Council
Agenda Report

FROM: Rafaela T. King, CPA, Finance Director
Nat Rojanasathira, Assistant City Manager
Hans Uslar, City Manager

SUBJECT: Primer on the Fiscal Year 2022-23 Budget (Not a Project under CEQA Article 20, Section 15378 and under General Rule Article 5, Section 15061)

RECOMMENDATION:

That the City Council receive a primer on the Fiscal Year 2022-23 Budget.

VALUE DRIVERS:

This is consistent with the Council's value driver: "Serve as stewards of the City's financial resources through sound economic vitality efforts, streamlining operations, reasonable revenue enhancements, visionary long-term planning, fiscal transparency, and community partnerships**."**

POLICY IMPLICATIONS:

This request is consistent with City Charter Section 6.3 Budget: "Based on the recommendation of the City Manager, the City Council shall adopt a budget estimating the revenues and expenditures for the City for the period covered." This is a first look at the overall projected financial position for FY 2022-23 for Council consideration and feedback.

FISCAL IMPLICATIONS:

There is no cost to present this update.

ENVIRONMENTAL DETERMINATION:

The City of Monterey determined that the proposed action is not a project as defined by the California Environmental Quality Act (CEQA)(CCR, Title 14, Chapter 3 ("CEQA Guidelines"), Article 20, Section 15378). In addition, CEQA Guidelines Section 15061 includes the general rule that CEQA applies only to activities which have the potential for causing a significant effect on the environment. Where it can be seen with certainty that there is no possibility that the activity in question may have a significant effect on the environment, the activity is not subject to CEQA. Because the proposed action and this matter have no potential to cause any effect on the environment, or because it falls within a category of activities excluded as projects pursuant to CEQA Guidelines section 15378, this matter is not a project. Because the matter does not cause a direct or any reasonably foreseeable indirect physical change on or in the environment, this matter is not a project. Any subsequent discretionary projects resulting from this action will be assessed for CEQA applicability.

DESCRIPTION:

Overview

In February 2022, City Staff started the process of preparing the annual budget for the upcoming FY 2022-23. Department heads and their staff were charged with estimating revenues from their departmental programs. Due to the compounded changes stemming from the pandemic, staff level changes, Consumer Price Index (CPI) increases, and overall changes in services provided, departments were asked to start with a zero-based budget and build their expenditure budget from scratch based on their actual needs using the FY 2021-22 budget plus 3% as a baseline and guide.

Most recently, on March 1 2022, the City Council received a budget update highlighting the results of the audited numbers for FY 2020/21. Council was informed about expenditures as well as revenues for current FY 2021/22. A major component of Council's mid-year budget adjustments were the allocation of one-time mid-year savings towards various fiscal reserves including the replenishment of funds for the fund of economic uncertainty. While the budget update in March was a "good news" budget report in the sense that the City is beginning to recover, it was also clear the City is not "out of the woods" on its fiscal, pension liability, and deferred maintenance/facility challenges. Two weeks later, on March 15, 2022, the City Council received a briefing about the City's CalPERS Pension obligations, which are presently estimated at $173,694,057. For FY 2022/23 the City's contribution towards CalPERS is projected to be approximately $15 million.

Finance staff has a solid grasp on expected revenues and is working diligently with the City Manager and Budget Team to balance the budget from the multiple requests competing for the same limited resources. As staff is developing the final draft budget proposal for Council's review, input and approval, the City Council, staff, and community must be mindful of several aspects of budget projections and budgetary spending. The City's budget challenge can be categorized into two types of challenges: "revenue challenges" and an "expenditure challenges":

Revenue Challenges

- Slower recovery than expected in group and business travel
- Low demand equates to lower revenues for Sports Center, Conference Center
- High inflation could potentially lead to less visitor spending coming to the Monterey Peninsula
- Potential revenue losses due to War in Ukraine, projected increases in COVID-19 variants in fall/winter 2022

Expenditure Challenges

- Record inflation has increased costs for supplies and goods needed to deliver City services
- Significant deferred maintenance and facility needs must be addressed now (cannot continue to be postponed)
- Funding strategy for unfunded pension liability (currently at $173.6M) must be addressed

Revenue Challenges, continued

- Mandated 16% allocation of TOT revenue towards the Neighborhood and Community Improvement Program (NCIP) restricts discretionary budgeting abilities for City Council.

