CITY AND COUNTY OF SAN FRANCISCO

MEMORANDUM

TO: Mayor Edwin Lee
Members of the Board of Supervisors

FROM: Ben Rosenfield, Controller
Kate Howard, Mayor's Budget Director
Severin Campbell, Budget & Legislative Analyst's Office

DATE: March 22, 2016

SUBJECT: Update to the City's Deficit Projection ("Joint Report Update")

On December 7, 2015, the Five Year Financial Plan Update for General Fund Supported Operations ("Joint Report") for FY 2016-17 through FY 2019-20 was jointly released by the Controller's Office, Mayor's Office, and Board of Supervisors Budget and Legislative Analyst's Office. This memo updates the December projection with the most recent information on the City's fiscal condition.

The cost of City services is projected to outpace revenue growth during the coming four fiscal years. Total General Fund expenditures are projected to grow by $1.1 billion over the next four years. In contrast to this expenditure growth, available General Fund sources are projected to grow $442.4 million over the same period. Absent corrective action, the projected gap between revenues and expenditures will rise from $85.5 million in FY 2016-17 to approximately $690.1 million in FY 2019-20, as shown in the Table 1 below. To the extent that ongoing solutions are implemented to solve shortfalls in the early years of the projection period, future year shortfalls will be reduced commensurately.

Table 1: Updated Base Case – Summary of General Fund-Supported Projected Budgetary Surplus/(Shortfall)

	Savings/ (Cost) Change from Prior Year, $ Million			
Sources	**FY 2016-17**	**FY 2017-18**	**FY 2018-19**	**FY 2019-20**
Use of One-Time Sources, Prior Year Fund Balance & Reserves	(95.1)	108.3	(216.5)	-
Regular Revenues, Transfers, & Other	194.7	138.6	154.5	158.0
Subtotal - Sources	**99.6**	**246.9**	**(62.0)**	**158.0**
Uses				
Salaries & Benefits	(115.0)	(144.4)	(137.8)	(160.1)
Other Expenditures, Reserves & Transfers	(70.1)	(177.8)	(194.7)	(132.8)
Subtotal - Uses	**(185.1)**	**(322.2)**	**(332.4)**	**(292.8)**
Total Net General Fund Impact (from Prior Year)	(85.5)	(75.3)	(394.4)	(134.9)
Projected Cumulative Surplus / (Shortfall)	**(85.5)**	**(160.9)**	**(555.3)**	**(690.1)**

The following significant changes have occurred since our previous projection in December 2015:

- Recent improvements in our current year tax revenue, reported in the Controller's FY 2015-16 Six-Month Budget Status Report, have increased projected fund balance in the current year and future year projected tax revenues.
- Current year investment returns are expected to fall short of actuarial expectations, requiring higher projected employer-paid pension contributions to the San Francisco Employee Retirement System (SFERS).

- The California Department of Finance's projections of inflation are higher than assumed in December 2015, driving higher assumed costs for both labor and non-labor expenses.
- Cost of proposed local policies, including a ballot measure to increase funding for the Recreation & Parks Department and a number of current year supplemental appropriations, have increased.
- Changes in the City's approach to several large capital programs has changed our projections of future debt service costs.
- Lastly, in order to manage shortfalls over the coming two fiscal years, our offices suggest, and this projection assumes, a slower draw on fund balance over the two year period, with 1/3rd of projected current year fund balance drawn in FY 2016-17 and the remaining 2/3rds drawn in FY 2017-18.

Background

The Five Year Financial Plan is required under Proposition A, a Charter amendment approved by the voters in November 2009. The City Charter requires the plan to forecast expenditures and revenues during the five year period, propose actions to balance revenues and expenditures during each year of the plan, and discuss strategic goals and corresponding resources for City departments. The last Five Year Plan was issued in December 2014. The Five Year Financial Plan Update for General Fund Supported Operations ("Joint Report") for FY 2016-17 through FY 2019-20 was jointly released by Controller's Office, Mayor's Office, and Board of Supervisors Budget and Legislative Analyst's Office in December 2015.

This memo serves as an update to the Joint Report. It updates the deficit projected in the Plan with recent information on the City's fiscal condition.

