Transmittal of Proposed Budget

CITY MANAGER’S LETTER OF TRANSMITTAL

Honorable Mayor Bonilla and Members of the City Council:

Over two years have passed since the onset of the pandemic, and the San Mateo community continues to navigate the ongoing challenges of COVID-19, historically high inflation, and the global economic impacts of geopolitical conflict.

Two years ago, the financial impact of the pandemic was immediate and severe, primarily with the City’s transient occupancy tax (TOT) and sales tax revenues, which experienced a 90% and 20% reduction, respectively. With the City Council’s support, we responded immediately by implementing the Fiscal Sustainability Plan to provide the General Fund with relief while the economy and tax revenues recovered, which primarily consisted of the majority of our bargaining units partnering with the City to keep employee compensation static in order to preserve core service levels.

Fortunately, sales tax revenues have recovered back to pre-pandemic levels faster than anticipated. While TOT revenues have not done likewise, their rate of recovery is faster than anticipated, and average occupancy rates are currently at 60%. In addition, real property transfer tax revenues are on pace for a record-breaking year in fiscal year (FY) 2021-22 due to the high demand for housing and several large commercial property sales. Within this context, we honored our commitment to reopen labor negotiations with the bargaining units that partnered with the City to provide employees with additional compensation to help employees offset inflation and align with the City’s goal of providing employee compensation at the median to the market. With the improved outlook for the General Fund, FY 2022-23 marks the return of the two-year business plan, in which two one-year operating budgets and the five-year CIP are presented, but only year one of the operating budget is adopted/appropriated. In year one, the City completes a comprehensive review of the operating budget. In year two, the focus is on the CIP, and the operating budget updates any assumptions as needed. This budget practice reduces the amount of staff resources that are required for budget development on an annual basis.

2022-2023 Budget and Long-Term Financial Plan Overview

The proposed 2022-23 budget projects General Fund total revenues of $159.5 million and total expenditures of $164.2 million. The $4.7 million in projected net loss will be funded by General Fund committed fund balance, which represents funds that were committed by resolution in fiscal year 2021-22 to serve as a funding source for the cost of negotiated changes to employee compensation for the bargaining units that partnered with the City to provide relief to the General Fund as a part of the Fiscal Sustainability Plan, and funds that were committed to support additional CIP for 2022-23.

Based on the latest General Fund Long-Term Financial Plan, while the General Fund is anticipated to draw down on the Rainy Day Reserve by $30 million, from the peak of $54 million in fiscal year 2018-19, the most recent pre-pandemic fiscal year, to the trough of $24 million in fiscal year 2026-27, the Rainy Day Reserve is projected to recover to the reserve policy level of $30 million by the end of the forecast. As such, the General Fund is expected to be able to maintain core service levels throughout the forecast.

In the period of time between the Great Recession and the COVID-19 pandemic, the City of San Mateo prudently prepared itself for the next recession by accumulating reserves in the General Fund above and beyond the 25% operating reserve – the Rainy Day Reserve, which serves as the City's financial backstop during periods of economic retraction. Without it, the City would not have been in the position to use measured decision-making at the outset of the pandemic, but rather, it would have had to cut the cost of operations immediately to ensure the City's long-term fiscal sustainability. The City Council's fiscal discipline also ensures the provision of services at the levels and quality that are needed and expected by the San Mateo community.

2022-23 Proposed Budget

With this framework in mind, I am pleased to present the 2022-23 budget. Overall, the proposed citywide budget, including both operating and capital, is $284.8 million for fiscal year 2022-23.

The City's proposed budget for 2022-23 continues to provide for core services, Measure S initiatives, and Council priorities, while also making a substantial investment in our capital and infrastructure needs. The table below summarizes the adopted spending plans for operating and capital expenditures for 2022-23.

