



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Item Number: 1

Additional Information related to the Proposed Ballot Measure to Increase the Transient Occupancy Tax (TOT)

OVERVIEW

On March 29, 2017, the Office of the Mayor issued a report outlining a proposal to increase the City's TOT in order to finance the proposed Phase III Contiguous Convention Center Expansion, fund additional road repair and maintenance, and establish a dedicated revenue stream to more significantly address the City's significant homelessness issues. The Rules Committee will receive a presentation of this proposal on April 5th. Committee members are being asked to comment and provide direction regarding the Mayor's proposal. Staff is specifically requesting that the Committee direct the City Attorney's Office to work with the Mayor's Office to prepare a draft ordinance for consideration by the City Council in June to place on the ballot for a special election in November of 2017.

The IBA was briefed about the proposed TOT increase late last week and received additional information about underlying assumptions behind preliminary tax revenue projections this week. We understand that the proposal is still under development and certain elements may be subject to change.

If the current proposal were to be placed on the November ballot and be adopted by two-thirds of the voters, the TOT levied by the hotels in the City would be increased by 1%, 2%, or 3% (depending on the geographic location of the hotel) beginning April 1, 2018 for a period of up to 40 years. It is estimated that \$53.5 million of new TOT revenue would be received in the first full fiscal year of the tax increase (FY 2019). This amount is conservatively projected to grow annually by approximately 3% over the term of the tax increase.

This report endeavors to provide additional information and supplement information presented in the Mayor’s staff report and memorandum docketed for the Committee. We additionally highlight other considerations and options for the Committee to contemplate in its review of this proposal.

FISCAL/POLICY DISCUSSION

The Proposed TOT Increase

The City's current TOT is 10.5% for all hotels in the City. Additionally, hoteliers renewed their Tourism Marketing District (TMD) in 2013 for another 39.5 years. The TMD requires all hotels with 70 rooms or more to assess their guests, or alternatively pay, an additional 2%. The 2% assessment is used to fund programs and services that benefit the assessed lodging businesses such as tourism marketing and promotion. This results in a current combined charge to hotel guests staying at the City’s larger hotels of 12.5%.

Similar to the proposed TOT increase in 2012 to finance the Phase III Convention Center expansion, the current proposal would also increase TOT by 1%, 2% or 3% depending on the geographic location of the hotel in the City. Generally, hotels closest to the Convention Center (those in the downtown area) will be required to increase their TOT levy by 3% (to 15.5%), those outside of the downtown area by 2% (to 14.5%), and those furthest from downtown by 1% (to 13.5%). One difference between the proposed 2012 TOT increase and the current proposal is that the tax area boundaries have been modified as described in Table 1.

Table 1: Current and Proposed TOT Levy by Tax Area				
Tax Area	Current 10.5% TOT + 2% TMD Assessment*	Proposed Tax Increase	Proposed New TOT + TMD Assessment*	Applicable Tax Area
1	12.5%	1.0%	13.5%	Citywide
2	12.5%	Add 1.0%	14.5%	South of Hwy 56, North of Hwy 54 & Downtown
3	12.5%	Add 1.0%	15.5%	Downtown Area

*Hotels with fewer than 70 rooms do not pay the 2% TMD assessment and have TOT rates that are 2% lower.

Table 2 shows the number of hotel rooms, applicable TOT increase, and associated revenue in FY 2019, and the proposed utilization of the tax proceeds collected in tax area.

Table 2: Estimated New TOT Revenue in FY 19 for each Tax Area and Proposed Utilization				
Tax Area	Number of Hotel Rooms Subject to Applicable Tax	Applicable TOT Increase	Projected New Revenue in FY 2019	Proposed Utilization of Tax Area Proceeds
1	48,655	1.00%	\$22.4M	Primarily for Homelessness & Streets
2	44,700	1.00%	\$21.7M	Entirely for Convention Center Expansion, Capital & O&M
3	16,022	1.00%	\$9.4M	Entirely for Convention Center Expansion, Capital & O&M

Proposed Allocation of the TOT Increase

The following allocation detail is based on preliminary information shared by the Office of the Mayor and is potentially subject to change after consideration of City Council and City Attorney input. As noted in Table 2, proceeds from the first full year of the proposed TOT increase (FY 2019) are currently estimated to be \$53.5 million. This estimate includes approximately 1,300 new hotel rooms that are planned to open in FY 2017 and FY 2018.

