THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: December 6, 2022 **IBA Report Number:** 22-33

City Council Docket Date: December 13, 2022

Item Number: TBD

IBA Review of the FY 2023 First Quarter Budget Monitoring Report

OVERVIEW

The Department of Finance issued the *Fiscal Year 2023 First Quarter Budget Monitoring Report* (First Quarter Report) on November 10, 2022. 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 2022 through September 2022. The report also provides revenue updates from specific departments and on American Rescue Plan Act (ARPA) funding. For expenditures, the report provides projections and updates on public safety personnel expenses; information technology; energy, fuel, and water costs; and Proposition B unwinding. An update on the General Fund Reserve and Excess Equity is also included. Year-end projections for other General Fund revenues and expenditures are not included in the First Quarter Report but will be provided in the FY 2023 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 include forecasted year-end results. This is the first of those quarterly reports for FY 2023. 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 as appropriate for Council's consideration.

Our review of the First Quarter Report includes an analysis of major General Fund revenues and additional information on non-discretionary energy and utilities expenditures, public safety overtime, and Proposition B unwinding. The projections and Excess Equity estimate included in the First Quarter Report inform the projections included in the FY 2024-2028 Five-Year Financial Outlook (Outlook), which our Office analyzed and reviewed in IBA Report 22-32.

FISCAL AND POLICY DISCUSSION

MAJOR GENERAL FUND REVENUES

General Fund revenues in the First Quarter Report are $35.4 million above amounts included in the Adopted Budget. The increase is largely driven by property tax revenue reflective of a hot housing and property market in 2021 and continual recovery of Transient Occupancy Tax and leisure travel. Each of the four major General Fund revenues is discussed below. A discussion of Cannabis Business Tax revenue is also included.

Major General Fund Revenues *($ in millions)*							
	FY 2022 Unaudited Actuals[1]	**FY 2023 Adopted Budget**	**FY 2023 Projection**	**1st Quarter Projections vs Adopted Budget**	**Variance from Adopted Budget (%)**	**1st Quarter Projection vs FY 2022 Actuals**	**Variance from FY 2022 Actuals (%)**
Property Tax	$ 663.1	$ 706.2	$ 720.4	$ 14.2	2.0%	$ 57.3	8.6%
Sales Tax	375.6	380.2	386.0	5.8	1.5%	10.4	2.8%
Transient Occupancy Tax	136.5	135.2	149.9	14.7	10.9%	13.4	9.8%
Franchise Fees	89.8	93.8	94.5	0.7	0.7%	4.7	5.2%
Total	**$ 1,265.0**	**$ 1,315.4**	**$ 1,350.8**	**$ 35.4**	**2.7%**	**$ 85.8**	**6.8%**

[1] FY 2022 Unaudited Actuals are from the FY 2022 Year-End Financial Performance Report.

Property Tax

Property taxes represent the single largest source of General Fund revenue. The first quarter projection for Property Taxes is $720.4 million, which is an increase of $14.2 million from the Adopted Budget of $706.2 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 represents payments to the City as a result of the dissolution of the former Redevelopment Agencies.

The increase is mostly within the 1% property tax allocation ($13.1 million), but there is also an increase in the MVLF payment ($2.6 million). These increases are attributable to higher than expected property tax apportionments within the first three months of FY 2023, which have been driven by the increases in the housing and other property markets during calendar year 2021. This increase comes despite the fact that the Adopted Budget contained a 6.00% growth assumption for most property tax categories for FY 2023, which is one of the highest budgeted growth percentages used in several years. However, as it currently stands, receivables on current secured property taxes, which is the largest category of property taxes, are projected to grow at 7.83%. While high, our Office concurs with this projection.

Offsetting some of the increase in overall property taxes are projected decreases in the RPTTF totaling $1.4 million. These are due to the changes in the latest Recognized Obligation Payment Schedule (ROPS) which include increased enforceable obligations from prior year projections. However, this projection could change as the City and the Successor Agency go through the ROPS adoption process.

Sales Tax
The First Quarter Report projection reflects sales tax revenue totaling $386.0 million in FY 2023, representing a 1.5% increase as compared to projections in the Adopted Budget of $380.2 million. Additionally, this is a $10.4 million, or 2.8%, increase over unaudited actual sales tax revenues in FY 2022.

