MEMORANDUM

May 18, 2018

TO: MEMBERS, PORT COMMISSION
Hon. Kimberly Brandon, President
Hon. Willie Adams, Vice President
Hon. Doreen Woo Ho
Hon. Gail Gilman
Hon. Victor Makras

FROM: Elaine Forbes
Executive Director

SUBJECT: Informational Presentation on Trends and Implications of the Port's Audited Financial Statements and Future Financial Projections

DIRECTOR'S RECOMMENDATION: Informational Only – No Action Required

The purpose of this item is to present staff analysis on the Port's financial performance. The following report reviews and evaluates trends and implications of the last five years of audited financial statements; estimates the Port's financial condition for the current Fiscal Year (FY) 2017-18 and the upcoming budget years of FY 2018-19 and FY 2019-20; and outlines financial strategies the Port can pursue to maintain and improve its financial condition. Port staff welcomes Port Commission and public feedback.

EXECUTIVE SUMMARY

During the February 2018 staff presentations on the proposed budget for FY 2018-19 and FY 2019-20, Commissioner Doreen Woo Ho requested an update on the Port's financial performance. In addition to seeking more information about the Port's historic and projected financial position, the Commissioner requested an update on risks and opportunities that could impact the Port.

The first part of this report updates the Port Commission on the Port's operating activities and financial position based on the Port's audited financial statements for the last five fiscal years. The second part of this report provides the Port Commission information on the Port's financial projections for the current year and the next two fiscal years, from FY 2018-19 to FY 2019-20. As part of this outlook, staff analyzed risks and opportunities that could impact the Port's financial performance, advising areas to monitor moving forward. Finally, this report outlines key areas for the Port to maintain or improve its financial performance and specific goals to pursue in the years ahead.

Under the City Charter, the City must examine financial trends every other fiscal year to understand risks and opportunities to the General Fund and other funds. As a City department, the Port participates in this exercise and benefits from the opportunity to understand how citywide trends may impact the Port's financial condition. Port staff will return to the Port Commission in December 2018 with a comprehensive five-year financial plan that incorporates the income statement and balance sheet perspectives applied in the Port's financial statements and in this report.

STRATEGIC OBJECTIVES

Regular review of the Port's financial performance is central to meeting the *Stability* objectives of the Port's 2016-2021 Strategic Plan by:

- Examining risks to the Port's revenues and evaluating potential impacts to operations;
- Identifying opportunities to enhance Port operating revenues to increase income and mitigate risk;
- Discussing strategies to improve the Port's overall financial performance, which will enhance the Port's ability to deliver its overall strategic objectives.

AUDITED FINANCIAL STATEMENTS

The Port's financial statements are audited annually and are historical in nature, providing the means to look back at the Port's financial position and the annual operating activities that change that financial position. The most recent audit covered the years ended June 30, 2017 and 2016. The independent auditors, Macias, Gini & O'Connell LLP ("MGO"), issued their audit report on October 23, 2017. MGO issued a "clean" or unqualified opinion on the financial statement prepared by Port management. Staff distributed the audited financial statement to the Port Commission in early November of 2017. The financial statement is also available online.[1]

As shown in **Table 1**, between 2013 and 2017, the Port's net position increased by $27.1 million (7.5%), from $362.6 million to $389.7 million. A strong economy and careful financial management supported growth in the Port's net operating income in four of the last five years. While the overall trend in the Port's net position has been positive, it is notable that the Port recorded a net operating loss in 2017. This shift resulted from additional Governmental Accounting Standards Board (GASB) requirements regarding reporting of post-employment benefits, continued growth in the

[1] See, "Port of San Francisco Independent Auditor's Report, Management's Discussion and Analysis, and Financial Statements for the Years Ended June 30, 2017 and 2016," Macias, Gini & O'Connell LLP, http://sfport.com/sites/default/files/Business/Docs/Finance%20%26%20Administration/Port%20of%20SF%202017%20BFS.pdf.

Port depreciation and amortization schedule, and by a decline in grants and other contributed capital.