All City hotel rooms would be subject to a 1% TOT increase to be applied in Tax Area 1. Hotel rooms in Tax Area 2 would be subject to an additional 1% TOT increase and hotel rooms in Tax Area 3 would be subject to yet another 1% TOT increase. New TOT tax proceeds would be allocated in accordance with the defined uses for the tax proceeds collected in each tax rate area as described below:

Tax Area 1: As proposed, approximately 90% of the new TOT proceeds from Tax Area 1 (an additional 1% levied on all hotel rooms citywide) would be split to fund street improvements and efforts to address homelessness over the term of the TOT increase. Approximately 10% of the new TOT proceeds from Tax Area 1 would be used to fund the Phase III Convention Center expansion and potentially used to address a) other capital or operating and maintenance expenses at the facility or b) other yet to be specified tourism related expenses. Total Tax Area 1 proceeds for FY 2019 estimated to be \$22.4 million, of which approximately \$20 million would be split to address streets and homelessness needs.

Tax Area 2: All of the new TOT proceeds from Tax Area 2 (the additional 1% levied on those hotels within the boundaries of Tax Area 2) would be used to fund the Phase III Convention Center expansion and potentially used to address a) other capital or operating and maintenance expenses at the facility or b) other yet to be specified tourism related expenses. Total Tax Area 2 proceeds for FY 2019 estimated to be approximately \$21.7 million.

Tax Area 3: All of the new TOT proceeds from Tax Area 3 (the additional 1% levied only on downtown hotels within the boundaries of Tax Area 3) would be used to fund the Phase III Convention Center expansion and potentially used to address a) other capital or operating and maintenance expenses at the facility or b) other yet to be specified tourism related expenses. Total Tax Area 3 proceeds for FY 2019 estimated to be approximately \$9.4 million.

Assumed Annual Growth of New TOT Proceeds

The City's average annual growth rate for TOT has significantly exceeded 3% over the last 10 (3.5%), 20 (5.4%), and 30 (6.1%) year periods. Based on their review of historical TOT, staff has developed a reasonable cyclical pattern of annual changes in TOT (5-6 years of growth followed by 1-2 years of decline) that averages to be approximately 3% over the period of the proposed TOT increase (up to 40 years). Given the City's historical TOT growth rates and the likelihood of additional hotels being added over time, the IBA believes this is a reasonable and potentially conservative estimate.

Based on the assumed average annual growth rate of approximately 3%, the amount of the annual allocation attributable to the proposed TOT increase grows significantly over time. While total tax proceeds are preliminarily estimated to be \$53.5 million in FY 2019, they could reasonably be approximately four times that amount in the 40th year of the tax (FY 2058). As noted in the staff

report, preliminary revenue projections would be sufficient to finance all costs associated with the Phase III Convention Center Expansion.

Other Considerations Related to the Proposed TOT Increase

Baseline TOT Growth Attributable to Phase III Convention Center Expansion

The Mayor's staff report (page 2) indicates the proposed Phase III Convention Center Expansion will generate over 380,000 new hotel room nights annually that will in turn result in approximately \$15 million in additional TOT to the City's General Fund for core City services. The Mayor's Office indicates this data was provided by a TMD consultant analyzing the proposed Convention Center expansion (the consultant's analysis has yet to be released). In comparing the above figures with estimation approaches included in the docketed memorandum from the DCOO of Public Works to the COO dated March 27, 2017, we find that the 380,000 new hotel room nights estimate reasonably fits within the high end of the range established by the two approaches detailed in the memorandum to the COO. However, with respect to the estimate for additional TOT revenue for the City's General Fund, we find the \$15 million estimate to be overstated and significantly out of the range established by the two alternative approaches detailed in the memorandum to the COO.