Changes from the Joint Report Released in December 2015

Most of the key assumptions outlined in the Joint Report still apply to this memo. Table 2 identifies changes from the December 2015 plan update, which are described in greater detail below. The City's projected deficit decreased by $14.3 million in FY 2016-17 and $79.4 million in FY 2017-18, and increased by $80.8 million in FY 2018-19 and $151.8 million in FY 2019-20.

Table 2: Summary Changes to Updated Projected Budgetary Surplus / (Shortfall)

	2016-17	2017-18	2018-19	2019-20
Cumulative Surplus / (Shortfall) - December 2015	**(99.8)**	**(240.2)**	**(474.5)**	**(538.4)**
INCREMENTAL INCREASE / (DECREASE) TO:				
Sources - Revenue and Fund Balance	24.0	94.4	(104.0)	(6.6)
Uses - Baselines and Reserves	(3.3)	1.9	(5.7)	(5.1)
Uses - Salaries and Benefits	(2.6)	(44.2)	(39.1)	(39.2)
Uses - Citywide Operating Budget Costs	(2.7)	9.6	(15.2)	(13.3)
Uses - Departmental Costs	(1.1)	3.5	3.8	(6.7)
Total Incremental Change	**14.3**	**65.1**	**(160.2)**	**(71.0)**
Total Cumulative Change	**14.3**	**79.4**	**(80.8)**	**(151.8)**
Updated Cumulative Surplus / (Shortfall) - March 2016	**(85.5)**	**(160.9)**	**(555.3)**	**(690.1)**

The changes from the December 2015 projections are described in more detail below:

SOURCES – Revenue and Fund Balance: Projected General Fund sources have increased primarily driven by changes in projected fund balance and revenue.

- **Fund Balance.** On February 10, 2016, the Controller's Office issued its FY 2015-16 Six-Month Budget Status Report. The report projected the FY 2015-16 ending fund balance to be $58.9 million above the balance assumed in the December 2015 Joint Report. Additionally, at the close of FY 2014-15, the City reserved $19.6 million to offset potential future losses of state AB85 revenue and Medi-Cal Expansion rate reduction at the Department of Public Health (DPH). This loss has been confirmed and reflected in current year projections, allowing the liquidation of the reserve for this item in the current year and increasing available fund balance by $19.6 million.

  Due to these two changes, total available fund balance assumed in this projection is $324.8 million, an increase of $78.5 million from the December projection. This update assumes one-third of this fund balance to be spent in FY 2016-17 and two-thirds to be spent in FY 2017-18. This allocation of fund balance is revised versus our assumption that available fund balance will be spend evenly over each of the coming two fiscal years. This revised schedule for fund balance draws will smooth projected shortfalls over the coming two fiscal years.

- **Revenue.** The changes to revenue projections are due to new information about citywide revenues, updated revenues at the Department of Public Health, and changes in property tax increment required to support operations at the Office of Community Investment and Infrastructure (OCII).

  - **Citywide Revenue:** Citywide revenue has changed mainly because of increases in projected property tax revenues due to increased estimated supplemental and escape assessments. Additionally, revenue projections for hotel taxes have been increased slightly to reflect expected increases in the City's hotel room supply of approximately 5 percent by the end of the projection period. Aside from hotel tax, growth rates for the most economically sensitive revenues, such as business, sales, and property transfer taxes are largely unchanged from the Joint Report published in December 2015.

    California Proposition 4, the "Gann Limit" Initiative, passed by voters on November 6, 1979 amended the California Constitution to limit growth in government appropriations to the percentage increase in the cost of living and the percentage increase in population. Any funds collected from tax proceeds in excess of the limit must be returned to taxpayers. As a result of the City's recent rapid economic expansion, tax proceeds are approaching the annual limit. Based on current projections the City is expected to remain approximately $70 million below the limit annually from FY 2016-17 through FY 2019-20. To the extent that taxes come in higher than projected or new or increased taxes are approved by the voters, tax proceeds could exceed the limit. State law requires voter approval to spend proceeds that exceed the limit, otherwise, the excess revenue is returned to taxpayers.