Table 1: Historical Statement of Operations ($ thousands)

	BASE 2013	+1 2014	+2 2015	+3 2016	+4 2017	Change	% Change
Net Position, Beginning FY	**$ 335,476**	**$ 362,609**	**$ 371,289**	**$ 352,595**	**$ 387,670**	**$ 52,194**	**15.6%**
Operating Revenues	$ 81,520	$ 85,739	$ 95,296	$ 99,733	$ 113,353	$ 31,833	39.0%
Operating Expenses	(79,165)	(83,596)	(83,683)	(86,820)	(114,075)	(34,910)	44.1%
Operations & Maintenance	*(63,951)*	*(61,427)*	*(59,831)*	*(63,537)*	*(87,698)*	*(23,747)*	*37.1%*
Depreciation & Amortization	*(16,367)*	*(20,434)*	*(22,787)*	*(21,924)*	*(24,191)*	*(7,824)*	*47.8%*
Non-budgetary accrual adjustments	*1,153*	*(1,735)*	*(1,065)*	*(1,359)*	*(2,186)*	*(3,339)*	*-289.6%*
Subtotal, Operating	**$ 2,355**	**$ 2,143**	**$ 11,613**	**$ 12,913**	**$ (722)**	**$ (3,077)**	**-130.7%**
Non-Operating Income/(Expense)	(471)	(3,184)	(1,398)	(1,919)	970	1,441	-305.9%
Grants & Other Contributed Capital	25,832	9,721	1,560	24,081	1,822	(24,010)	-92.9%
Subtotal, Non-Operating	**$ 25,361**	**$ 6,537**	**$ 162**	**$ 22,162**	**$ 2,792**	**$ (22,569)**	**-89.0%**
Total Change in Net Position	**$ 27,133**	**$ 8,680**	**$ (18,694)**	**$ 35,075**	**$ 2,070**	**$ (25,063)**	**-92.4%**
Net Position, End of FY	**$ 362,609**	**$ 371,289**	**$ 352,595**	**$ 387,670**	**$ 389,740**	**$ 27,131**	**7.5%**
Average						*$ 6,783*	*1.9%*

As detailed in **Table 2** below, the Port's balance sheet also reflects growth in the Port's net position. While the Port's net position increased during the five-year period, growth in the Port's financial position narrowed each year as the rate of growth for total liabilities and the deferred inflow of resources (46.8%) far outpaced growth in total assets and the deferred outflow of resources (20.6%). Notably, the balance sheet also shows that current and other assets grew as the Port increasingly funded its capital budget, without completing all funded projects. This has resulted in higher current and other assets from funded but unspent capital allocations sitting in the Port's cash balance, and relatively level growth in capital assets.

Table 2: Historical Balance Sheet ($ thousands)

	BASE 2013	+1 2014	+2 2015	+3 2016	+4 2017	Change	% Change
Current and other assets	$ 135,786	$ 151,355	$ 152,032	$ 191,839	$ 208,502	$ 72,716	53.6%
Capital assets	409,032	439,773	444,105	430,850	427,742	18,710	4.6%
Total Assets	$ 544,818	$ 591,128	$ 596,137	$ 622,689	$ 636,244	$ 91,426	16.8%
Deferred outflows of resources	$ -	$ -	$ 5,555	$ 6,467	$ 20,916	$ 20,916	na
Subtotal Assets & Deferred	**$ 544,818**	**$ 591,128**	**$ 601,692**	**$ 629,156**	**$ 657,160**	**$112,342**	**20.6%**
Current liabilities	$ (61,249)	$ (39,020)	$ (24,788)	$ (23,454)	$ (26,505)	$ 34,744	-56.7%
Noncurrent liabilities	(120,960)	(180,819)	(209,459)	(210,874)	(238,705)	(117,745)	97.3%
Total liabilities	$ (182,209)	$ (219,839)	$ (234,247)	$ (234,328)	$ (265,210)	$ (83,001)	45.6%
Deferred inflows of resources	$ -	$ -	$ (14,850)	$ (7,158)	$ (2,210)	$ (2,210)	na
Subtotal Liabilities & Deferred	**$ (182,209)**	**$ (219,839)**	**$ (249,097)**	**$ (241,486)**	**$ (267,420)**	**$ (85,211)**	**46.8%**
Total net position	**$ 362,609**	**$ 371,289**	**$ 352,595**	**$ 387,670**	**$ 389,740**	**$ 27,131**	**7.5%**
Net investment in capital assets	*319,829*	*312,572*	*315,037*	*304,396*	*298,928*	*(20,901)*	*-6.5%*
Restricted	*27,139*	*16,389*	*6,511*	*26,152*	*24,365*	*(2,774)*	*-10.2%*
Unrestricted	*15,641*	*42,328*	*31,047*	*57,122*	*66,447*	*50,806*	*324.8%*