Expenditure Challenges, continued

- City must begin to fund facility reserves for the library, sports center, conference center, public safety facility, fire stations, community centers, other City facilities
- City continues to fund regional destination marketing at 6% of Hotel Tax (approx. $1.8 million)
- Currently, the City funds 75% of trolley service plus additional General Fund allocations to business districts
- Labor negotiations need to address necessary Cost of Living Adjustment salary increases for City employees.

Slow Return of Group Business Slows Growth in the Hospitality Sector

The hospitality revenues generated through hotel tax (Transient Occupancy Tax) and sales tax will remain the City's main revenue sources, accounting for approximately 48% of General Fund revenues. The projected revenues in the hospitality sector are based on the current visitor volume utilizing data from regional and state tourism research firms.

While leisure travel is strong on weekends, midweek occupancy remains lower than 2019 levels. Furthermore, a significant portion of Monterey's hospitality revenues is based on group business (e.g., conferences, tradeshows, weddings, meetings, and special events) which support longer stays and drive sales tax. Group business remains a fraction of pre-2019 levels. This is one reason why leisure-focused destinations such as Carmel-by-the-Sea are recovering more quickly than Monterey, which relies on both leisure and group business.

Uncertainty Looms Over Record Inflation, War in Ukraine, and COVID-19

While there are reasons to be hopeful about the City's revenues, uncertainty still looms. Inflation has reached a 40-year record, which has affected goods, supplies, and services used by the City. Putin's war in Ukraine has the potential to escalate to a world war. In early May, the Biden Administration warned that the United States could see 100 million coronavirus infections and a potentially significant wave of deaths this fall and winter due to new omicron subvariants. Despite this uncertainty, the proposed budget will remain fairly optimistic.

If inflation worsens significantly, a world war erupts, or the pandemic causes severe drops in revenues, the City will likely need to utilize the City's reserve funds and/or take other cost-cutting measures reminiscent of the early days of the pandemic.

Demand for Services Lag Behind in the Sports Center, Conference Center, and Library

We also need to realize that the fear of COVID infections caused City's customers to not return. Our Sports Center has seen less than 50% of 2019 visitation levels return, thus resulting in corresponding losses in revenues. Paired with the "fixed" cost of operating a 30-year-old facility, we expect a financial contribution of $2.5M General Fund revenues allocated to just the Sports Center.

Similarly, while the leisure travel market has returned in full force, group sales and conference business are still lagging behind. Currently, we are at about 50% group business level when compared with 2019.

The Monterey Public Library has also seen a reduction in patrons. When compared to 2019 data, we have seen 50% of our library users return. And, as an additional data point, Monterey's library still remains the region's most sought-after public library with 50% of the patrons not residing or living in Monterey. The costs to operate the library for next FY are estimated to be around $2.8M.

For these reasons, staff will be recommending staffing levels for these facilities that are commensurate with demand, as well as best practices and benchmarks in their respective areas.

NCIP

The City's Charter mandates an investment into the Neighborhood and Community Improvement Program (NCIP) of 16% of the hotel tax collected. The intent of the NCIP is to provide neighborhoods with a dedicated funding source for projects that would benefit residents. Over the years, this unique and valuable program has funded many worthy projects that have been beneficial to the community. However, the funding of NCIP-initiated projects at its current level comes at the expense of funding rehabilitation projects that support the Library, Sports Center, community centers, police station, and fire stations. A long-standing challenge is that many NCIP projects are funded for construction, but expect maintenance of the project to be covered by limited General Fund dollars.

For FY 22/23 NCIP is projected to receive an allocation of funds of almost $5 million. In contrast, the projected General Fund allocation towards Capital Improvement Projects will only be between 10 to 20% of that ($500,000 to $1 million). Now might be time for our City residents to evaluate and discuss the funding formula and the City's priorities and needs in order to reform this unique and valuable community engagement program established 37 years ago.

Funding Reserves, Facilities, and Unfunded Liability

The City's selected path to allocate funding towards our various reserves needs to continue. The need for facility renovation or retrofitting is immense, with a total unfunded price tag exceeding $100M. We need to remain mindful of the concept of "Intergenerational Equity" as we allocate taxpayer dollars. Stated simply: we need to stop "kicking the can down the road." It would be financially irresponsible (and unfair to future generations of taxpayers) to inadequately fund reserves for facility needs. While some cities designate as much as 10% to 15% of their

General Fund operating budgets for capital improvements, the City of Monterey has historically designated a fraction (as little as 1%) of General Funds for this purpose. This means that very little if any funding is available when City facilities need significant rehabilitation or repair.