Looking at quarter over quarter growth, sales tax revenue in the first quarter of FY 2023 came in 8.2% higher than the first quarter of FY 2022. As noted in the First Quarter Report, the San Diego Consumer Price Index (CPI) also increased by 8.2% during this time – from September 2021 to September 2022. Although the CPI does not explain all of the growth in sales tax revenue, it suggests that inflation is driving much of the growth experienced – suggesting households are not necessarily consuming more, but are instead paying higher prices for the things they buy.

We do not anticipate remaining quarters in FY 2023 to increase at this high 8.2% rate due to an anticipated slowdown of the economy in response to continued economic tightening by way of increased federal interest rates. Therefore, we believe adjusting the FY 2023 projection upward to $386.0 million, representing a 2.8% increase over FY 2022, is reasonable. This projection is close to the City's sales tax consultant's projection of $388.4 million for FY 2023, representing a 3.4% growth over FY 2022 sales tax revenue. Our Office will continue to closely monitor sales tax revenue throughout the fiscal year.

Transient Occupancy Tax
Transient Occupancy Tax Transient Occupancy Taxes (TOT) – or hotel taxes – the third largest major General Fund revenue source. San Diego's 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. The other allocations are budgeted in the Transient Occupancy Tax Fund and have both direct and indirect impacts on the General Fund.

Transient Occupancy Tax Revenue *($ in millions)*			
	FY 2023 Adopted	**FY 2023 Projection**	**1st Quarter Projections vs. Adopted Budget**
General Fund Allocation (5.5%)	$ 135.2	$ 149.9	$ 14.7
Special Promotional Programs (4.0%)	97.2	107.9	10.7
Council Discretionary (1.0%)	24.3	27.0	2.7
Total	**$ 256.7**	**$ 284.8**	**$ 28.1**

Note: figures may not total due to rounding.

As stated in the First Quarter Report, the General Fund allocation is projected to be over budget by $14.7 million by the end of FY 2023, which is a 10.9% increase from the FY 2023 Adopted Budget. Because the FY 2022 unaudited actual TOT revenues came in slightly above what was *budgeted* for FY 2023, the updated FY 2023 projection results in a growth rate of 9.9% as compared to FY 2022. An increased TOT projection in the current year is supported by sustained growth in revenue in the first three months of FY 2023 and higher forecasts of room rates and hotel occupancy since the Adopted Budget.

The First Quarter TOT projection reflects continued revenue recovery that the City experienced throughout FY 2022 coming off of huge declines beginning in the third quarter of FY 2020 and ending in the third quarter of FY 2021 that were associated with the pandemic-related stay-at-home orders and travel restrictions. Growth in TOT has been continuously strong, reaching pre-pandemic levels (FY 2019 levels) with the close of FY 2022.[1] As forecasted in the Outlook, TOT growth is expected to slow after FY 2023, and potentially sooner if an economic downturn occurs.

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 cable companies are based upon a percentage of revenue generated, while franchise fees from refuse haulers are based on tonnage.

Franchise fee projections overall increase by $0.7 million to $94.5 million, up from a total of $93.8 million in the Adopted Budget. This increase is due to increased tonnage being deposited in the landfill during the first quarter. Of note, the vast majority of franchise fee revenue comes from the gas and electric franchise agreements with SDG&E, which total $67.2 million in the Adopted Budget. The projection for these fees historically remains unchanged until the Third Quarter Report, at which point it is adjusted when the February Clean-up payment[2] is included into the projections. Other franchise fees remain as projected.

Cannabis Business Tax

While not all departmental revenues are included within the First Quarter Report, this year's report does contain an early projection on FY 2023 revenues from the City's non-medical Cannabis Business Tax (CBT). The tax applies to cannabis related business activities which includes, but is not limited to, transporting, manufacturing, packaging, and retail sales, with retail sales taxed at a rate of 8.0% while other activities are taxed at 2.0%.

The First Quarter Report projects that CBT revenue will decrease by $4.1 million, from $25.7 million in the Adopted Budget to $21.6 million, based upon gross revenue reductions reported in the last five months by retail outlets. The report notes that these reductions have been potentially due to increased competition from additional cannabis outlets in surrounding jurisdictions, as well as potentially reduced consumer spending due to inflation. This reduction will be important to

[1] If adjusted for inflation, real TOT revenue for FY 2022 remains below pre-pandemic levels. The FY 2023 projection would bring the City closer to this amount.

