THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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FY 2014 First Quarter Budget Monitoring

OVERVIEW

The Financial Management Director issued the Fiscal Year 2014 First Quarter Budget Monitoring Report (First Quarter Report) on November 15, 2013. The First Quarter Report describes the current status of revenues and expenditures and their year-end projections based on actual (unaudited) data from July 2013 through September 2013.

The First Quarter Report provides detail on a significant rise in projected total General Fund revenue to be received in FY 2014 in addition to a moderate increase in total projected expenditures. General Fund revenues have increased primarily due to one-time revenue sources that were not budgeted, including $8.0 million from the San Diego Data Processing Corporation's dissolution and $34.8 million that the City will receive as its share of the Successor Agency's Non-Housing Due Diligence Review (DDR) payment to the County Auditor and Controller. The expenditures variance is primarily due to a $5.5 million increase in public safety personnel expenses and $9.5 million in unbudgeted election expenses. This increase in both projected revenues and expenditures in FY 2014 has resulted in a $40.5 million budgetary surplus.

Our Office's report highlights the following:

- Additional detail for individual variances noted in the First Quarter Report.
- Detail for items that have not been noted in the First Quarter Report that are projected to impact the General Fund.
- Potential impacts to the General Fund that require further monitoring during the current fiscal year.

FISCAL/POLICY DISCUSSION

General Fund Revenues

General Fund projected revenues increased by approximately $58.3 million from the Adopted Budget, or 4.9 percent, primarily due to unanticipated increases in property tax revenue distributions. Additional increases are due to the projected receipt of revenue from the dissolution of the San Diego Data Processing Corporation, increases in property transfer tax, and Fire-Rescue Department increases, among others.

Revenue Source *(in millions)*	FY 2014 Adopted Budget	FY 2014 1st Qtr Report Projection	Variance - Adopted Budget to 1st Qtr
Property Tax	$ 408.0	$ 454.0	$ 46.0
Sales Tax	248.1	248.5	0.4
Transient Occupancy Tax	87.9	87.6	(0.3)
Franchise Fees	67.0	67.2	0.2
Departmental & Other Revenue	392.0	404.1	12.1
TOTAL GENERAL FUND REVENUE	**$ 1,203.0**	**$ 1,261.4**	**$ 58.3**

Major General Fund Revenues

The year-end projections for the General Fund's four major revenues (property tax, sales tax, transient occupancy tax, and franchise fees) have increased significantly from projections for the FY 2014 Adopted Budget - approximately $46.3 million or 5.7 percent. This increase is attributable to revised property tax revenue projections. This section outlines variances in major General Fund revenues and other notable non-departmental revenues.

Property Tax

As outlined in the First Quarter Report, property tax revenue projections have increased $46.0 million from the Adopted Budget due to an increase in the projected growth rate for the City's 1.0 percent revenue, motor vehicle license fee (MVLF) backfill, and Residual Property Tax Trust Fund (RPTTF) distributions. The revised projection for each of these categories of property tax revenue is discussed below.

- 1.0 Percent Revenue

According to a discussion with the Chief of Assessment Services with the County of San Diego Tax Assessor's Office, a significant number of temporary property tax reductions granted to homeowners during the recent recession were to be eliminated in FY 2014 due to the economic recovery and associated growth of the San Diego housing market. These revised assessments are projected to affect over 60,000 properties county-wide. In addition to projected positive revenue impacts for the City due to these reassessments, property tax rates are annually impacted by Proposition 13 growth which is limited to a maximum of 2.0 percent growth in each property tax bill per year. This growth is based on the annual change in the California Consumer Price

Index, which has grown modestly. With these two positive revenue indicators, the County of San Diego Assessor's Office has reported that projected current property tax receipts to be received by the City will increase 3.8 percent above FY 2013 revenue. The revised 4.0 percent growth rate incorporated into the First Quarter Report (up from 2.2 percent growth in the Adopted Budget) has led to an increased projection of $7.7 million for this category of property tax revenue. Based on the current growth information from the County Assessor's Office, the revised growth projection for year-end property tax 1.0 percent revenue is appropriate.

- MVLF Backfill

The State of California annually distributes property tax revenues to reimburse the City for lost motor vehicle license fee (MVLF) revenues due to State actions of prior fiscal years. The projection included in the Adopted Budget for this category of property tax revenue was $106.4 million. After development of the projected amount of MVLF revenue to be received in FY 2014, the State notified the City that the actual amount to be received in FY 2014 was $108.4 million, or a positive revenue impact to the City of $2.0 million.