Key assets of our City include the Monterey Sports Center (MSC), the Monterey Library, and our Conference Center. The capital needs of those facilities alone are adding significant pressure on our General Fund. For example, right now, the Sports Center is in immediate need of more than $2.5M in capital replacement costs. In the case of the MSC, the City Council allocated at mid-year $750,000 towards the facility reserve, but that is not enough to address immediate needs in the community facility.

Other key assets of our City include the future replacement of the Public Safety building at the corner of Madison and Pacific Streets and the replacement/rehabilitation of three fire stations. Lastly, as Council recalls, the Board of Library Trustees shared with the community their vision and expectations for a new, state-of-the-art library. Somehow, we will need to address these capital needs as well.

Investments in the Hospitality Sector Continue

The City's investment into the hospitality sector will remain strong and significant with an overall investment of more than $2 million towards a variety of purposes.

The most significant direct investment into the hospitality sector is the City's funding of the Monterey County Convention & Visitors Bureau (MCCVB) at a formula equal to 6% of TOT, (hotel tax). This is estimated to total $1.8 million in funding for the region's Destination Marketing Organization[1]

Staff will be recommending to continue funding MCCVB at the 6% of TOT level in FY 2022/23, but this level of funding may not be sustainable in the long term. With other neighboring cities funding the MCCVB at 3% of TOT, the City must ensure that its contributions beyond the standard TOT funding rate of 3% are directly benefitting the City of Monterey.

In addition to destination marketing, the City carries more than 75% of funding for trolley service along the Old Monterey, Cannery Row, and New Monterey Business Districts, and Fisherman's Wharf. In FY 2018/19 the City's costs for the trolley services were in excess of $602,136 without offsetting revenues.

Other core City services support the hospitality sector and visitors to the region well in excess of $2 million, including Parks and Recreation (including the Monterey Bay Coastal Recreation Trail, beaches, and parks), Public Works (streets, roads, sewers, parking), Public Safety (police and fire services), and other services.

This does not include justified requests to increase staff and service levels in certain areas, such as public restroom cleaning and maintenance in visitor-serving areas such as Cannery

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[1] Per agreement with the MCCVB, annually, and for a length of 20 years, $350,000 of the investment is being returned to the City to help pay for the construction costs of the rehabilitated Monterey Conference Center. The net contribution of the City towards the MCCVB is therefore approximately 4.9%.

Row, Old Monterey, Fisherman's Wharf, San Carlos Beach Park, Coast Guard Pier, Municipal Wharf 2, Monterey Bay Coastal Recreation Trail, and El Estero Park.

Recognizing the City's ongoing multi-million dollar investments in hospitality marketing and visitor-serving amenities, the City is unable to afford ongoing contributions to business districts. Staff proposes reclaiming the City's voluntary contributions to business districts to support City operations and services in these districts.

Expenditures Increase Due to Inflation, Increased Costs

Inflation will put additional needs and pressure on our operational accounts. Like our businesses and residents, the City also sees increased costs in purchasing the supplies necessary to operate and maintain our infrastructure. Supply chain issues are real and range from getting white paint for crosswalks to replacing police patrol cars. In many instances, costs have risen more than twofold. These additional costs for supplies and services have increased expenditures across City departments.

Labor Negotiations with Employee Bargaining Units

Employee expenses represent consistently the City's largest expense, and rightfully so, because City government is in the business of providing services to the community. Currently, the City is negotiating with all seven bargaining units. Our employees have expressed their expectations for cost of living adjustments given the rising costs of housing, fuel, and other goods.

One of the City's strategic priorities is to "provide fair, competitive, and market-rate compensation to employees through effective labor negotiations." Our future budget needs to consider the new labor agreements that provide competitive wages and benefits to successfully recruit and retain employees. During the pandemic, our employees were classified as essential employees and thanks to their efforts, Monterey remained a safe and functional City. Our proposed budget needs to recognize our workforce as well.

City staff is looking forward to a robust discussion about the City's finances.

RTK/HU/NR

Writings distributed for discussion or consideration on this matter within 72 hours prior to the meeting, pursuant to Government Code § 54957.5, will be made available at the following link: https://monterey.org/Submitted-Comments