THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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IBA Review of the FY 2021 First Quarter Budget Monitoring Report

OVERVIEW

The Department of Finance issued the *Fiscal Year 2021 First Quarter Budget Monitoring Report* (First Quarter Report) on November 4, 2020. The First Quarter Report describes the current status of major General Fund revenues and their year-end projections based on actual (unaudited) data from July 2020 through September 2020. The report also provides revenue updates on COVID-19 relief funds and specific department revenues that have been impacted by COVID-19. For expenditures, the report provides projections and updates on public safety personnel expenses, energy, fuel and water costs. An update on General Fund Reserves is also included. Year-end projections for other department revenues and expenditures are not included in the First Quarter Report but will be provided in the FY 2021 Mid-Year Budget Monitoring Report (Mid-Year Report).

In accordance with *Council Policy 000-02: Budget Policies*, the Department of Finance monitors the City's annual operating budget and presents quarterly reports to the Budget and Government Efficiency Committee and City Council which forecast year-end results. This is the first of those quarterly reports for FY 2021. The first quarterly report each year serves as an initial, high-level look, based on only three months of actual data and select areas of focus. The mid-year and third quarter reports are more robust, projecting full revenues and expenses for the General Fund as well as non-general fund departments, and often include requests for budget adjustments.

Our Office reviews these quarterly reports and provides additional information and recommendations for Council's consideration. Our review of the First Quarter Report includes an analysis of major General Fund revenues; the General Fund Reserve and Excess Equity; additional information on public safety overtime; and a discussion of financial support that is likely needed for the San Diego Convention Center. The projections and Excess Equity estimate included in the

First Quarter Report inform the projections included in the FY 2022-2026 Five-Year Financial Outlook (Outlook), which our Office has analyzed and reviewed in IBA Report 20-25.

FISCAL AND POLICY DISCUSSION

Major General Fund Revenues

General Fund Revenues in the First Quarter Report are $10.2 million below amounts included in the Adopted Budget. While revenue projections for Property Tax and Sales Tax show increases over amounts projected in the Adopted Budget, Franchise Fee projections show small decreases, and Transient Occupancy Tax (TOT) projections show a significant decrease. Revenue projections used for the Adopted Budget were developed during the uncertainty surrounding the initial outbreak of the COVID-19 pandemic, so some variation in projections was to be expected. Each of the four major General Fund revenues is discussed below.

Major General Fund Revenues *(in millions)*							
	FY 2020 Unaudited Actual[1]	**FY 2021 Adopted Budget**	**FY 2021 Projection**	**FY 2021 Projected Variance**	***Variance %***	**FY 2021 Projection vs FY 2020 Actual**	***Variance %***
Property Tax	$ 609.3	$ 630.6	$ 635.4	$ 4.8	*0.8%*	$ 26.1	*4.3%*
Sales Tax	282.8	274.4	284.0	9.6	*3.5%*	1.2	*0.4%*
Transient Occupancy Tax	95.2	90.5	66.2	(24.3)	*-26.8%*	(29.0)	*-30.5%*
Franchise Fees	76.0	67.7	67.4	(0.3)	*-0.4%*	(8.6)	*-11.3%*
Total	**$ 1,063.3**	**$ 1,063.2**	**$ 1,053.0**	**$ (10.2)**	***-1.0%***	**$ (10.3)**	***-1.0%***

[1] FY 2020 Unaudited Actuals from the FY 2020 Year-End Financial Performance Report

<u>Property Tax</u>

Property taxes represent the single largest source of General Fund revenue. The first quarter projection for Property Taxes is $635.4 million, which is $4.7 million above the Adopted Budget of $630.6 million. City property taxes are derived from three major sources: the Proposition 13 1% levy on the assessed value of property throughout the City, of which the City receives approximately 17%; Motor Vehicle License Fee (MVLF) backfill payments; and distributions from the Redevelopment Property Tax Trust Fund (RPTTF), which represent payments to the City as a result of the dissolution of the former Redevelopment Agencies.

The increases in the First Quarter Report are mostly due to projected increases in the City's share of the MVLF backfill payments ($2.5 million) as well as projected increases from the RPTTF ($2.2 million) due to higher than projected growth in RPTTF deposits. However, it should be noted that the residual distributions from the RPTTF will most likely change based on the next submission of the Recognized Obligation Payments Schedule (ROPS), which will be presented to the Council in January. The ROPS is a schedule of all payments that the City Successor Agency will need to meet its fiscal obligations during the next fiscal year as it continues to wind down former redevelopment activities. An increase in obligations on the ROPS would decrease the RPTTF distributions to the City.

