendment to the Operating Agreement entirely, including nullifying all waivers received by the City;
- Distribute \$6.0 million of the approximately \$10.0 million in TMD assessments currently being held by the City to the SDTMD;
- Withholding an annual amount from assessments to accumulate \$30.0 million by the end of FY 2017 to limit any potential liability to the General Fund based on any possible court action that would invalidate the TMD. The withholding schedule is outlined in Attachment 1 of the Second Amendment.

This report details the current plan to utilize these funds distributed under the Second Amendment, discusses the potential General Fund exposure associated with adopting the Second Amendment, and other fiscal considerations related to continuing to withhold TMD funds.

FISCAL/POLICY DISCUSSION

Revised Projected Budget

	Original TMD Budget June 2013	Second Amendment TMD Budget November 2013	Variance
TMD Assessments	\$ 28,500,000	\$ 28,500,000	\$ -
Less Holdback for TMD Reserve	-	(5,500,000)	5,500,000
Interest / Penalties	40,000	40,000	-
Carry-Over Revenue	3,278,748	3,278,748	-
Total Revenue	\$ 31,818,748	\$ 26,318,748	\$ 5,500,000
San Diego Tourism Authority	\$ 22,015,000	\$ 17,065,000	\$ 4,950,000
Balboa Park Centennial	2,335,000	1,785,000	550,000
Administration	1,625,000	1,625,000	-
Opportunity / Catastrophic Reserve	3,543,748	3,543,748	-
Liability Reserve	2,300,000	2,300,000	-
Total Expenditures	\$ 31,818,748	\$ 26,318,748	\$ 5,500,000

The FY 2014 original operating budget and report of activities for the TMD was presented to City Council on June 24, 2013. This operating budget outlined total estimated FY 2014 assessment collections and TMD operating revenue of \$28.5 million¹. Operating expenditures

¹ \$28.5 million in TMD operating revenue was based on the receipt of 100% waiver / indemnification agreements from hoteliers.

presented to Council in this budget reflected requirements as outlined in the First Amendment. Of this total \$28.5 million in operating revenue, approximately \$22.0 million was projected to be disbursed to the San Diego Tourism Authority (SDTA – formerly known as The San Diego Convention and Visitor’s Bureau / ConVis) and 10% of disburseable funds to Centennial, Inc.

Based on the proposed Second Amendment, the TMD would continue to distribute funds in accordance with their operating budget as presented to Council. However, the proposed holdback of \$5.5 million of FY 2014 assessment collections will reduce distributions to both SDTA and Centennial, Inc. as estimated above.

Distribution of Funds and Proposed Utilization

With the indemnification and waiver requirement of the First Amendment, SDTA’s FY 2014 operating revenue was projected to total approximately \$4.4 million in funding from the SDTMD; of which, \$2.7 million was projected to be utilized on media and production spending. This has dramatically reduced the amount of SDTA spending in various markets nationwide for marketing San Diego and hoteliers in the TMD in both FY 2013 and 2014.

It has become a concern that due to the lack of advertising, the City’s General Fund transient occupancy tax (TOT) may be negatively impacted. If the Second Amendment were to be approved by City Council and the Interim Mayor, \$6.0 million would be available immediately to fund advertising by the SDTA or other expenditures the TMD should decide upon within their Council-approved plan of work. At the November 18, 2013 SDTMD board meeting, the following question was posed to SDTA: How will funds be distributed in FY 2014 to ensure that marketing activities will be resumed in the quickest and most effective way?

At this meeting, SDTA and their marketing firm, Mering Carson, outlined their recommendations for the most effective use of TMD funds for media and production spending based on the estimated level of funding from the proposed Second Amendment². Media and production spending proposed in this recommended option includes promotional activities and spot market television ads for various markets, digital outreach (including on-line travel agencies), print advertising, and co-operative spending with other San Diego destinations, among others. Marketing is projected to begin in February 2014 for a full spring marketing campaign - however, it will be necessary to purchase this media in advance of this date, so expenditures will need to be made soon after distribution of funds. The SDTA is still exploring other opportunities to further refine this recommended option. If the SDTMD should decide to provide funding to new opportunities for advertising that does not conform to their budget approved in June 2013, they would be required to return to City Council for approval of a modified report of activities for FY 2014.

General Fund Exposure Associated With Adopting the Second Amendment

Pending the outcome of litigation related to the legality of TMD assessments, the City has withheld approximately \$10.0 million of TMD assessments since July 1, 2013. The Second Amendment would release \$6.0 million of these assessments to the TMD on November 30, 2013 and retain the remaining \$4.0 million to establish a self-insurance reserve. Additionally, the

² Of the SDTA estimated \$17.0 million in funding, approximately \$11.0-12.0 million is projected to be spent on media and production

Second Amendment requires the City to withhold a specified amount of monthly TMD assessment collections (\$1.5 million in FY 2014; \$6.5 million in FY 2015; \$7.5 million in FY 2016; and \$10.5 million in FY 2017) until the self-insurance reserve reaches \$30.0 million at the end of FY 2017. A \$30.0 million self-insurance reserve exceeds the \$28.5 million budgeted for TMD assessments in FY 2014.

The stated goal of the self-insurance provision is to “balance the City’s interest in funding TMD activities which help generate TOT and sales tax revenue while retaining appropriate reserves in the event of adverse legal outcomes arising from current lawsuits.” While establishing a growing self-insurance reserve increasingly mitigates the City’s risk over time, an adverse legal outcome could expose the General Fund to a significant financial risk. As noted in the City Attorney memorandum dated November 19, 2013, “the decision to distribute *any* portion of TMD assessment funds prior to the conclusion of litigation entails some level of financial risk to the City and remains solely a policy decision of the Council.”