Operating Revenues

As detailed in **Table 3** below, between 2013 and 2017 the Port benefited from a period of significant economic expansion that helped operating revenues grow by $31.8 million (39.0%), at an average rate of 9.8% per year. This growth was supported primarily by increased Real Estate ($15.4 million, 25.2%) and Maritime ($6.2 million, 41.5%) revenues, as well miscellaneous revenues ($10.3 million, 83.2%) compared to 2013. In 2017 the miscellaneous revenue line was bolstered by one-time sources including a $6.0 million lease transfer transaction and a $4.9 million settlement with the Port's former shipyard operator. Excluding these one-time sources, operating revenues would have only increased by $20.9 million (25.7%) compared to 2013, at an average rate of 6.4% per year.

Table 3: Historical Operating Revenues ($ thousands)

	BASE 2013	+1 2014	+2 2015	+3 2016	+4 2017	Change	% Change
Real Estate	**$ 61,048**	**$ 66,330**	**$ 73,640**	**$ 75,023**	**$ 76,410**	**$ 15,362**	**25.2%**
Commercial and industrial	43,274	46,606	51,328	53,519	54,510	11,236	26.0%
Parking	17,774	19,724	22,312	21,504	21,900	4,126	23.2%
Maritime	**$ 14,850**	**$ 15,983**	**$ 18,390**	**$ 21,096**	**$ 21,020**	**$ 6,170**	**41.5%**
Cruise	4,886	4,696	4,931	7,663	7,406	2,520	51.6%
Cargo	2,012	3,396	4,928	5,281	6,248	4,236	210.5%
Ship repair	2,825	1,790	2,045	2,543	1,398	(1,427)	-50.5%
Fishing	2,018	2,123	2,185	2,062	2,402	384	19.0%
Harbor services	1,553	2,136	1,996	1,768	1,827	274	17.6%
Other maritime	1,556	1,842	2,305	1,779	1,739	183	11.8%
Other Miscellaneous	**$ 5,622**	**$ 3,426**	**$ 3,266**	**$ 3,614**	**$ 15,923**	**$ 10,301**	**183.2%**
Total Operating Revenues	**$ 81,520**	**$ 85,739**	**$ 95,296**	**$ 99,733**	**$ 113,353**	**$ 31,833**	**39.0%**
Average						**$ 7,958**	**9.8%**
Less one-time sources	*$ 81,520*				*$ 102,453*	*$ 20,933*	*25.7%*
Average						*$ 5,233*	*6.4%*

The significant growth in Port real estate revenues since 2013 is attributable to the strong economy paired with the diversity of the Port's portfolio, which includes office, industrial, storage, retail, restaurants, parking lots, parking meters, and major tourist attractions. The Port Commission's policy of adhering to a schedule of market rents (parameter rent schedule) has supported this growth, allowing ground lease rates to reflect the strength of the economy and current lease environment. Other real estate revenues have also captured the upside of a strong regional economy, including percentage rents in retail industries and parking revenues from tourism and business activities along the waterfront.

Maritime revenues grew due to robust performance in both the cruise and cargo business lines. Revenues from passenger cruises resulted primarily from the Port's $6 increase in the cruise passenger facility charge, from $12 to $18, as well as increased cruise ship calls and overall passenger volume, special events and parking at the newly constructed James R. Herman Cruise Terminal. While ship repair revenues declined during this period due to growing competition on the West Coast, the Port's cargo revenues grew significantly because of a new terminal operator agreement with Pasha Automotive. Additionally, since 2013, Port revenues from other maritime business lines have been relatively constant, adjusting for inflation.

Operating Expenses

Between 2013 and 2017, operating expenses grew by $34.9 million at an average rate of 11.0% per year. As detailed in **Table 4** below, general operations and maintenance expenses grew by $23.7 million (9.3% average) especially in the areas of personal services, contractual, and interdepartmental services. Additionally, depreciation and amortization expenses grew by $7.8 million (12.0% average) and non-budgetary accrual adjustments increased by $3.3 million.