  - **Revenues from the Department of Public Health.** Overall revenue from the Department of Public Health is projected to decrease from the Joint Report in all years. This change is due to increased expected hospital operating revenues offset by expected losses related to the Section 1115 Medi-Cal Waiver.

    - **Increase Hospital Revenues:** Anticipated increases in hospital revenues at Zuckerberg San Francisco General Hospital and Laguna Honda Hospital are driven by continued growth in fee-for-service revenues and Medi-Cal managed care enrollment, as well as an increase in Short Doyle Medi-Cal revenues for mental health services.

- **1115 Medi-Cal Waiver Losses:** In early 2016, the Centers for Medicare and Medicaid Services reached agreement with the State of California and county health providers on a plan for a new Section 1115 Waiver ("the waiver"), also called Medi-Cal 2020. The waiver includes two new programs, PRIME and the Global Payment Program (GPP), which are successor programs to the Delivery System Reform Incentive Pool and Disproportionate Share Hospital (DSH)/Safety Net Care Pool programs under the previous Section 1115 Waiver. Under the new waiver, the federal government plans to implement scheduled reductions to federal DSH allocations, which reduce the total level of funding available through the GPP over time.

- **Increased Tax Increment for the Office of Community Investment and Infrastructure (OCII).** This projection is updated to reflect infrastructure and housing related expenditures, updated operating costs, and asset management activities related to its State Department of Finance approved asset disposition plan.

USES – Baselines, Set-Asides and Reserves: As a result of increases in the City's projected General Fund sources over the next five years, corresponding baseline and reserve increases are required. Additionally, this report reflects policy changes made or proposed by the Mayor and the Board of Supervisors including a new proposed baseline for the Recreation and Park Department and the requirement to replenish the General Fund reserve from several current year supplemental appropriations.

- **Baselines.** Due to overall increases in projected revenue, baseline funding to the Municipal Transportation Agency, Library, Children's and Public Education Enrichment Fund, and other baselines have increased.

  Additionally, Proposition B, passed by the voters in November 2014, requires MTA's baseline to be adjusted annually to reflect the greater of night-time or daytime population growth in the City. Since the Joint Report was published in December, projections for growth in daytime population have increased as a result of the continuing strong local job market. This has resulted in an increase in the projected population adjustment in each year of the projection period.

- **Proposed Park, Recreation, and Open Space Fund Revenue Baseline.** The creation of a Park, Recreation, and Open Space Fund revenue baseline will be put before the voters on the June 2016 ballot. If approved, the baseline measure will establish on-going General Fund support for the Recreation and Park department based on FY 2015-16 General Fund funding levels for FY 2016-17 through FY 2045-46. Additionally, each year, beginning in FY 2016-17 through FY 2025-26, the baseline will increase by $3 million and then increase annually by the percentage increase in aggregate City discretionary revenues through FY 2045-46. This report assumes the cost of the $3 million annual increase that would begin in FY 2016-17 if the voters approve the measure.

- **Reserves**. The update assumes an increase in required General Reserve deposit in FY 2016-17, due to (1) changes in revenue projections; (2) six approved or pending current year supplemental appropriations totaling approximately $10 million. These appropriations, if approved, require the replenishment of the General Reserve in FY 2016-17 and therefore increase the projected shortfall in that year.

USES – Salaries and Benefits: Salary and benefit costs are projected to increase as a result of projected losses to the City's pension system and an increase in the Consumer Price Index.

- **Labor Agreements**. This update continues to assume the negotiated rates for closed labor agreements, including raises from 2.25% to 3.25% in July of 2016 for most employees, based on the latest inflation projections from the California Department of Finance for February 2016. This update includes no change to the closed police officers and firefighters bargaining agreement through FY 2017-18. For open contracts, this update assumes that bargaining units receive salary increases equivalent to the change in the Consumer Price Index (CPI) projected by Department of Finance to be 3.1% for FY 2017-18 through FY 2019-20.