- RPTTF Tax Sharing & Residual Revenue

As sufficiently detailed in the First Quarter Report, the City projects to receive $47.4 million in RPTTF tax sharing pass through and residual property tax payments. This is an increase of $36.3 million above the Adopted Budget, which is the primary contributor to the total projected General Fund surplus ($0.5 million due to tax sharing revenue above the budgeted amount and $35.8 million due to an increase in residual RPTTF received per the Non-Housing DDR).

Sales Tax

Revenue Source ***(in millions)***	**FY 2014 Adopted Budget**	**FY 2014 1st Qtr Report Projection**	**FY 2014 Revised Projection**	**Variance - Adopted / Revised Projection**	**Variance - 1st Qtr / Revised Projection**
Sales Tax	248.1	$ 248.5	$ 246.3	$ (1.8)	$ (2.2)

The First Quarter Report projects a slight surplus to sales tax revenue at year end as compared to the current budget. The report notes that the City experienced a growth in taxable sales of 3.9 percent from the first quarter of FY 2014, and continues to project annual growth of 5.5 percent for the remaining three quarters. That projected growth is roughly consistent with the overall annual growth in taxable sales as forecasted by Beacon Economics and MuniServices for the San Diego area this fiscal year (growth rates of 5.2 percent and 5.3 percent respectively), and statewide increase of 4.0 percent as projected by UCLA Anderson. As noted in the First Quarter Report, the upcoming holiday shopping period will provide additional indication of the accuracy level of projected growth rates.

We do note that the annual sales tax projections in the First Quarter Report assume that the $61.5 million reimbursement from the Sales and Use Tax Compensation Fund (commonly known as the triple flip) contemplated in the Adopted Budget remains constant. However, since adoption of the City's budget, the County has released its schedule of triple-flip reimbursements which shows that the City will receive $59.4 million this fiscal year. This reduces the expected sales tax revenue to the City in this year by $2.2 million, though that amount is expected to be recouped during FY 2015 as part of the prior-year true-up process, and will be reflected in our review of the Five-Year Financial Outlook. This adjustment will result in an expected sales tax revenue level $1.8 million lower than projections included in the Adopted Budget, and $2.2 million below that which was included in the First Quarter Report.

Transient Occupancy Tax (TOT)

The year-end projection for the General Fund 5.5 cent TOT revenue in the First Quarter Report is approximately $0.3 million or 0.3 percent below projections included in the Adopted Budget. Impacts to FY 2014 TOT growth may be attributable to the withholding of Tourism Marketing District (TMD) hotel assessment revenue. However, this revised projection represents a projected 4.4 percent increase in TOT revenue to the General Fund over FY 2013 unaudited actual revenue[1].

The San Diego Tourism Marketing District (SDTMD), which controls and distributes TMD revenues for marketing activities under an agreement with the City, has received only a small portion of total assessments in FY 2014. As outlined in IBA Report 13-52, the operating agreement for the TMD was amended in April 2013 to require waivers and indemnifications from hoteliers to limit any potential liability to the City if the TMD were to be invalidated by a court of law based on the current lawsuit filed by San Diegans for Open Government. Due to the SDTMD receiving only 18 percent of total waivers and indemnifications, marketing activities during the second half of FY 2013 and the first half of FY 2014 have been dramatically reduced. However, on November 21, 2013, the San Diego City Council approved the second amendment to the SDTMD, which enacted 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;
- Withhold the remaining $4.0 million in current assessments and an additional $1.5 million in assessments received by the City in FY 2014 to establish a $5.5 million reserve, with future contributions to be made annually, to reach $30.0 million in total reserves by the end of FY 2017.

With the approval of this second amendment, marketing activities will resume. However, it is unknown what impacts, if any, the delay in expanded marketing activities provided for by TMD funds will have on future TOT receipts. Based on current information, FY 2014 projected TOT receipts appear appropriate but should be monitored closely for any potential negative impacts from the delay in TMD funds, with any necessary adjustments to the year-end projection detailed in the FY 2014 Mid-Year Budget Monitoring Report.

[1] FY 2013 unaudited TOT revenue as reported in the City Comptroller period 12 Charter 39 financial performance report

Other Non-Departmental Revenue Variances

- Dissolution of San Diego Data Processing Corporation (SDDPC)

As outlined at the October 16, 2013 Budget and Finance Committee, the dissolution of SDDPC will result in any remaining cash being transferred by the corporation to the City (distribution of assets is projected to occur prior to December 30, 2013). The First Quarter Report projects $8.0 million in cash to be received by the City from the dissolution which was not included in the Adopted Budget. Additionally, in IBA Report 13-32, our office noted that SDDPC retains approximately $10.8 million in additional assets outside of cash, from real estate and various equipment and hardware held by SDDPC.