Under the Second Amendment, the City would establish a \$30.0 million self-insurance reserve to cover the City’s potential liability in the event of an adverse legal outcome in the pending litigation; however, we believe there are other prolonged litigation scenarios that could potentially increase the City’s maximum exposure above \$30.0 million. Depending on the timing and the outcome of litigation challenging the legality of the TMD, the City’s General Fund exposure ranges from nothing to an amount that is potentially greater than \$30.0 million. If we assume the City’s maximum liability is \$30.0 million and the Council approves the Second Amendment as drafted, the potential exposure to the General Fund is quantified in the table below:

Fiscal Year End	Estimated TMD Reserve Level	Potential General Fund Exposure
2014	\$ 5,500,000	\$ 24,500,000
2015	\$ 12,000,000	\$ 18,000,000
2016	\$ 19,500,000	\$ 10,500,000
2017	\$ 30,000,000	\$ -

The Office of the City Attorney has briefed the Council on the merits of the outstanding litigation against the TMD. If the Council is uncomfortable with the potential General Fund exposure associated with the Second Amendment, there are other alternatives that could be pursued to better mitigate the City’s risk. These alternatives include but are not limited to:

- Increasing monthly withholding levels in the Second Amendment to more quickly build the self-insurance reserve.
- Continue to seek City indemnification agreements and waivers from hotels before releasing funds.
- Require a surety bond or some other instrument securing the TMD’s indemnification obligations under the Operating Agreement.
- Continue to withhold all TMD funds until litigation is resolved.

The IBA understands these may not be ideal alternatives because they potentially delay the release of TMD funds which will be used to beneficially market the City, and in turn generating additional TOT and sales tax dollars for City services. We further understand that there are

potentially significant fiscal consequences associated with the City continuing to withhold TMD assessments. These considerations are discussed in the following section.

Potential General Fund Implications of Not Adopting Second Amendment

The withholding of TMD revenue in FY 2013 and FY 2014 led to the reduction and/or elimination of sales and marketing campaigns designed to encourage visitation to San Diego. It is almost certain that these limited marketing expenditures have reduced room nights booked and visitor spending in the City which in turn impacts the amount of TOT and sales tax received by the City. Having said that, it is extremely challenging to accurately estimate the incremental difference in room nights booked or the amount visitor spending attributable to a marketing expenditure that was or was not made.

The City's FY 2014 Adopted Budget assumed a 6.0% growth rate in TOT over FY 2013. A significant amount of the TMD's annual marketing expenditures are typically made early in the calendar year to generate visitation in the spring and summer months; however, these expenditures were either not made or severely curtailed in 2013 which might suggest there would be a significant downturn in TOT revenue in the first quarter of FY 2014 (summer months). On November 15, 2014, the City released its First Quarter Budget Monitoring Report which showed TOT growth of 5.7% (a small 0.3% variance from the 6.0% that was projected). Although this projected FY 2014 year-end TOT revenue variance is small, it does not necessarily mean that the TMD marketing efforts that were eliminated early in the year did not have an adverse impact on City revenues (i.e., first quarter TOT growth might have significantly exceeded 6.0% had the TMD marketing expenditures been made).

It would be fair to say that many variables influence actual tourism activity and that marketing is an essential variable to compete effectively in a competitive market. Joe Terzi, President & CEO at SDTA, showed the IBA data suggesting San Diego's year-to-date performance relative to other top 25 tourist markets has declined. This data suggests the reduction in marketing expenditures may have caused the City to lose a portion of its market share to other top 25 tourist cities.

In an effort to ascertain the ramifications of reduced TMD funding, SDTMD hired Tourism Economics to evaluate the fiscal impact of reduced marketing expenditure in FY 2013 and FY 2014. This analysis was based on an assumption that the TMD would not be able to spend \$30.0 million on marketing that it would have normally expended in FY 2013 and FY 2014. In a report to SDTMD dated November 15, 2013, Tourism Economics concluded that the \$30.0 million reduction in TMD marketing expenditures will result in a \$200 million reduction in hotel room revenues and a \$560 million reduction in visitor spending. These reductions extrapolate to an estimated \$22.3 million reduction in City tax revenues (TOT and sales taxes).


CONCLUSION

The proposed Second Amendment to the TMD Operating Agreement achieves the goal of funding TMD activities (which help generate TOT and sales tax revenue for the City) while retaining some reserves in the event of adverse legal outcomes arising from current lawsuits challenging the legality of TMD assessments. However, it is important to note that the proposed release of TMD revenue exposes the City's General Fund to significant financial liability in the

event the courts rule against the legality of TMD assessments. The establishment of a self-insurance reserve increasingly mitigates this risk over time, but does not eliminate it.

This report also discusses potential General Fund implications associated with continuing to withhold TMD assessments and thereby reducing beneficial tourism marketing campaigns. While the exact impact of reduced marketing is difficult to estimate, the IBA believes reduced marketing expenditures will reduce room nights booked and visitor spending in the City. These reductions in turn adversely impact the amount of TOT and sales tax received by the City.

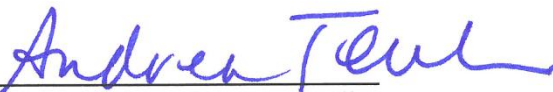
In a memorandum to the City Council dated November 19, 2013, the Office of the City Attorney states that “the decision to distribute *any* portion of TMD assessment funds prior to the conclusion of litigation entails some level of financial risk to the City and remains solely a policy decision of the Council.” Understanding the competing concerns and risks associated with this policy decision, the IBA has suggested other alternatives the Council could consider to better mitigate the City’s financial risk. We also acknowledge that these may not be ideal alternatives because they potentially delay or reduce the release of TMD funds which will be used to beneficially market the City.



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