- **Retirement Benefits**. Pension contribution cost estimates in the December 2015 Joint Report reflected the assumption that the Retirement System will achieve an average annual rate of return of 7.5% on the investment of its assets, which is the rate of return recommended by the System's actuary and adopted by its Board. However, year-to-date investment returns through January 31, 2016 were -4.7%. Because there is no expectation of a rapid improvement in market conditions, this deficit projection assumes returns of -5.0% through the remainder of the current fiscal year.

USES – Citywide Operating Costs: Citywide operating costs are changing due to the increase in the Consumer Price Index and policy changes made by the Mayor and the Board of Supervisors related to the City's Certificates of Participation debt program.

- **Inflation on Non-Personnel Costs**. This update assumes that the cost of materials and supplies, professional services, contracts with community-based organizations and other non-personnel operating costs will increase by 3.1% FY 2017-18 through FY 2019-20, consistent with the California Department of Finance's projections.

- **Debt Payments**. This update incorporates two changes to the City's Ten-Year Capital Plan: The first is related to Board of Supervisors Resolution No. 02-16, which was passed in January 2016 and called for a working group to re-envision the jail replacement project. The working group started meeting earlier this month in March 2016, and it will complete its work in the fall of 2016. The working group seeks to plan for the permanent closure of County Jails 3 and 4; therefore, the debt service for the Replacement Facility has been extended by one year to allow this planning process to take place and inform the next iteration of this projection, (which will be released in late 2016). The second change is that a new facility for Animal Care and Control (ACC) has been assumed in the Certificates of Participation (COP) program, which will require additional debt service payments beginning in FY 2017-18.

USES – Departmental Costs: Departmental costs are only changing slightly from the December projection, mainly related to funds identified in the FY 2015-16 Six-Month Report.

Key Factors that Could Affect the Forecast

As with all projections, uncertainties exist regarding key factors that could affect the City's financial condition. In addition to the factors identified in the Joint Report released in December 2015, additional factors have been identified as potential risks:

- **Continued Economic Recovery**: The projections assume that the economic recovery and expansion that began in FY 2009-10 will continue through the forecast period and will be reflected in tax revenue increases. Economic growth, and the revenue derived from it, is heavily dependent on changes in employment, business activity and tourism. During the first two years of the forecast, economic growth is expected to increase, albeit at a slower pace than FY 2012-13 and FY 2013-14. In the final three years of the forecast, economic growth is assumed to slow to long-term average rates. This report does not assume any economic downturns or large changes in macroeconomic conditions.

- **Adoption of Additional Current Year Policy Changes:** Additional adopted policy changes that increase or decrease spending or revenue to the City (such as baselines, set asides and supplemental appropriations) will impact future budgets.

Conclusion

Over the past four months the City has seen modest changes to its fiscal outlook, including increases as well as decreases to projected revenues in the current year and future years; increased costs due to inflation on both personnel and non-personnel costs; increased employer contributions due to investment losses in the City's pension system; and potential impacts from proposed local policy changes.

Although revenue growth is quite strong, the City is still projecting expenditure growth to outpace revenue growth in each year over the next four. While the projected shortfalls shown in the Joint Report and this updated memo reflect the difference in projected revenues and expenditures if current service levels and policies continue, San Francisco's Charter requires that each year's budget be balanced. Balancing the budgets will require some combination of expenditure reductions and additional revenues. These projections assume no ongoing solutions are implemented. To the extent that budgets are balanced with ongoing solutions, future shortfalls will decrease.

Appendix A: Updated Base Case – Key Changes to General Fund-Supported Sources & Uses FY 2016-20

This appendix provides an updated version of Table A-1 from the Joint Report.