Citywide Budget	**2022-23 Proposed**	**2023-24 Projected**
Citywide Operations		
General Fund	$ 151.2	$ 156.0
Special Revenue / Debt Service Funds	$ 24.0	$ 23.8
Enterprise Fund	$ 41.7	$ 42.3
Total	**$ 216.9**	**$ 222.1**
Capital Improvement Program	**$ 67.9**	**$ 94.0**
Total	**$ 284.8**	**$ 316.1**

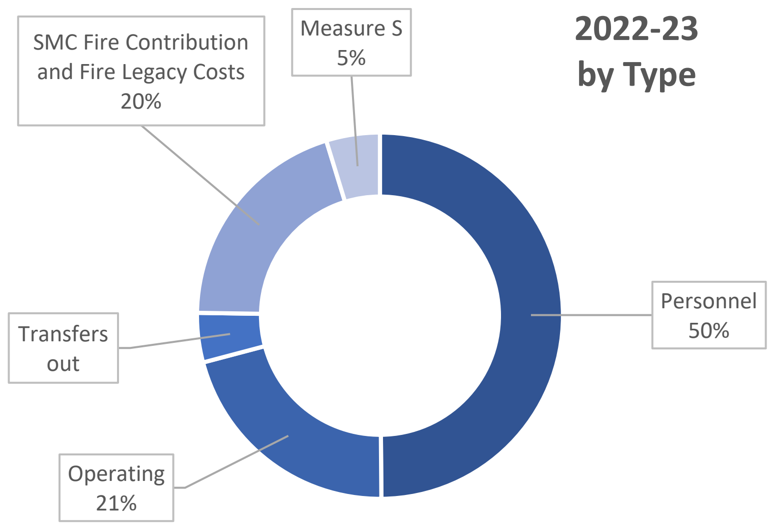
In millions. Operating costs include debt service payments.

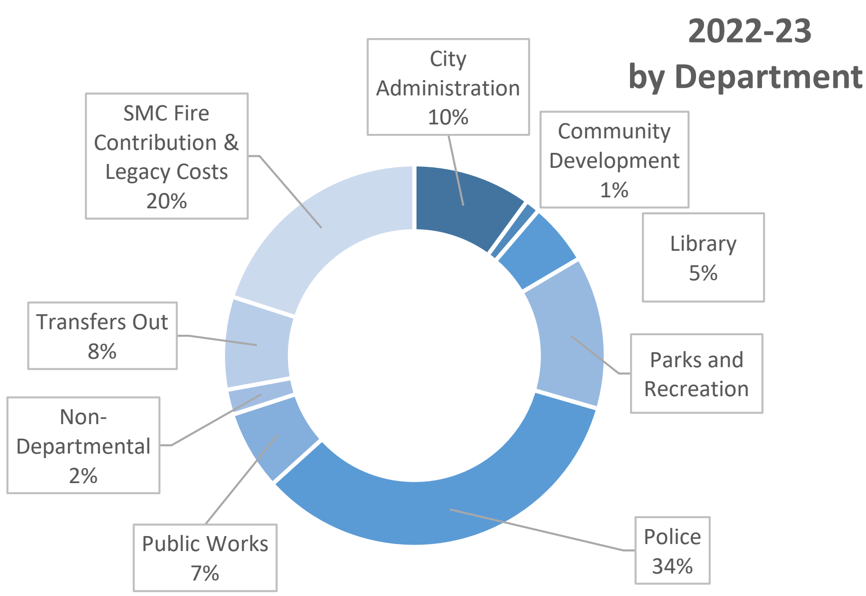
The total City operating budget for 2022-23 is $216.9 million and is up 7.9% over the adopted 2021-22 budget. The cost escalation is primarily attributable to increases in the cost of salaries and benefits for bargaining units that partnered with the City as a part of the Fiscal Sustainability Plan, which largely kept employee compensation static. With the recovery of sales tax revenues, upward trajectory of the TOT recovery, and resetting the baseline assumption for real property transfer tax revenues based on the average of the current and previous major economic cycles, the City was able to provide additional compensation to help employees address inflationary pressure and maintain consistency with the City's goal of paying at the median compared to the market. In addition, the General Fund is providing $6.75 million in support for CIP for 2022-23, which is $4.5 million more than it has provided in the wake of the pandemic.

The Capital Improvement Program (CIP) for 2022-23 totals $67.9 million, which is $15.3 million more than the adopted 2021-22 CIP, and only $2.4 million less than the 2022-23 CIP Plan estimate from the adopted 2021-22 CIP. Nearly half of the proposed 2022-23 CIP budget is for Sewer Fund capital improvements, and the majority of which are for the Clean Water Program annual citywide sanitary sewer rehabilitation ($11.7 million) and Wastewater Treatment Plant (WWTP) Flow Management Upgrade and Expansion ($14.1 million) project.

General Fund and Budget Development Priorities

The General Fund is the primary funding source for the City's core services. The total spending plan for the General Fund for 2022-23, including the transfers to the Capital Improvement Projects Fund, is $164.2 million, and is outlined in the chart below.