If this real estate is sold prior to the dissolution of SDDPC, cash received will fall to the General Fund. However, if these real estate assets are not sold prior to dissolution, the properties will revert to the City and revenue from the sales would go to the Capital Outlay Fund per City Charter Section 77. Restrictions for use of monies from this fund would apply. The Real Estate Assets Department is currently handling the potential sale for SDDPC and the Mid-Year Budget Monitoring Report should reflect additional cash received by the General Fund if this real estate is sold prior to SDDPC dissolution.

- Property Transfer Tax

The General Fund receives $0.55 per $1,000 of assessed valuation of any real property sold within the City as property transfer tax. The First Quarter Report includes a projected receipt of $8.0 million, which is $0.9 million or 13.4 percent above projections included in the Adopted Budget. Due to the increased sales activity in both the residential and commercial markets year-over-year after the end of the recent recession, the amount of transfer tax received by the City has increased significantly.

Departmental Revenues

Fire-Rescue Department

Departmental revenue is expected to exceed budget by $2.7 million, primarily due to reimbursements from the San Diego County Regional Airport Authority received in FY 2014 for services rendered in FY 2013. This portion of Airport Authority revenue is approximately $2.4 million. Apart from this specific invoice, however, ongoing revenue from services provided to the Airport Authority is anticipated to decrease to $4.5 million from the current FY 2014 budget amount of $5.0 million. This decrease is due to ongoing negotiations between the department and the Airport Authority over fringe and overhead rate issues highlighted by a recent audit.

The Combustible Explosive and Dangerous Materials (CEDMAT) Program is projecting a negative variance of approximately $675,000. The deficit is attributable to the Program's inability to achieve budgeted revenue levels with existing staff resources. As noted in the First Quarter Report, the department is in the process of hiring five additional inspectors to augment the CEDMAT Program's revenue-generating capacity. Although the First Quarter Report anticipates increased revenue to be realized at the end of FY 2014, it is important to take into account the lengthy training process the new inspectors will have to undergo before being able to complete a full caseload. As a result, the CEDMAT Program may not be positioned to fully recover budgeted revenue until future years.

General Fund Expenses

General Fund expenditures increased by approximately $17.9 million from the Adopted Budget, or 1.5 percent, which is attributable to an increase in both personnel and non-personnel expenditures. The increase in personnel costs are primarily attributable to $5.4 million in over budget pay-in-lieu of annual leave and $8.9 million in over budget overtime, which are partially offset by $8.1 million in salary savings. Non-personnel expenditures are projected to exceed budgeted levels primarily due to the $9.3 million unbudgeted requirement for a Mayor special election.

Expenditure Source *(in millions)*	FY 2014 Adopted Budget	FY 2014 1st Qtr Report Projection	Variance - Adopted Budget to 1st Qtr
Personnel Expenditures	$ 515.9	$ 522.2	$ 6.3
Fringe Benefits	370.5	371.2	0.7
Contracts	163.3	175.3	12.0
Energy & Utilities	38.7	38.3	(0.4)
Information Technology	29.8	30.1	0.3
Supplies	24.2	26.6	2.4
Other Expenditures	83.1	79.7	(3.4)
TOTAL GENERAL FUND EXPENDITURES	**$ 1,225.5**	**$ 1,243.4**	**$ 17.9**

City-Wide Expenditures

Salaries / Wages Vacancies

In March of 2013, the IBA issued report 13-14, which focuses on how vacancies at the end of December 2012, and before and after that snapshot, have impacted departments. This report also discusses the process of filling classified City vacancies, and specific issues and challenges facing certain General Fund departments.

In IBA report 13-14, which was presented at the March 13, 2013 Budget and Finance Committee, the IBA recommended that an updated list of vacancies be provided to Council coinciding with the budget process, and then annually as an attachment to the Mid-Year Budget Monitoring Report. The Financial Management Director subsequently indicated that a list of vacancies would be provided with the budget monitoring reports, and this list (as of November 5, 2013) has been included in the First Quarter Report (as Attachment IV).

The First Quarter Report indicates that the attrition rate, hiring plans and vacancies have a significant effect on the year-end projections for the General Fund. It also notes that savings are being accrued in the salaried wages accounts due to higher vacancies than assumed in the budget.