	2016-17	2017-18	2018-19	2019-20
SOURCES Increase / (Decrease)				
General Fund Taxes, Revenues and Transfers net of items below	180.6	131.3	137.0	143.6
Change in One-Time Sources	(95.1)	108.3	(216.5)	-
Department of Public Health Revenues	(0.1)	(0.8)	0.2	3.5
OCII Tax Increment	(3.2)	(3.2)	3.4	2.6
Other General Fund Support	17.3	11.3	13.9	8.2
TOTAL CHANGES TO SOURCES	**99.6**	**246.9**	**(62.0)**	**158.0**
USES Decrease / (Increase)				
Baselines, Set-Asides and Reserves				
Municipal Transportation Agency (MTA) Baselines	(18.6)	(22.3)	(26.9)	(21.5)
Children's Fund and Public Education Enrichment Fund	(16.5)	(12.5)	(14.5)	(8.5)
Housing Trust Fund	(2.8)	(2.8)	(2.8)	(2.8)
Proposed Recreation & Parks Set-Aside	(3.0)	(3.0)	(3.0)	(3.0)
All Other Baselines	(4.1)	(3.5)	(3.8)	(3.8)
Deposits to General Reserve	(5.7)	9.6	(1.0)	(0.9)
Other Contributions to Reserves	21.8	(0.4)	(0.4)	(0.4)
Subtotal Baselines and Reserves	**(28.9)**	**(34.8)**	**(52.4)**	**(40.8)**
Salaries & Benefits				
Annualization of Partial Year Positions	(19.7)	-	-	-
Previously Negotiated Closed Labor Agreements	(63.8)	(10.4)	-	-
Projected Costs of Open Labor Agreements	(17.3)	(68.2)	(88.7)	(92.1)
Health & Dental Benefits - Current & Retired Employees	(28.8)	(22.3)	(23.5)	(24.2)
Retirement Benefits - Employer Contribution Rates	3.2	(45.8)	(32.7)	(26.9)
Other Salaries and Benefits Savings / (Costs)	11.4	2.2	7.1	(16.9)
Subtotal Salaries & Benefits	**(115.0)**	**(144.4)**	**(137.8)**	**(160.1)**
Citywide Operating Budget Costs				
Minimum Wage	(11.3)	(14.8)	(16.1)	(7.6)
Legacy Business	(3.7)	(3.9)	(3.8)	(4.2)
Capital, Equipment, & Technology	19.1	(29.4)	(34.5)	(5.2)
Inflation on non-personnel costs and grants to non-profits	(14.8)	(39.2)	(38.6)	(39.0)
Debt Service & Real Estate	(7.4)	(12.2)	(25.2)	(17.3)
Sewer, Water, and Power Rates	(2.4)	(2.5)	(3.0)	(3.2)
Other Citywide Costs	(6.9)	(8.6)	(3.0)	(2.9)
Subtotal Citywide Operating Budget Costs	**(27.4)**	**(110.6)**	**(124.3)**	**(79.4)**
Departmental Costs				
City Administrator's Office - Convention Facilities Subsidy	(2.0)	(8.4)	(3.6)	-
Elections - Number of Scheduled Elections	4.0	-	-	(4.5)
Ethics Commission - Public Financing of Elections	(0.1)	(0.6)	0.7	(2.5)
Golden State Warriors Transportation and Infrastructure	(3.1)	0.7	(0.1)	(7.7)
Public Safety Hiring Plans	(11.6)	(7.9)	(2.8)	(3.2)
Mayor's Office of Housing - HOPE SF and Local Operating Subsidy	(1.8)	(2.3)	(4.6)	(2.7)
Human Services Agency - Aid	(1.8)	(2.7)	(2.8)	(2.7)
Navigation Center Operations	(1.0)	-	-	-
Public Health - Operating and one-time costs for capital projects	7.2	(10.2)	(2.9)	9.6
All Other Departmental Savings / (Costs)	(3.9)	(0.9)	(1.9)	1.3
Subtotal Departmental Costs	**(13.9)**	**(32.3)**	**(18.0)**	**(12.5)**
TOTAL CHANGES TO USES	**(185.1)**	**(322.2)**	**(332.4)**	**(292.8)**
Projected Surplus (Shortfall) vs. Prior Year	**(85.5)**	**(75.3)**	**(394.4)**	**(134.9)**
Cumulative Projected Surplus (Shortfall)	**(85.5)**	**(160.9)**	**(555.3)**	**(690.1)**

Appendix B: Updated Summary of General Fund Operating Revenues and Transfers In

This appendix provides an updated version of Table A-2 from the Joint Report.