The overall proposed budget for 2022-23 is an increase of 11.8% over the adopted 2021-22 budget of $146.9 million. The primary driver of the increase is the additional support for the CIP of $4.5 million. Absent the additional support for the CIP, General Fund appropriations increased by $12.8 million, or 8.7% more than the adopted 2021-22 budget. The growth in General Fund appropriations is principally attributable to:

- $1.5 million increase in the total operating contribution and legacy costs for San Mateo Consolidated Fire Department (SMC Fire), largely due to the anticipated cost of negotiated increases in employee compensation;
- $1.8 million increase in the City's Unfunded Accrued Liability (UAL) contribution to CalPERS – effectively a loan payment on the City's unfunded pension liability of $264 million with an interest rate of 6.8%;
- $2.8 million increase in the Parks & Recreation Department operating budget, reflecting the return of programming that had either been cancelled or shifted to the virtual space during the pandemic.

The City's fiscal focus and perspective remains in the long term to consider how near-term financial decisions impact the City's long-term sustainability. The City's ability to weather economic volatility and emerge from the pandemic-related recession is dependent upon its commitment to consistent, disciplined, and prudent fiscal decisions.

Challenges

Property Tax

Property tax remains the City's primary tax revenue source. However, there are two property revenue types that are at risk due to flaws in the State law and potentially unconstitutional efforts by the State to take away local property tax revenues.

In 1992, in order to balance its budget on the backs of local governments and meet its requirement to fund public schools, the State created the Educational Revenue Augmentation Fund (ERAF), which took away property taxes from local cities and counties. ERAF serves as a funding source for non-basic aid school districts, which are unable to meet their Proposition 98-determined funding level through property tax. Due to the high value of land and property in San Mateo County, the majority of the school districts in the county are basic aid. As such, San Mateo County is one of five counties in the state that have Excess ERAF, or ERAF funds remaining after non-basic aid school districts have been funded up to the State-determined minimum funding requirement. Excess ERAF is proportionately returned back to the local taxing entities.

In 2004, as a part of the State's budget agreement, in exchange for substantially reducing vehicle license fees, the State agreed to offset the revenue loss with property taxes revenues, known as property tax in lieu of vehicle license fees (VLF). The funding sources for VLF are 1) ERAF that otherwise would have gone to non-basic aid school districts, and 2) property taxes from non-basic aid school districts. Unfortunately, due to the dearth of non-basic aid school districts in San Mateo County, the amount of property tax and ERAF from non-basic aid school districts is less than the amount of VLF that is owed to the County and the cities, which is a VLF shortfall: a phenomenon that is uncommon and only impacts the counties of San Mateo and Alpine. Over the past two years, San Mateo County has experienced VLF shortfalls of $5.7 million and $96.1 million. The remedy for the VLF shortfall has been to file a claim with the State, which is then considered for inclusion in its budget for the subsequent fiscal year. The end result is 1) uncertainty of whether the State will honor the VLF shortfall claim, and 2) a two-year cash flow impact from when the VLF revenues were owed and when they are received. In an effort to address the impacts, the County submitted a legislative amendment proposal for the State to consider that addressed the VLF shortfall within one year. Unfortunately, the proposal did not receive sufficient political support with the State legislature, and in turn, the State countered with a proposal that has been folded into its proposed 2022-23 budget via a trailer bill. The State's proposed language would cap Excess ERAF revenues at the FY 2021-22 level and use subsequent growth as a funding source for the VLF shortfall. If Excess ERAF above the 2021-22 cap, property tax and ERAF from non-basic aid school districts are not enough to address the VLF shortfall, the State will backfill with its General

Fund. San Mateo County, the local cities, the California State Association of Counties, and other Excess ERAF counties have voiced opposition to the trailer bill, as the net effect is a takeaway of Excess ERAF revenues, which is potentially a violation of Proposition 1A from 2004 and Proposition 22 from 2010.

The remaining non-basic aid school districts are projected to shift to basic aid status within the next 7-10 years. Combined with the growth in assessed value, the annual impact to San Mateo County is projected to be $333 million by 2031-32, and the City's share of which is expected to be a loss of $6.7 million.