[2] SDG&E franchise fee payments are provided on a quarterly basis based on applicable calendar year revenues. The payment received by the City in February, also known as the Clean Up payment, reconciles what is owed to the City for the prior calendar year with the previous quarterly payments. After this reconciliation, the next three quarterly payments are based on the prior year receipts.

monitor going forward to see if the trend is temporary for FY 2023 or if it will continue to have an impact into FY 2024 and beyond.

GENERAL FUND EXPENDITURES

The First Quarter Report also provides projections and updates on General Fund expenditures for certain services and initiatives. In this section, we discuss expenditures related to non-discretionary energy and utilities, public safety overtime, and Proposition B unwinding costs.

Non-Discretionary Energy & Utilities Expenditures

While the First Quarter Report does not contain a full analysis of all General Fund expenditures for FY 2023, it does contain additional analysis on some important non-discretionary expenditures based on their first quarter performance. One spending item that is projected well above budget is spending for energy services costs. These costs are projected over budget by $8.1 million across all funds at $46.6 million, and within the General Fund in particular they are projected over budget by $4.8 million (43.8%) at $15.6 million, (the Adopted Budget included $10.9 million in energy services costs).

As mentioned in the First Quarter Report, this increase is mainly due to a timing issue of when the budget projection is produced, which is well in advance of the adoption of the budget. For FY 2023 in particular, given the volatility within energy markets worldwide, two rate increases that were not anticipated when the budget for energy was developed dramatically increased energy prices above FY 2023 projections. Additionally, the report notes that spending on energy within the non-General Funds, and in particular the Public Utilities Department (PUD), has increased as some PUD facilities have switched from gas-to-electricity generators to purchases of electricity. This type of switch may become even more prevalent in the General Fund if other facilities are switched off of gas-powered devices and onto electric-powered devices. Monitoring the implications of fuel switches as well as other energy price changes will be important moving forward, not only in FY 2023 but for future fiscal years as well. We discuss this and other related issues in our report on the Outlook.

Public Safety Overtime

<u>Fire-Rescue Overtime</u>

The Fire-Rescue Department is projected to exceed its overtime budget by $15.6 million at fiscal year-end for total projected overtime expenditures of $48.4 million. As noted in the First Quarter report, some of this increase is offset by projected salary savings of $6.0 million and increased deployment reimbursement revenue of $260,000, resulting in a net General Fund impact of $9.3 million. Issues related to staffing shortfall and backfill overtime account for the majority of the projected overage at $12.9 million and are discussed in more detail below; the balance is associated with various other overtime expenditures, including COVID-19 related expenditures ($692,000), strike-team deployments ($675,330), Fire Dispatcher vacancies ($581,000), seasonal lifeguard services ($307,000), training, education and other administrative needs ($247,000), and Fire Academies ($233,000).

As cited in the First Quarter Report, roughly half of the overtime increases are due to staffing shortfalls, accounting for $7.4 million of the overall projected overage. According to the Fire-Rescue Department, as of November 15, 2022 there were 73 sworn vacancies, as broken down by position in the table to the right.

Fire-Rescue Sworn Vacancies	
Fire Captain	29
Fire Engineer	33
Fire Fighter I/II	11
Total	**73**

Two of the three budgeted fire academies in FY 2023 are scheduled to have graduations occur this fiscal year in November 2022 (20 graduates anticipated) and March 2023 (37 graduates expected); the third academy will graduate in August 2023 (early-FY 2024; 36 graduates anticipated). With these new firefighters and after accounting for attrition anticipated through the remainder of the fiscal year (38 positions lost), our Office estimates that the number of sworn vacancies could be reduced to 54 positions by fiscal year-end and further reduced to 27 positions once the third FY 2023 fire academy graduates in August 2023. However, given that most of the Department's vacancies are in the Fire Captain and Fire Engineer ranks, reaching full staffing will depend on the Department's ability to promote existing firefighters into these positions.

The other main driver of the projected overtime overage is backfill overtime, which is necessary to maintain constant staffing levels for all fire suppression posts when leave time is taken; this overtime category is projected to increase by $5.5 million. This is primarily due to an increase in "Industrial Leave," of which COVID-19 related absences are a significant factor, and "Comp Time Taken." The latter is indicative of firefighters choosing to accept additional leave time rather than compensation for overtime hours worked; as such, this increase indirectly relates to the Department's staffing shortfalls.