Table 4: Historical Operations & Maintenance Expenses ($ thousands)

	BASE 2013	+1 2014	+2 2015	+3 2016	+4 2017	Change	% Change
Personal services	$32,894	$33,489	$29,406	$30,846	$ 47,998	$ 15,104	45.9%
Budgeted	*30,228*	*31,454*	*32,006*	*33,180*	*34,856*	*4,628*	*15.3%*
Net change in OPEB & pension	*2,666*	*2,035*	*(2,600)*	*(2,334)*	*13,142*	*10,476*	*392.9%*
Contractual services	6,630	4,770	4,978	5,895	11,660	5,030	75.9%
Utilities	2,040	1,974	2,395	2,146	2,833	793	38.9%
Materials and supplies	1,548	1,635	1,689	1,468	1,853	305	19.7%
General and administrative	3,618	3,988	4,266	4,058	4,345	727	20.1%
Interdepartmental Services	17,221	15,571	17,097	19,124	19,009	1,788	10.4%
Subtotal	*$63,951*	*$61,427*	*$59,831*	*$63,537*	*$ 87,698*	*$ 23,747*	*37.1%*
Depreciation & Amortization	16,367	20,434	22,787	21,924	24,191	7,824	47.8%
Non-budgetary accrual adjustments	(1,153)	1,735	1,065	1,359	2,186	3,339	-289.6%
Total Opps. & Maintenance	**$79,165**	**$83,596**	**$83,683**	**$86,820**	**$ 114,075**	**$ 34,910**	**44.1%**
Average						*$ 8,728*	*11.0%*

Salary and mandatory fringe benefit costs represent the most significant area of growth in the Port's operating expenses, with an increase of $15.1 million (11.5% average). These expenses are subject to collective bargaining arrangements and continue to rise, especially for health plan costs and pension contributions. In 2017, the required accrual adjustment for pension and OPEB expense increased $13.1 million. While these accrued expenses do not impact the Port's budget, they will continue to impact its financial statements.

Contractual services and interdepartmental services from other City departments have collectively grown by $6.8 million. These expenses vary with the amount of development and Port capital project activities and the Port's capital and development programs will likely continue to accelerate. These outside services are a valuable supplement to the Port's internal work force, particularly to supply services for duediligence work, conceptual design and other work to support and manage capital projects.

Non-Operating Income and Expense

As depicted in **Table 1** above, Non-Operating Income and Expenses represents the net impact of various non-operating items. These items include investment activities (interest and investment income), certain capital and noncapital items (the cost of pier removal and other asset dispositions), and financing activities (interest expense). Other than interest income and expense, much of the activities are non-recurring. Between 2013 and 2017, non-operating income grew by $1.4 million, shifting from a net expense in all prior years to a net source of income in 2017.

Contributions to Capital

Finally, as depicted in **Table 1** above, Grants and Other Contributed Capital declined by $24.0 million (92.9%) compared to 2013. While the Port received $63.0 million in funding to complete projects such as the James R. Herman Cruise Terminal, Brannan Street Wharf, Heron's Head Park, and portwide security system improvements over the course of the five-year period, the flow of these funds fluctuates widely. These funds are based on numerous factors including the availability of grant funds and the capital work actually in progress at the Port. With the guidance of the Port's new Capital Improvement Program, staff will continue to pursue capital grants and other contributions from federal, state and local grant agencies, to support the Port's highest priority capital projects. Examples include Regional Measure 3 proceeds for the Mission Bay Ferry Landing and a citywide General Obligation Bond for the Seawall Earthquake Safety and Disaster Prevention Program.

Analysis

While the Port's total net position grew substantially over the five-year period, the annual change reduced over time as growth in operating expenses and depreciation/ amortization outpaced growth in sources. Specifically, in 2017 the Port generated a $2.1 million change in net assets, representing a $25.1 million (92.4%) reduction in the annual change to net assets compared to 2013. While $22.6 million of this decline can be attributed to non-operating activities and readjustments related to employee pensions and health care, operating activities declined by $3.1 million and generated a $0.7 million deficit.

Looking ahead, the Port must maintain its strong fiscal policies and practices, including controlling operating expenses, while actively pursuing new revenue streams and external funding sources, to maintain growth in its net position.

FINANCIAL PROJECTIONS

The following financial outlook is comprised of projected revenues and expenditures for the current year and revenues and expenses detailed from the proposed budgets for FY

2018-19 and FY 2019-20. The format mirrors the audited financial statement for operating revenues, operating expenses, funding for the Mission Bay Ferry Landing and Seawall Program, and an adjustment to environmental remediation liability related to Pier 70 in the current year. Otherwise, this report does not attempt to forecast other accrual accounting components of the financial statements, basing future non-budgetary accrual adjustments upon the most recent five-year average.