As of November 5, 2013, there were 168 more vacancies than were budgeted for FY 2014. For comparison, our office reported in IBA report 13-14 that as of December 27, 2012 there were 248 more vacancies than what was budgeted for FY 2013. From the December 2012 snapshot to the November 2013 snapshot, there has been a 32 percent decline in the number of actual vacancies above budgeted vacancies. Note that these vacancies are snapshots in time and vacancy levels fluctuate.

When the budget is developed, a certain number of positions are kept vacant to account for savings that routinely occur due to turnover, including retirements, transfers and resignations. A department must monitor hiring, salaries and wages, and all budget expenditures to keep within the department's bottom line budget; and thus a department may keep positions vacant, which would produce vacancy savings, or salary savings.

The FY 2014 projection for "pay in lieu of annual leave" is an example of where a projected over budget expenditure could necessitate spending reductions in other areas in order to balance to the bottom line budget. General Fund pay in lieu of annual leave for FY 2014 is projected to be $7.3 million, which is $5.4 million higher than the budgeted amount of $1.9 million. To keep within budget, departments may have to generate vacancy savings to offset increased pay in lieu of annual leave expenditures.

Actual vacancies that are higher than budgeted vacancies can increase workloads for existing staff. Having fewer staff than needed can impact desired service levels and decrease response times to citizens or to "client departments" within the City.

Vacancies can also cause increased overtime as a department tries to keep service levels consistent or to acceptable minimum levels. The first quarter projection shows overtime to be over budget by $8.9 million, with the Police and Fire-Rescue Department having the greatest overages (which is discussed more in department sections). These two departments are also incurring the majority of salary savings.

There are other reasons why departments could hold vacancies open such as reorganizations and implementation of managed competitions, where departments keep positions open to avoid lay-offs.

On a final note with respect to vacancies, some concerns have been expressed regarding the length of time for the hiring process, which includes both personnel and hiring department activities. The IBA has explored various aspects of the civil service hiring process in IBA reports 13-14 and 13-30, and is planning to release a report to be heard at the December 11, 2013 Economic Development and Inter-Governmental Relations Committee. Additionally, the Office of the City Auditor release an audit relating to the hiring process on November 27, 2013.

Departmental Expenditures

Fire-Rescue Department

The Fire-Rescue Department uses a constant staffing model to budget for personnel expenditures. Generally speaking, this methodology uses salary savings from vacancies to offset overages in overtime, pay-in-lieu, and other personnel costs. The department has experienced difficulty in prior budget years in maintaining overtime spending within budgeted levels. In FY 2014, the First Quarter Report projects that the Fire-Rescue Department will exceed its overtime budget by $4.5 million. This overage is offset by projected salary savings of $1.4 million (page 5 of the First Quarter Report inadvertently transposes the salary savings figures for Police and Fire-Rescue).

Recent and planned future hiring of new recruits may impact Fire-Rescue's usage of overtime during the remainder of FY 2014. The First Quarter Report notes that 55 new fire fighters from two FY 2013 academies have been fully integrated into department operations. An additional 30 recruits began academy training in the second quarter of FY 2014. It will be important to continue to monitor staffing and expenditure levels to determine the effect these new fire fighters may have on overtime usage.

Police Department

The Police Department is projected to exceed budgeted overtime expenditures by $3.6 million, which is offset by salary savings of $3.8 million (page 5 of the First Quarter Report inadvertently transposes the salary savings figures for Police and Fire-Rescue). However, the department projects overall personnel expenditures to exceed budget by $1.1 million, largely due to overages of approximately $1.8 million in pay-in-lieu.

The department anticipates spending $1.2 million in over budget overtime related to AB 109, which mandates that certain offenders be released early from prison. Officers use this overtime primarily to monitor parolees. While the First Quarter Report explains that an unbudgeted AB 109 disbursement from the State in FY 2014 will partially mitigate these overtime costs, it is important to note that the department still projects a $500,000 year-end overtime deficit for this program.

Public Works – General Services (Facilities Division)

- Status of Condition Assessments

The FY 2014 Adopted Budget includes $1.0 million to hire a consultant to conduct a condition assessment of General Fund facilities; $600,000 to include water and wastewater facilities; and $257,000 to include Park & Recreation facilities. The City has an estimated $185.0 million deferred capital for buildings, but this is anticipated to be significantly higher once the updated condition assessment is completed. The current estimate is based on three condition assessments of about 30 percent of the City's 1,600 facilities conducted in fiscal years 2007 and 2009. Updating and expanding the assessment to other facilities is critical for identifying health and safety conditions of the building occupants, code violations, energy-saving opportunities as well as for City financial planning and transparency of the condition and needs of the City's facilities.