The data provided in the approaches included in the memorandum to the COO suggest additional annual TOT for the City's General Fund might range from \$4 million to \$9 million a year. Based on discussions with industry professionals and previous analysis done by our Office, we believe the \$4 million to \$9 million annual estimate to be more realistic. As this is an important estimate that is one of the key drivers for the proposed tax increase and the Phase III Convention Center expansion, the IBA recommends the Committee and Council be provided a copy of the consultant's analysis, once released, and/or any other credible analyses estimating potential additional TOT funds for the City's General Fund attributable to the Phase III Convention Center expansion.

Options for Increased Funding to Reduce Homelessness

Our Office has been asked if it would be possible to increase the amount of funding to address homelessness issues over the term of the proposed TOT increase. One way to do this would be to simply increase the proposed TOT increase in Tax Area 1. Another method would be to alter the proposed TOT allocation to shift some of the tax proceeds away from the Convention Center and/or street repairs in order to increase funding to better address homelessness issues. It should be noted that the Mayor's Office strongly believes that such a modification significantly reduces the likelihood of voter approval, noting that the City currently does not have a spending plan for additional homelessness funds.

An alternative option might be to amend the proposal to allow TOT received over and above the amount necessary to finance the Phase III Convention Center expansion, net capital, and operating and maintenance costs, if any, to be allocated to homelessness programs/services. The IBA has reviewed preliminary projected TOT revenue and Convention Center expense data which suggests that there could be significant additional funds available after paying for all of the Convention Center-related costs addressed in the staff report. Unless there are other, yet to be specified, Convention Center-related expenses to be funded with the proposed TOT increase, this approach might allow additional funding to be used for homelessness programs/services (or alternative public infrastructure) without significantly disturbing the proposed TOT allocation methodology for the Convention Center and street repairs.

Questions related to Future Road Repairs

Improving the condition of our streets and roads continues to be a top City priority. Over the past several years the Mayor and City Council have increased funding allocated to street repair, and significantly increased the miles of streets repaired each year. As a result of these efforts, the most recent streets condition assessment, completed in 2016, showed that City Streets had an Overall Condition Index (OCI) rating of 72, which indicates that the average condition of City streets is good. In that condition assessment, 60% of individual City streets were found to be in “good” condition, 34% in “fair” condition, and 6% in “poor” condition. One of the Mayor’s stated goals for allocating a portion of the proposed TOT increase to street repair is to reach and maintain an OCI of 70 or greater in each individual San Diego neighborhood.

TOT dedicated to road repairs is forecast to total \$900 million over the proposal’s 40 year term. If the Council desires to issue bonds to be repaid with the first 30 years of TOT revenue, approximately \$150 million could be raised in FY 2019. Our office believes it is important that an expenditure plan be developed for a potential FY 2019 street repair bond issuance and that potential uses for the last 10 years of the 40 year increase also be contemplated.

To meet and maintain the street condition goals discussed above, the 2018-2022 Five Year Capital Infrastructure Outlook, issued in January 2017, shows a plan over the next five years to complete 445 miles of asphalt overlay and concrete street replacement, at an estimated cost of \$227 million. The Capital Outlook shows this five year plan to be 100% funded through FY 2022, largely with future planned lease revenue bonds and Transnet funds. The FY 2018-FY 2022 Financial Outlook indicates that the Mayor plans to issue three series of \$90 million lease revenue bonds – one in FY 2018, the second in FY 2020 and a third in FY 2021 - for infrastructure purposes. The Five Year Capital Outlook earmarks \$126 million of these lease revenue bonds as a funding source for street repair.