Sales Tax

Even though sales tax revenues have recovered to the pre-pandemic baseline, there are three major factors that impact sales tax revenue growth. The first factor is the State's antiquated revenue and taxation code that has not adapted to modern commerce and technology. The local 1% sales tax, which is assessed in accordance with the Bradley Burns Uniform Sales and Use Tax Law (Bradley Burns), is allocated based on point of sale, not destination. As such, combined with the second factor of the generational shift of consumer habits of buying more of their taxable goods online rather than physical stores, the City only receives a fraction of the 1% Bradley Burns, as sales tax that is assessed on online transactions is collected as use tax, which is allocated on a proportional basis at the county level based on each city's proportional share of the Bradley Burns, which for the City is typically 10%. The third factor is the degradation of the use tax base by sales tax rebate agreements between local cities and retailers.

The impact of these factors on the Bradley Burns is quantifiable when comparing to the local 1/4% transactions and use tax, Measure S, which is allocated based on destination, which precludes Measure S revenues from being subject to the same factors of the Bradley Burns. As such, if Bradley Burns were modernized to be allocated by destination rather than point of sale, FY 2022-23 sales tax revenues would be closer to $28.0 million rather than $22.4 million.

Hotel Tax

Transient occupancy tax, or hotel tax, is dependent on both the occupancy levels and room rates of the City's hotel stock. Hotel tax revenue is very sensitive to broader economic trends. In good economic times, both occupancy rates and room rates increase, but during recessionary periods, both go down, which can result in a significant reduction in hotel tax revenue.

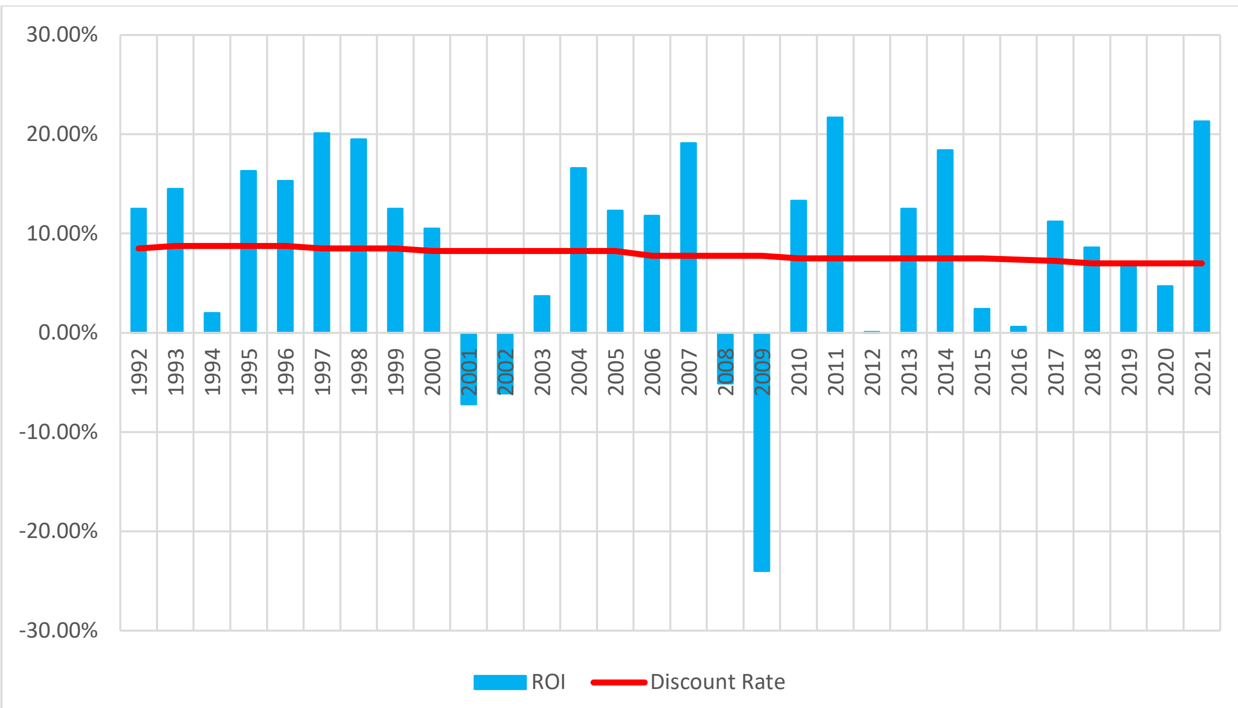
The COVID-19 pandemic devastated hotel tax revenue. Occupancy rates dropped to single-digits during the shelter-in-place mandate that started in March 2020 but have recovered to 60% over the past nine months. Revenues are estimated to end 2021-22 at $3.0 million, which is 43% of the pre-pandemic 2018-19 actuals. The City's TOT tax base is largely from business travel. Based on the accelerated recovery in comparison to previous projections, the General Fund Long-Term Financial Plan assumes that TOT revenues will recover to the pre-pandemic baseline by the end of the ten-year term. The City will continue to monitor this trend, its impact on TOT revenues, and update the General Fund Long-Term Financial Plan accordingly.