To combat previous increases in backfill overtime, the Fire-Rescue Department created a Relief Pool, established with a total of 72.00 FTEs in the FY 2020 and FY 2021 Adopted Budgets, that would utilize firefighters on regular time to backfill for those firefighters out on leave or otherwise unable to work in order to reduce overtime spending. However, severe vacancies at the Engineer and Captain level, along with academies being delayed or not producing enough recruits to cover attrition, have resulted in no progress being made on filling the Relief Pool. The Department has indicated that the Relief Pool cannot be established and function as intended until the regular positions are fully staffed.

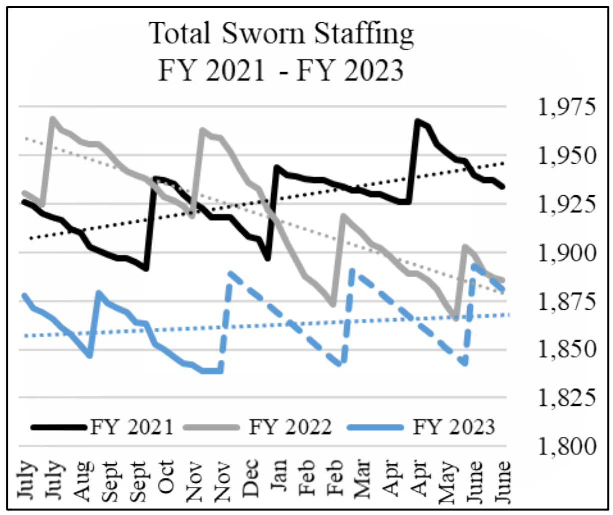
Police Overtime

The Police Department is projected to exceed its overtime budget by $9.9 million at fiscal year-end, for a total projected expenditure of $50.1 million; $6.5 million is expected to be reimbursed for special event and grant-funded task force activity resulting in a projected net General Fund impact of $43.6 million.

Similar to last fiscal year, the Extension of Shift overtime category, projected to exceed budget by $11.1 million, continues to be the primary driver of the overage. While a portion of this projected overtime expenditure overage is attributed by the Department to the deployment of specialized details to address violent crime, the majority is due to significant sworn staffing shortages that are reaching critical levels. Of the $11.1 million Extension of Shift overage, $7.1 million is attributable to Patrol Staffing Backfill overtime which is utilized when a patrol area command does not meet its minimum patrol staffing requirement. For FY 2023, $6.4 million is budgeted for Patrol Staffing Backfill overtime which includes a $4.0 million one-time increase in the FY 2023 Adopted Budget that was added to the May Revision based on the overage projected in FY 2022. Even with this addition, Patrol Staffing Backfill overtime is projected to end FY 2023 at more than 200% compared to budget and 650% compared FY 2021 actuals.

Patrol Staffing Backfill OT		
FY 2021 Actual	$	2,053,607
FY 2022 Actual	$	9,274,456
FY 2023 Proj.	$	13,501,557

Offsetting the Extension of Shift overtime overages discussed above are projected saving in other overtime categories. Most notable is a projected $2.7 million savings in Neighborhood Policing and CleanSD overtime which are tied to specific service levels/programs. According to the Department, the volume of work is outpacing the SDPD's staffing abilities to the point where police resources must be specific and focused towards addressing patrol operations as the top priority. Because Neighborhood Policing is unable to maintain the needed level of staffing that it has in the past, cleanup efforts have been hampered and response times to address quality of life crimes have increased.



The chart on the right depicts SDPD's sworn staffing levels over the last few fiscal years, including projections through the end of FY 2023 based on current attrition rates and police academy sizes. While staffing levels were slowly rising in FY 2021, a significant increase in officer attrition began to occur in December 2021 (FY 2022) corresponding with the implementation of the City's Mandatory COVID-19 Vaccination Policy which went into effect on December 1, 2022. In total, 241 officers left the Department in FY 2022 – an attrition rate of 20 officers leaving per month. Attrition has slowed slightly since the end of FY 2022 but is still elevated compared to normalized attrition of levels of 13-14 officers lost per month in FY 2017 through 2021. As of November 28, 2022, 81 officers have left in FY 2023 amounting to approximately 16 officers per month; currently 1,839 of 2,036 budgeted sworn positions are filled.[3]

The Department's success meeting its goal of averaging 50 recruits per police academy plays a significant role in overall sworn staffing levels. While the goal had largely been achieved over the last few years, the two most recent academies consisted of less than 40 recruits. The FY 2023 Adopted Budget included the addition of $75,000 for the Department's Recruiting Unit which is anticipated to be utilized for recruitment marketing purposes in an effort to boost academy sizes.