Sales Tax
After property tax, sales tax represents the second largest single source of General Fund revenue and represents 27% of receipts from the four major General Fund revenues sources. Historically, sales tax revenues have experienced volatility during times of severe economic recession or expansion, though current sales tax revenues are significantly more stable than revenue from the City's Transient Occupancy Tax (see following section on Transient Occupancy Tax).

The First Quarter Report projects sales tax receipts to come in at $284.0 million, which is an increase of $9.6 million or 3.5% over projections used in the Adopted Budget, and an increase of $1.2 million or 0.5% over FY 2020 year-end unaudited actuals. While this is a significant increase over the amount assumed in the FY 2021 Adopted Budget, it still represents a decline of $13.9 million from what had been projected in the FY 2020 Adopted Budget.

Sales tax revenue is directly impacted by local taxable sales; the FY 2021 Adopted Budget was developed during the initial outbreak of the COVID-19 pandemic, and assumed the pandemic and stay-at-home orders would result in significant declines in overall sales throughout the San Diego region. While actual experience since that outbreak has shown declines in sales in many areas, declines have been more moderate than initially estimated, and growth in online sales has helped to partially offset declines in other areas. Additionally, sales tax revenue projections in the First Quarter Report align closely with those provided by the City's sales tax consultants, and our Office believes that projections here are reasonable.

Transient Occupancy Tax
Transient Occupancy Taxes (TOT) – or hotel taxes – have historically represented the third largest major General Fund revenue source. San Diego's effective TOT rate is 10.5%, with 5.5% of that amount allocated to the General Fund (to support general City services), 4.0% to Special Promotional Programs (to support programs and services that encourage tourism to the San Diego area), and 1.0% allocated as discretionary/council directed funding. While the First Quarter Report references the 5.5% General Fund allocation of TOT, it is important to note that changes in TOT receipts impact all of these allocations, as shown on the table below.

Transient Occupancy Tax Revenue *(in millions)*						
	FY 2020 Adopted Budget	**FY 2020 Unaudited Actual**	**FY 2020 Variance**	**FY 2021 Adopted Budget**	**FY 2021 Current Projection**	**FY 2021 Variance**
General Fund Allocation (5.5%)	$ 136.9	$ 95.2	$ (41.7)	$ 90.5	$ 66.2	$ (24.3)
Special Promotional Programs (4.0%)	98.7	68.8	(29.9)	64.9	47.3	(17.6)
Council Discretionary (1.0%)	24.7	17.2	(7.5)	16.2	11.8	(4.4)
Total (10.5%)	**$ 260.3**	**$ 181.2**	**$ (79.1)**	**$ 171.6**	**$ 125.4**	**$ (46.2)**

The FY 2021 Adopted Budget assumed that TOT revenue would be significantly below historical amounts due to the restrictions and general uncertainty surrounding the COVID-19 pandemic that led to large drops in tourism, business travel, and industry and trade conventions. While the Adopted Budget assumed that TOT revenue would bottom out in April 2020 and begin slowly recovering in May 2020, with projected occupancy rates ranging from 52.5% to 68.4%, actual recovery has been slower than anticipated, with actual occupancy rates in the City hovering in the 30.0% to 50.0% range. Accordingly, revenues have been adjusted downwards to reflect a 56.3%

decline from FY 2020 Adopted Budget amounts, and 26.8% below projections assumed in the FY 2021 Adopted Budget.

As noted above, the First Quarter Report focuses attention on the 5.5% General Fund allocation, as that directly impacts the City's discretionary General Fund dollars. While it is not called out specifically in the First Quarter Report's discussion, declines to the 1.0% Council Discretionary allocation also impact the City's General Fund budget, as the General Fund receives that amount as a transfer.

We also note that declines in the Special Promotional Programs allocation may further impact the City's General Fund. While the Special Promotional Programs allocation encourages tourism by supporting various arts and cultural programs, it also supports certain City operations. San Diego's parks, sports facilities, and beaches all help to drive tourism to the region, and revenue from the Special Promotional Programs allocation is used to reimburse various expenses for City operations at Balboa Park and other facilities, street sweeping in high tourism areas, and the City's lifeguard program. Declines in revenue here will require additional decisions to be made about how those programs currently receiving reimbursement from the Special Promotional Programs allocation should be impacted, and if other General Fund revenue should be used to offset Special Promotional Programs reimbursements.

Franchise Fees

Franchise fees represent payments made by private companies to the City for the right to operate within the City's right-of-way. The main sources of franchise fee revenue are from San Diego Gas & Electric (SDG&E) for the right to provide City residents and businesses with gas and electric services, from Cox Communications, AT&T, and Spectrum for the right to provide cable services to City residents, and from private refuse haulers that conduct business within City limits. Franchise fees from SDG&E and the cable companies are based upon a percentage of revenue generated, while the franchise fees from refuse haulers are based on tonnage.