Table 5: Projected Statement of Operations, FY 2017-18 to FY 2019-20

	AUDITED 2017	CY 2018	BY 2019	BY+1 2020	Change	% Change
Net Position, Beginning FY	**$ 387,670**	**$ 362,609**	**$ 371,289**	**$ 352,595**	**$ (35,075)**	**-9.0%**
Operating Revenues	$ 113,353	$ 97,824	$ 124,950	$ 130,760	$ 17,407	15.4%
Operating Expenses	(114,075)	(119,920)	(157,224)	(142,186)	(28,111)	24.6%
Operations & Maintenance	*(87,698)*	*(104,613)*	*(134,254)*	*(118,286)*	*(30,588)*	*34.9%*
Depreciation & Amortization	*(24,191)*	*(22,465)*	*(21,931)*	*(22,862)*	*1,329*	*-5.5%*
Non-budgetary accrual adjustments	*(2,186)*	*7,158*	*(1,038)*	*(1,038)*	*1,148*	*-52.5%*
Subtotal, Operating	**$ (722)**	**$ (22,096)**	**$ (32,274)**	**$ (11,427)**	**$ (10,705)**	**1482.7%**
Non-Operating Income/(Expense)	$ 970	$ 6,500	$ 28,940	$ 12,060	$ 11,090	1143.3%
*Mission Bay Ferry Landing, City Funding**	*-*	*3,500*	*11,000*	*-*	*-*	*0.0%*
Mission Bay Ferry Landing, RM3^*			*12,940*	*12,060*	*12,060*	*100.0%*
*Seawall Program, City Funding**	*-*	*3,000*	*5,000*	*-*	*-*	*0.0%*
Grants & Other Contributed Capital	1,822	-	-	11,353	9,531	523.1%
*Seawall Program, GO Bond^*	*-*	*-*	*-*	*11,353*	*11,353*	*0.0%*
Subtotal, Non-Operating	**$ 2,792**	**$ 6,500**	**$ 28,940**	**$ 23,413**	**$ 20,621**	**738.6%**
Total Change in Net Position	**$ 2,070**	**$ (15,596)**	**$ (3,334)**	**$ 11,986**	**$ 9,916**	**479.0%**
Net Position, End of FY	**$ 389,740**	**$ 347,013**	**$ 367,955**	**$ 364,581**	**$ (25,159)**	**-6.5%**
Average					*(8,386)*	*-2.2%*

** Funding supports non-capitalizable expenses that are reflected as operating expenses.*
^ Pending approval by voters in regional and local elections. "RM3" represents Regional Measure 3.

As shown in **Table 5** above and explained in more detail below, the Port's net position is projected to be reduced by $25.2 million (6.5%), from $389.7 million to $364.6 million, because of projected shortfalls in net operating income. While operating revenues are projected to grow by $17.4 million (15.4%), operating expenses are projected to grow by $28.1 million (24.6%), outpacing revenues in each fiscal year. As a result, net operating income is projected to decline by $10.7 million compared to the 2017 financial statements. The Port is fortunate to receive non-operating income and is pursuing grants and other contributed capital that will offset operating losses and generate overall growth in the Port's net position for FY 2019-20.

Operating Revenues

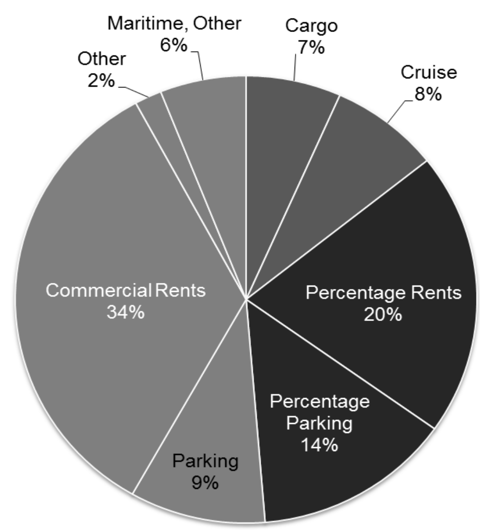
The proposed budget estimates the Port will generate $130.8 million in operating revenues by FY 2019-20, a 17.4 million (5.1% average) increase compared to FY 2016-17. As detailed in **Table 6** below, most of this growth is projected in Commercial/ Industrial Rents ($22.2 million) because of growing base rents, new leasing opportunities in recently renovated facilities, and one-time revenues from major lease transactions such as the expected sale of the master lease of landmark Port property. While many other revenue lines are projected to grow by inflation, several business lines are projected to decline including Ship Repair ($1.4 million), Parking ($0.7 million), and other miscellaneous sources such as from one-time property sales. The overall positive revenue trend bodes well for the Port, but there are several factors of risks and opportunities that could affect the Port for worse or better, as detailed below.