The significant amount of attrition over the prior two years will be difficult to recover. For illustration purposes, in a best case scenario, if the Department was meet its recruitment goal of 50

[3] While this suggests a vacancy rate of 9.7%, it should be noted that SDPD's goal is to fill all budgeted positions. SDPD generally feels that the Department would be understaffed even with no vacancies, especially given increased call volumes and additional work the Department has absorbed in recent years.

recruits for each of its four annual police academies (200 graduates annually) and attrition returned to the normalized level of 13 officers lost per month (156 lost officers annually), sworn staffing would see a net increase of 44 officers. At this rate, it would take, at best, two years to return to FY 2021 staffing levels (1,926 filled sworn positions at the end of the year) and four and half years to reach full budgeted staffing (2,036 budgeted sworn positions). Additionally, as veteran officers leave the SDPD, they are generally replaced by new recruits, resulting in the department losing the benefit of those officers' years of experience.

Police overtime expenditures will require continued close monitoring in the current fiscal year and beyond. Given that staffing issues appear to be the primary cause of the department's increased reliance on overtime, police overtime expenditures are unlikely to be abated in the immediate future. As the FY 2024 proposed budget is prepared, further review by the Department of Finance and SDPD is warranted to ensure that overtime is appropriately budgeted.

Proposition B Unwinding

The First Quarter Report discusses the unwinding of Proposition B, providing background information on the issues and status of the unwinding process. The City has concluded negotiations with five of its six Recognized Employee Organizations (REOs) regarding unwinding provisions for ***active employees*** who were hired when Proposition B was in effect. Accordingly, most of those employees have now joined the San Diego City Employees' Retirement System (SDCERS). Negotiations have not been fully completed with respect to those employees who are no longer employed with the City, and for members of the San Diego Police Officers Association (POA).

The First Quarter Report also provides costs related to the initial transition of the active employees to SDCERS membership. Of the associated $142.0 million in costs, $22.8 million related to the interest penalty mandated by the California Court of Appeal has been paid. The remaining $119.2 million is expected to be treated as a long-term debt to SDCERS – to be amortized over 20 years as part of the Unfunded Actuarial Liability (UAL) – as was recommended by SDCERS' actuary. As such, these amounts would not be billed until FY 2024 and beyond, as part of the Actuarially Determined Contribution (ADC) pension payments. However, the SDCERS Board is the final authority for how the debt is treated, and the Board could alternatively amortize the $119.2 million as an experience loss over 15 years or request upfront payment from the City. The Board is expected to review this issue in January 2023.

Additionally, the Board will be reviewing the treatment of FY 2022 and FY 2023"normal cost" [4] amounts for the active employees affected by Proposition B. SDCERS' actuary recommends that the City pay these amounts in FY 2024. However, the City has already budgeted for these amounts in FY 2023, and it could be operationally prudent to pay amounts related to FY 2022 and FY 2023 during FY 2023. These costs, which total $37.9 million if paid before FY 2024 (as not to accrue additional interest) are anticipated to be billed to the City by June. The Department of Finance estimates that the General Fund portion of this $37.9 million will be about $23.1 million.

[4] Normal cost is defined as the actuarial present value of retirement system benefits allocated to the current year by the actuarial funding method. In other words, it is the contribution amount associated with the pension benefits earned in the current year.

Lastly, the First Quarter Report projects that there will be FY 2023 budget amounts remaining after the payment of the aforementioned FY 2022 and FY 2023 normal costs and the interest penalty – $17.8 million Citywide ($9.2 million for the General Fund). As mentioned earlier, there are still aspects of Proposition B unwinding which have not been fully negotiated, for which there will likely be additional costs. Further, Proposition B unwinding is only one portion of the FY 2023 Budget, and the First Quarter Report does not include a comprehensive projection of all expenditures. The Mid-Year Report, which is expected to be released February 3, 2023, will provide more insight into overall expenditure projections and any anticipated budget surplus or deficit.

CONCLUSION

Our review of the First Quarter Report includes an analysis of major General Fund revenues, as well as additional information on non-discretionary energy and utilities expenditures, public safety overtime, and Proposition B unwinding. 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 updated 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 February 3, 2023.

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