Pension Costs

As a part of its quadrennial Asset Liability Management (ALM) cycle, the CalPERS Board recently selected a 6.8% discount rate. The discount rate is the projected return on investment (ROI) over the next thirty years, as well as the level of risk that CalPERS is willing to take in order to achieve that ROI.

In July 2021, CalPERS reported a preliminary ROI of 21.3% for fiscal year 2020-21. At first blush, higher interest returns may seem favorable, but interest is a measure of risk, and the deviation from the discount rate means that CalPERS' investment portfolio is taking on too much risk. As such, the Funding Risk Mitigation Policy (RMP) was triggered, which reduced the discount rate from 7.0% to 6.8%. The investment gain – the difference between the 7.0% discount rate and the 21.3% ROI, will be amortized over 20 years, with a ramp up over the first five years (1/5th or 20% of the annual amortization amount recognized each year), beginning in the actuarial valuations with a measurement date of June 30, 2021, which applies to the pension contribution rates for 2023-24. The reduction of the discount rate will be amortized over 20 years with no ramping, as ramping for changes in actuarial assumptions was eliminated beginning in measurement periods of June 30, 2019.

Due to the ongoing market volatility, CalPERS' year-to-date ROI is negative 5.2%. The graph below illustrates the historical ROI volatility and the disparity between the discount rate and the ROI:



Every deviation between the ROI and the discount rate (a gain or a loss) results in an amortization base being generated, which is essentially a mortgage or loan that is paid off over time. Gains or losses incurred before June 30, 2019 have an amortization period of 30 years, while subsequent gains or losses are amortized over 20 years; a policy change to reduce the cost of interest expense. In addition to the payment on the UAL, the City's pension contribution also includes the normal cost, which is the cost for the current year of service. Assuming that CalPERS will be able to achieve its long-term ROI of 6.8%, as shown in the table below, it takes nearly all of the City's sales tax revenues, which is second to only property tax as the General Fund's top tax revenue source, to cover the escalating cost of pension contributions for the General Fund.

Fiscal Year	General Fund Pension Contribution (in millions)	Projected Local 1% Sales Tax Revenue (in millions)	Pension as a Percentage of Sales Tax
2021-22	$19.3	$19.4	100%
2022-23	$20.7	$20.2	102%
2023-24	$20.9	$20.9	100%
2024-25	$21.2	$21.5	99%
2025-26	$20.5	$22.0	93%
2026-27	$20.3	$22.6	90%
2027-28	$20.5	$23.1	89%
2028-29	$20.5	$23.5	87%
2029-30	$21.0	$24.0	88%
2030-31	$21.5	$24.5	88%

However, if CalPERS' asset allocation from its ALM and the inherent risks do not achieve the required return on investment, the magnitude of the variance between the discount rate and the ROI will determine the impact to the projected relationship between pension contributions and sales tax revenues.

Opportunities

Capital and Infrastructure Investments

Even as we face the economic crisis from the COVID-19 pandemic, I don't want to lose sight of the many major initiatives that are occurring right now. The priority in investing in our community remains as strong as ever. We have made substantial funding commitments to the $1 billion Clean Water Program as it moves to build the foundation of the wastewater treatment plant. The City closed nearly $300 million in low interest loans with the Environmental Protection Agency (EPA) through the Water Infrastructure Finance and Innovation Act to finance the cost of capital improvements for the WWTP and sewer collection system at the end of 2020, and closed short-term notes in July 2021 to take advantage of the interest rate spread at that time, which saved sewer rate payers approximately $5.6 million in net present value. In addition, the City was able to close a State Revolving Fund (SRF) loan in the amount of $137 million with the State Water Resources Control Board at a 0.8% interest rate. Absent the SRF loan, the City would have had to access the bond market, in which the City would have had to pay substantially more in interest to potential investors with the current condition of the bond market. As such, the SRF loan will save rate payers approximately $120 million in debt service costs over the next 30 years. Tremendous progress is being made now that will upgrade and expand the wastewater treatment plant to provide high-quality services to our community for decades to come.