Overall franchise fee revenues are projected at $67.4 million, which is only $290,000 below the Adopted Budget. This is mostly due to a decrease in refuse collection franchise fees based on the most recent actuals. The first quarter projection contains no change to the franchise fees with SDG&E, which make up over 60% of these revenues. Typically, projections for SDG&E franchise fees do not change until the Third Quarter Budget Monitoring Report after the City receives its February payment, which is a cleanup payment for the preceding calendar year. The projections also do not assume any changes in regards to the agreements which expire on January 17, 2021, as it is still too early to determine the potential revenue impact of the expiration of these agreements without an extension of the current agreements with SDG&E or the award of new franchise agreements.

The majority of the SDG&E franchise fee revenue is derived from surcharges charged directly to customers within the City. For more information on these surcharges and the history of SDG&E franchise fees, refer to *IBA Report 20-17: Analysis of the Initial Recommendations Concerning the Electric and Gas Franchise Agreements*. **This is the revenue source that could potentially be in the most jeopardy if the franchise agreements were to expire without new agreements or an**

extension in place. A loss of surcharge revenue would decrease General Fund revenue by $13.0 million in FY 2021.

General Fund Reserve and Excess Equity

The FY 2020 ending fund balance in the General Fund (based on unaudited actual activity for FY 2020) was $220.1 million. This ending General Fund balance included $205.6 million in General Fund Reserve and $14.5 million in Excess Equity, as shown in the following table.

FY 2020 Fund Balance Components for the General Fund	
	(in millions)
FY 2020 Unaudited Ending Fund Balance	$ 220.1
Less: 15.5% Reserve Target for FY 2020	(205.6)
FY 2020 Year-End Excess Equity	**$ 14.5**

The FY 2021 Adopted Budget did not include a contribution to fund the General Fund Reserve to the FY 2021 15.75% Reserve target level designated in *Council Policy 100-20: Reserve Policy*. As such, the Reserve level for FY 2021 remains at $205.6 million, and the $14.5 million Excess Equity is available to mitigate any revenue shortfalls that may occur in FY 2021. Please refer to the General Fund Revenue section of this report for discussion of shortfalls anticipated at this time. Additionally, please see *IBA Report 20-25: IBA Review of the Mayor's FY 2022-2026 Five-Year Financial Outlook* for discussion on the status of the General Fund Reserve and the City's Reserve Policy and Reserve targets.

Public Safety Overtime

Fire-Rescue Overtime

The Fire-Rescue Department is projected to exceed its overtime budget by $5.3 million at fiscal year-end, for a total expenditure of $38.5 million. As noted in the First Quarter Report, the increase in overtime is more than offset by salary savings of $5.6 million and increased deployment reimbursement revenue of $1.1 million, resulting in a net positive General Fund impact of $1.4 million.

The Fire-Rescue Department has indicated that approximately $1.9 million of the projected overtime overage is related to staffing shortfalls which are primarily due to delays in the promotional process for Fire Captain and Engineer ranks associated with COVID-19 and the timing of the second fire academy graduation occurring late in the fiscal year (June 2021). The Department expects the promotion-related delays to be resolved and anticipates being back to full staffing by fiscal year-end following the academy graduation.

Other notable drivers impacting overtime expenses are Strike Team deployments projected at $1.3 million (of which $1.1 million in reimbursements are expected to be realized this fiscal year) and $1.1 million related to constant staffing needs. With respect to the latter, we note that the Department is in the process of building up a Relief Pool which is intended to mitigate overtime spending by utilizing a pool of fire personnel that can backfill other firefighters rather than using overtime.

Police Overtime

The First Quarter Report notes that the Police Department is projected to end the fiscal year near its budgeted level of $38.1 million in overtime (includes $33.7 million and $4.4 million budgeted in the General Fund and Seized Assets Fund, respectively). While certain overtime categories are significantly over budget by $4.8 million primarily due to COVID-19-related education and enforcement activities ($4.0 million over budget) and increased staffing needs during civil protests ($800,000 over budget), other categories such as special event and court overtime are projected to be under budget at year-end resulting in a net impact of $16,000.

We note that the FY 2021 Appropriation Ordinance included provisions which limited the Chief Financial Officer's authorization to appropriate and expend the Police Department's General Fund overtime and Neighborhood Policing budgets. For overtime, the authorization is limited to $17.0 million of the $33.7 million General Fund overtime budget; for Neighborhood Policing, it is limited to $12.0 million of the $24.3 million budget. As of October 31, 2020, the Department is not projected to exceed either of these limits before mid-fiscal year.