Table 6: Projected Operating Revenues, FY 2017-18 to FY 2019-20

	AUDITED 2017	CY 2018	BY 2019	BY+1 2020	Change	% Change
Real Estate	**$ 76,410**	**$ 74,118**	**$ 94,337**	**$ 97,951**	**$ 21,541**	**28.2%**
Commercial and industrial	54,510	53,174	70,485	76,721	22,211	40.7%
Parking	21,900	20,944	23,852	21,230	(670)	-3.1%
Maritime	**$ 21,020**	**$ 21,517**	**$ 20,775**	**$ 21,368**	**$ 348**	**1.7%**
Cruise	7,406	7,304	7,833	8,038	632	8.5%
Cargo	6,248	7,650	6,789	6,993	745	11.9%
Ship repair	1,398	690	-	-	(1,398)	-100.0%
Fishing	2,402	2,246	2,370	2,441	39	1.6%
Harbor services	1,827	1,697	1,884	1,941	114	6.2%
Other maritime	1,739	1,930	1,899	1,956	217	12.5%
Other Miscellaneous	**$ 15,923**	**$ 2,190**	**$ 9,838**	**$ 11,440**	**$ (4,483)**	**-28.2%**
Total Operating Revenues	**$113,353**	**$ 97,824**	**$ 124,950**	**$ 130,760**	**$ 17,407**	**15.4%**
Average					**$ 5,802**	**5.1%**
Less one-time sources	*$102,453*			*$ 115,760*	*$ 13,307*	*13.0%*
Average					*$ 4,436*	*4.3%*

<ins>Economic Trends (Risk)</ins> – The foremost risk to the Port is an economic slowdown. The City and County of San Francisco has enjoyed an extended period of economic expansion. Lasting approximately nine years, from 2009 to today, this period of growth is the third longest in U.S. history since 1945. Given that it would be an historic anomaly to avoid a recession in the next five years, the City is projecting lower revenue growth rates through FY 2021-22. The Port must watch key business lines for cooling; both for its own sake and to help the City detect and prepare for a shift in the overall state of the economy.[2]

Figure 1: Vulnerable Business Lines. The business lines filled in darker shades of gray are more vulnerable during times of recession.



As detailed in **Figure 1**, half of the Port's portfolio (lighter gray), including other Maritime business

[2] Mayor Mark Farrell released Executive Directive on May 8, 2018 directing department heads to notify the Mayor of signs of economy slowdown and provide solutions to help the City respond and mitigate impacts. See, "News Releases," http://sfmayor.org/article/mayor-mark-farrell-announces-additional-plans-city-prepare-and-recover-next-economic.

lines, ground rents from leased facilities, and parking, are all expected to be relatively stable through an economic downturn. The other business lines (medium and dark gray) including percentage rents/parking, cruise and cargo are all subject to softening in the event of an economic recession, as outlined in more detail below.

Slowdown in Percentage Rents (Risk) – One key Port business line that is more vulnerable to changing economic conditions is percentage rent. While the strong economy in recent years supported considerable growth in all areas of the Port's Real Estate portfolio, signs of economic easing are emerging, particularly in percentage rents for restaurant, retail, and parking. The Port's percentage rents have remained steady over the last five years but have softened in recent months, mirroring both national and regional trends.

Due to the structure of parking operator agreements, which include higher participation by the Port in gross revenues and lower base rents, parking rent is particularly vulnerable to changing demand—as growth eases, the Port loses significantly more (over nine times more) per dollar in rent than in any other area of its percentage rents portfolio, where other base rents and percentage rents are more balanced.