	FY 2014-15 Year-End Pre-Audit	FY 2015-16 Original Budget	FY 2016-17 Projection	FY 2017-18 Projection	FY 2018-19 Projection	FY 2019-20 Projection
Property Taxes	$ 1,272.6	$ 1,291.0	$ 1,386.0	$ 1,443.0	$ 1,517.0	$ 1,581.0
Business Taxes	609.6	634.5	657.2	694.5	731.4	769.6
Sales Tax	140.1	172.9	203.3	210.4	217.7	225.4
Hotel Room Tax	394.3	384.1	414.2	441.7	463.9	483.7
Utility Users Tax	99.0	93.6	92.4	93.4	94.5	95.5
Parking Tax	87.2	89.7	92.8	95.2	97.8	99.8
Real Property Transfer Tax	314.6	275.3	250.0	237.5	225.0	225.0
Stadium Admission Tax	1.3	1.4	1.4	1.4	1.4	6.5
Access Line Tax	48.9	45.6	46.0	47.2	48.5	49.9
Subtotal - Local Tax Revenues	**2,967.6**	**2,988.0**	**3,143.2**	**3,264.4**	**3,397.1**	**3,536.3**
Licenses, Permits & Franchises	27.8	27.2	27.2	27.4	27.5	27.7
Fines, Forfeitures & Penalties	6.4	4.6	4.6	4.6	4.6	4.6
Interest & Investment Income	11.7	10.7	13.2	13.6	13.9	14.3
Rents & Concessions	24.5	15.4	14.3	14.3	14.3	14.3
Subtotal - Licenses, Fines, Interest, Rent	**70.4**	**57.8**	**59.3**	**59.8**	**60.3**	**60.9**
Social Service Subventions	234.9	240.7	247.8	247.8	247.8	247.8
Other Grants & Subventions	(9.0)	2.2	2.2	2.2	2.2	2.2
Subtotal - Federal Subventions	**225.9**	**242.9**	**250.0**	**250.0**	**250.0**	**250.0**
Social Service Subventions	194.4	211.1	219.7	221.0	223.6	226.3
Health & Welfare Realignment - Sales Tax	129.8	137.7	138.7	140.0	141.4	143.7
Health & Welfare Realignment - VLF	27.6	31.8	34.9	36.2	37.6	38.9
Health & Welfare Realignment - CalWORKs MOE	14.9	25.4	25.3	25.3	25.3	25.3
Health/Mental Health Subventions	73.2	102.2	104.3	104.3	104.3	104.3
Public Safety Sales Tax	94.0	98.0	101.2	105.3	109.2	113.1
Motor Vehicle In-Lieu (County & City)	0.6	-	-	-	-	-
Public Safety Realignment (AB109)	32.1	36.4	40.5	42.7	43.3	44.5
Other Grants & Subventions	40.8	15.1	14.8	14.8	14.8	14.8
Subtotal - State Subventions	**607.3**	**657.6**	**679.5**	**689.7**	**699.5**	**710.9**
General Government Service Charges	54.5	56.0	56.0	55.3	55.3	55.3
Public Safety Service Charges	38.4	36.3	37.1	37.0	36.9	36.8
Recreation Charges - Rec/Park	20.9	18.8	18.8	18.8	18.8	18.8
MediCal, MediCare & Health Svc. Chgs.	78.4	78.2	78.6	78.6	78.6	78.6
Other Service Charges	18.4	16.5	17.1	17.1	17.1	17.1
Subtotal - Charges for Services	**210.6**	**205.8**	**207.7**	**206.9**	**206.8**	**206.7**
Recovery of General Government Costs	5.8	9.7	9.9	9.9	9.9	9.9
Other General Fund Revenues	11.5	35.7	11.5	11.5	11.5	11.5
TOTAL REVENUES	**4,099.1**	**4,197.5**	**4,361.1**	**4,492.2**	**4,635.1**	**4,786.1**
Transfers in to General Fund						
Airport	40.5	40.8	41.8	42.7	44.9	46.6
Other Transfers	121.6	165.9	165.9	165.9	165.9	165.9
Total Transfers-In	**162.1**	**206.8**	**207.7**	**208.5**	**210.8**	**212.5**
TOTAL GF Revenues and Transfers-In	**4,261.2**	**4,404.3**	**4,568.8**	**4,700.7**	**4,845.9**	**4,998.6**