Support for the San Diego Convention Center Corporation (SDCCC)

The City Council created the SDCCC in 1984 to manage and operate the Convention Center. In recent years, the Convention Center has had record-setting activity and performance. A successful Convention Center operation significantly contributes to the regional economy and to City hotel/sales tax revenue (approximately $29 million in FY 2019). SDCCC has effectively managed their budget and Convention Center operations with relatively little financial support from the City's General Fund. The City's annual support payment to SDCCC ($2.1 million in FY 2020) has been used in recent years to cover the annual payment SDCCC makes to the San Diego Tourism Authority for long-term marketing services. Due to budgetary pressures resulting from the COVID-19 pandemic, the City did not make an annual support payment to SDCCC in FY 2021.

Convention activity was sharply curtailed with the onset of the pandemic in February 2020. This stressed SDCCC's operating budget in FY 2020 and continues to severely impact their FY 2021 budget. SDCCC expects most booked conventions will cancel through at least May of 2021. Convention activity is unlikely to resume until State and County operating regulations have been issued and confidence has been restored for corporations/industries and the travelling public.

Given these adverse fiscal circumstances, SDCCC has taken aggressive actions and made difficult decisions in an effort to remain solvent in FY 2021. These actions include laying off most of their staff (approximately 75% of their pre-COVID staff by January 2021), utilizing all operating budget reserves, cutting back on planned facility maintenance, and delaying needed capital improvement projects.

SDCCC and the City also partnered to use the vacant Convention Center as a temporary shelter for as many as 1,500 vulnerable homeless citizens beginning in April of 2020 (Operation Shelter to Home) which has helped to partially mitigate SDCCC's budget challenges. This partnership enabled the City to use Federal CARES Act funds to pay SDCCC approximately $2.3 million a month (since July 2020) for use of the facility and for other expenses/services in support of the shelter. SDCCC additionally acquired a Paycheck Protection Program loan through the CARES

Act to retain staff and support shelter operations from April through June. This loan is expected to be forgiven early in 2021.

Despite these actions, SDCCC is currently projecting to end FY 2021 with an operating budget shortfall of approximately $4.2 million assuming the temporary shelter closes in December, consistent with how long it was budgeted to remain open. Once the shelter closes, SDCCC will no longer receive the $2.3 million monthly rent/services payment. Faced with a projected $4.2 million budget shortfall, SDCCC's Board will likely request a $4.2 million operating subsidy from the City's General Fund in FY 2021.

On December 2, 2020, Mayor-Elect Gloria announced he would be directing staff to develop funding options to continue shelter operations at the Convention Center citing his interest in best serving the City's vulnerable homeless citizens. Extending the shelter at the Convention Center increases the City's overall shelter capacity and may also enhance the well-being of shelter clients considering the colder winter months and the current resurgence of the COVID-19 virus. The consolidated presence of service providers and the unique characteristics of the Convention Center (large open space, air conditioning, built in facilities) provides a more optimal environment for homeless citizens than the pre-existing shelters at this time, albeit at a higher cost.

Staff from the Homeless Strategies Division previously informed the City Council that there are significant additional monthly costs associated with operating the shelter out of the Convention Center that do not exist at the pre-existing shelters, such as the $2.3 million rent payment. However, these costs have been covered to date using COVID-19 related state and federal funds, and other federal funds, thereby not burdening the City's General Fund.

If the Mayor-Elect proposes to extend the Convention Center shelter using another non-General Fund resource to cover the additional costs, there may be a partially offsetting benefit to the City's General Fund relating to SDCCC. If the Convention Center shelter were to be extended for two months through February 2021, SDCCC's CFO believes the two additional $2.3 million monthly rent/service payments from the City might enable SDCCC to balance their FY 2021 budget (although their operating reserves would be fully depleted and there are critical capital improvement projects requiring attention and funding). If SDCCC can balance their current year budget, the City's General Fund might avoid the potential burden of an unanticipated $4.2 million operating support payment request from SDCCC's Board in FY 2021.

CONCLUSION

Our review of the First Quarter Report includes an analysis of major General Fund revenues, the General Fund Reserve and Excess Equity; additional information on public safety overtime; and a discussion of funding that is likely needed for the San Diego Convention Center. As noted earlier, the First Quarter Report provides an initial, high-level look at the status of certain revenues and expenditures for the General Fund and more information, including a full set of projections, will be included in the Mid-Year Report. Our Office will continue to monitor the items we have discussed in this report as part of our review of the Mid-Year Report, expected to be released on January 27, 2021.

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