On November 21, 2013, Council authorized the execution of up to three As-Needed Facilities Condition Assessment Contracts in an amount not to exceed $5.0 million and up to five years for each agreement. These contracts are required to conduct thorough assessments for various City departments including Public Utilities, Environmental Services, and Park & Recreation. Public Works anticipates work beginning on the General Fund facilities condition assessment contract in January 2014 and expects to spend about $500,000 of the $1 million allocated in FY 2014. They plan to request that the remaining $500,000 be carried over to be spent in early FY 2015. Additionally, the contracts will integrate the data into a comprehensive Asset Management system and include creation of a Facility Condition Index, Facility Maintenance Schedule and Strategic Facility Management Plan for projection of a 5 year incremental and 20 year forecast of repairs, capital project renewals and replacements, integration of the financial and building data into a database, and integration of that information into iMaint (specialized program used by Facilities Division) and ultimately into the new asset management module of the Enterprise Asset Management (EAM) SAP system that is in pilot stage at Public Utilities.

- Continuing Impact of Maintenance, Repair, and Operation (MRO) Contracts

MROs are competitively bid cooperative agreements with vendors to purchase equipment and supplies. The original intent behind these agreements was to increase purchasing efficiencies in ordering and delivery, among other things. When these were initially budgeted in FY 2012, it was anticipated that the use of these purchasing agreements would result in savings. However, the use of MROs has been a major contributor to over-budget projections for supply expenditures since that time, and Facilities Division is projecting a slight deficit in NPE attributed to increased cost for supplies purchased through the MRO contracts.

Facilities Division has been paying high price markups for supplies and purchases under MRO agreements, because MRO vendors do not directly sell many of the supplies and equipment necessary for Facilities Operations. The Purchasing & Contracting Department has worked with Facilities to find other options for purchasing supplies, such as Purchase Orders; however, the City's Municipal Code limits the Purchase Orders to $50,000 for vendors other than the MROs. As a result, the MROs continue to have all of the major contracts and are still a challenge for Facilities Division.

The Purchasing & Contracting Department plans to bring several operational improvement and streamlining measures to Council in early 2014, including an anticipated recommendation for an increase in the Purchase Order limit as well as potentially maintaining on-site supplies to reduce travel time for Facilities Division staff. Given increasing needs for Facilities maintenance and limited resources, it is important that the Purchasing & Contracting Department expeditiously identify a solution to ensure that Facilities and other City departments impacted by MROs are able to obtain needed supplies and equipment at the most economical price.

General Fund Reserves

The unaudited FY 2013 year-end total General Fund reserve was reported by the Office of the Comptroller as $181.9 million, which is subject to change based on completion of the FY 2013 CAFR. The FY 2014 Adopted Budget included the utilization of $22.4 million in reserves and prior year surplus; however, due to a projected increase in net resources (increased one-time resources include $34.8 million in RPTTF Residual Property Tax revenues and $8.0 million in SDDPC dissolution revenues), the reserves and prior year surplus will not be needed to balance the budget. Instead, an $18.0 million surplus is forecasted for FY 2014.

With the $18.0 million in FY 2014 projected surplus, the General Fund reserve would reach $199.9 million. However, $21.1 million of the total reserve was approved by City Council on November 21, 2013 for a loan to the City's Successor Agency for the Non-Housing DDR "Clawback." After adjusting for this loan, the FY 2014 projected General Fund reserve is $178.8 million or 14.2 percent of total projected General Fund revenue.

	Estimate	% GF Projected FY 14 Revenue
FY 2013 Ending Reserve Balance	$ 181.9	14.4%
FY 2014 Projected Surplus	18.0	
Sub-Total FY 2014 Projected Reserve	$ 199.9	15.8%
Non-Housing DDR "Clawback"	(21.1)	
Net FY 2014 Projected Reserve	$ 178.8	14.2%

The First Quarter Report General Fund reserve estimate also details $20.4 million in Successor Agency loans that do not impact total reserve levels. This represents miscellaneous loans from the City to the former Redevelopment Agency (RDA) for funding various projects from other City sources over several years prior to dissolution. We would note that these loans to the former RDA, along with an additional $190.6 million outside of the General Fund, were written off by the Office of the City Comptroller.

CONCLUSION

In summary, the First Quarter Report accurately details large variances in General Fund revenues and expenditures from the FY 2014 Adopted Budget. Our Office has identified some additional items of note for departmental revenue and expenditures that should be monitored and potentially addressed in the Mid-Year Budget Monitoring Report including public safety overtime costs and any variance in CEDMAT and transient occupancy tax revenues.

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