Given this, it will be important to clarify whether TOT revenue in the proposal will replace the need for lease revenue bonds for street repair. Provided that it does, Council should be apprised as to whether the Mayor’s Office still plans to move forward with the lease revenue bond issuances for other infrastructure needs, such as facility repair, sidewalks, fire stations, parks, libraries, streets, and storm water permit compliance efforts. The Five Year Capital Outlook also calls for 1,515 miles of slurry seal at an estimated cost of \$151 million over five years to meet street OCI goals. As slurry seal is considered an operating cost and not a capital cost, new TOT revenue could be used for slurry seal, but it should be used for this purpose on a pay-as-you go basis. Slurry seal is currently funded through a combination of funding from Gas Tax and Prop 42 revenue, Transnet, and the City’s General Fund. A dedicated stream of TOT revenue could help free up these General Fund dollars for other needs.

While there will always be a need to fund street repair, particularly to meet the goal of maintaining an OCI of 70 over the long term, no other specific expenditure plans for street repair have been made available beyond five year plan reflected in the FY 2018-2022 Five Year Capital Outlook, as discussed above.

Fifth Avenue Landing (FAL) Property

FAL is a developer with a controlling leasehold interest in approximately five acres of bayfront property needed for the envisioned Phase III Convention Center Expansion. The developer is planning to construct a 44-story, 4-star, \$300 million hotel on the property but still needs to obtain important approvals for their project from the Port and the Coastal Commission which could take more than a year. FAL has initiated a lawsuit against the Convention Center Corporation alleging they are undermining their development plans. As the City Council contemplates a proposed ballot measure for a November special election, it will be important to monitor the situation with the FAL property and also consider whether the ability to use TOT proceeds to potentially acquire the rights to develop the FAL property need to be built into the proposed ballot measure.

Legal Considerations

The Office of the City Attorney will need to have a clear understanding of the City Council's objectives for this proposed ballot measure, if it is to be advanced, to ensure the resulting ordinance 1) clearly conveys its intent to the voters, 2) complies with all applicable laws and 3) can withstand any possible legal challenges. As elements of this proposal are still under review and development, it will be critical for the City Attorney's Office to have time to incorporate all aspects of the City Council's intent and for the City Council to have sufficient time to review the resulting ordinance before the deadline for submission to the Office of the City Clerk in late July.

Need for Enhanced Expenditure Detail

Our Office has received inquiries about the proposal concerning how the City specifically plans to spend TOT proceeds for road repairs and helping the homeless. The City currently exceeds its Overall Condition Index (OCI) goal of 70 for streets and uses multiple sources of revenue to maintain this goal. While the staff report indicates a new source of noncapital funding is needed for slurry seal and other street maintenance activities to maintain an OCI of 70, it may be helpful to provide additional detail for how the funds are envisioned to be expended. The staff report further states that a dedicated revenue stream will help address homelessness issues using long-term regional efforts and a non-exhaustive list of other possible services. It may be beneficial to provide voters with additional specificity about planned homelessness expenditures if it should become available.

It is also possible that there would be additional funding above that needed to finance the Phase III Convention Center expansion, net capital, and operating and maintenance costs. If so, it will be important for the measure to specify the eligible expenditures for these TOT proceeds.

Timing


The current plan calls for the Mayor's Office to work with the City Attorney's Office to develop an ordinance in support of the proposed TOT increase for City Council consideration in June. This will be the first public opportunity for the City Council to review a multi-faceted ordinance to increase the City's TOT rate for a period of up to 40 years. Should the City Council have significant questions or concerns in June, or wish to make changes to the ordinance, the City Attorney's Office would have limited time to make the requested changes and return to Council before the deadline for submission to the Office of the City Clerk in late July.

CONCLUSION

This report provides additional information, considerations and raises questions for the Committee to consider or ask of staff. Given a number of outstanding questions concerning the proposal, the short timeframe for review, and the time available between the Rules Committee meeting on April 5th and a proposed City Council meeting in June, we recommend this item be returned to Committee or City Council in May for further review, discussion and updates.



Jeff Kavar
Deputy Director



APPROVED: Andrea Tevlin
Independent Budget Analyst