Other major initiatives that are underway include accelerated street repair and reconstruction, and the flood control infrastructure in North Shoreview. In February 2020, the City, through the San Mateo – Foster City Public Financing Authority, issued $42.3 million in lease revenue bonds to finance these improvements. For streets, approximately 9.5 miles of failed streets remain from the original 22 miles that were identified in 2013. Funding from the bonds will be utilized to accelerate street improvement projects, and we are on target to eliminate the 9.5 miles of failed streets by 2026. Funding from the bonds will also be utilized to finance flood control improvements, which will take the North Shoreview neighborhood off the FEMA flood map and save residents from the cost of flood insurance. Carrying on initiatives like these are a testament to the investment and commitment we make to our community, even as we face unprecedented times from the pandemic. The work continues, and I am confident that the investments we are making now will position our community for long-term success.

Measure S

Measure S, the 0.25% sales tax extension, maintains funding for its core priorities, which include safety, public services, and infrastructure improvements. The proposed 2022-23 budget appropriates $3.1 million in Measure S funds for CIP projects, including $1.25 million for the Columbia Drive and Crystal Springs Road Storm Drain Channel, $0.8 million for citywide street reconstruction, $0.6 million for refurbishment of the Gateway Park Pedestrian Bridge, $0.2 million for radio dispatch consoles, and $0.25 million for neighborhood traffic management. While Measure S revenues experienced some retraction result of COVID-19, they were not been impacted to the same degree as sales tax revenues due to differences in tax law. The local 1% sales tax is assessed, collected, allocated, and remitted pursuant to the Bradley Burns Uniform Sales and Use Tax Law, while the Measure S ¼ cent transactions and use tax is under the State of California's District Tax Law. Revenues will continue to be monitored carefully, and recommendations on funding adjustments will be presented to the Measure S Oversight Committee as appropriate.

Operational Modernization

In April 2022, City staff that had been working entirely remotely began to return to the office two days a week, which increased to three days a week in May 2022. In addition, effective May 18, 2022, the City ended its declaration of a local emergency due to COVID-19, which also brought an end to virtual City Council meetings and began the hybrid format, which continues to provide the San Mateo community the flexibility of accessing City Council meetings in person or remotely with the City's investment in updating its meeting equipment. We will continue to balance the health and welfare of our employees and the community that we serve with the goal of maintaining core service levels.

Beginning in March 2022, the City began implementation of a new cloud-based enterprise resource planning system, Workday. This process equips the City and its employees with new technology to better serve the San Mateo community, offers the means to comprehensively modernize our business processes and procedures, and leverage the technology to recognize efficiencies. It is through new technology like the ERP that we will continue to adapt our service delivery to respond to growing needs in a rapidly changing environment.

Concluding Remarks

Despite the ongoing challenges that we will face with the pandemic, I am confident that the City will be able to deftly navigate them, execute the City Council's strategic plan, and address the needs of the San Mateo community.

This letter summarizes our financial position and the concrete steps we have taken and will prospectively take in the future to address the challenges in front of us. We are making a number of important decisions to ensure the long-term health of our organization and thoughtfully prepare for next year and beyond. We continue to invest in our core priorities of infrastructure needs, and we are finding new ways of providing services and engaging our community while relying on public health guidelines. We have much work ahead, but we have an exceptionally talented and dedicated team of people with great creativity and skill who have shown their commitment to addressing the complexities and challenges of the pandemic, and together, we will continue to prevail.

While events in the past year have been historic, the resultant dilemmas have been equally met with support from the City Council for our community and for our organization. Our staff have stepped up to the moment and proved what is possible when faced with extremely challenging circumstances. And as I take a moment to reflect on the intensity of the past two years, I am truly humbled to be a part of this resilient community that has made the best of a once-in-a-lifetime crisis.

The development and delivery of the recommended budget to the City Council is the culmination of months of work from staff throughout the organization, and it is a true team effort. First and foremost, I would like to thank the City Council for articulating a vision and setting priorities that helped us develop the budget. I would also like to thank the executive team, along with their respective staff members, for their efforts in supporting the budget development process. And finally, I'd like to thank the members of the Finance Department, led by Finance Director Rich Lee, who drove the process to develop the budget and prepare this document.

Respectfully submitted,

Drew Corbett, City Manager