This risk factor is also tied to shifting trends in the use of parking facilities, particularly in the use of ridesharing over driving and the public's preference for neighboring parking lots that are better-secured and maintained. Port staff is evaluating ways to realign parking services to meet demand and improve the stability of revenues through future operator agreements. In the near-term, however, the Port may observe slowing growth or even a decline in parking revenues.

Delayed Leasing (Risk) – The proposed budget includes $1.6 million in FY 2018-19 and $3.8 million in FY 2019-20 for new leasing revenues generated from currently vacant facilities or facilities unavailable due to capital improvement work. However, the Port runs a risk of not meeting its leasing goals, including potential delays in securing tenants at Pier 29, Piers 19 and 23, and Pier 38.

Potential external delays to delivering leases include permitting, code compliance, on-going negotiation, and proposed changes from the waterfront land use plan, combined with the effects of a high construction cost environment on tenant improvement proposals. Additionally, the Port faces internal challenges of identifying adequate staffing to complete projects and developing professional services and construction contracts, and finalizing lease documents. All these factors make the timing of the delivery of these sites and associated revenues uncertain.

One-Time Sources (Risk/Opportunity) – The Port's FY 2017-18 projected revenues are projected to decline considerably from FY 2016-17 largely due to the completion of two major one-time revenue sources totaling $10.9 million. The forecasts for FY 2018-19 and FY 2019-20 improve, however, largely due to a projected one-time $15.0 million lease transaction assumed for each fiscal year ($30.0 million total). Should either event fail to take place, the Port's projected net position would decline and the Port's planned use of these funds to support its capital improvement program will be significantly impacted. Alternatively, if the transactions generate greater than anticipated one-time revenues, the Port's financial outlook could improve from current expectations. Given the Port's strategy of investing one-time sources into capital, any additional funds would eventually be converted to investments in fixed capital assets.

Cruise Terminal Revenues (Risk/Opportunity) – In the event of an economic slowdown, cruise dockage and wharfage revenues could decline as a result of fewer passengers. While cruise calls are scheduled in advance, the volume of passengers could decline as travelers opt to stay closer to home or choose alternative travel accommodations. One positive outcome of such a shift, however, would be a potential increase in available days for special events at the cruise terminal. With an estimated $22,000 in net revenues generated per event, ongoing activities at the James R. Herman Cruise Terminal could help stabilize Port revenues in the event of a downturn.

Cargo Volume (Risk/Opportunity) – Cargo volumes may be impacted during an economic downturn, as both auto transport and aggregate volumes would decline due to reduced demand for vehicles and construction materials. However, Port staff is actively pursuing growth in cargo operations at Piers 80, 94, and 96. Cargo volume at Pier 80 has doubled in the last two years under a terminal operating agreement with Pasha for automobile import/export operations. Port staff and Pasha expect cargo volume at Pier 80 to continue to grow as they work to execute a new partnership with a domestic auto manufacturer.

Improved Parameter Rents (Opportunity) – The Port adheres to a schedule of market rents through its parameter rent policy. The policy includes annual increases and allows the Port to keep its rental rates current with the market. The budget does not assume this increase and rents generated at the new standard will help ensure revenue keeps pace with current market conditions and inflation.

Updated Permitting Fees (Opportunity) – Port staff is evaluating its fees to understand if current fee structures adequately recover costs and are aligned with fees at sister agencies. The Department of Building Inspection, Planning Department, and Fire Department are all examples of departments that recover for their cost of service. In some cases, the Port has adopted the code of the issuing department, such as the Fire Department. However, in the case of building permit and planning fees, the Port can update its fee structure to align with the cost to deliver services and improve operating revenues. The Engineering Division is currently evaluating building permit fees and intends to bring an item to the Port Commission in the coming months.

Operating Expenses

Total Operating Expenses are projected to increase by $28.1 million (8.2% average), from $114.1 million in FY 2016-17 to $142.2 million in FY 2019-20. This change reflects increases in Operations & Maintenance Expenses of $30.6 million, or 34.9% over the three-year period. As detailed in **Table 7** below, this growth is driven by personnel ($7.3

million, 5.1% average), non-personnel including programmatic projects[3] ($11.2 million, 9.4% average), and significant capital projects that may not be capitalized ($12.0 million). In addition to this forecast, there are several factors detailed below of risks and opportunities that could affect the Port for worse or better.

Table 7: Projected Operating Expenses, FY 2017-18 to FY 2019-20

	AUDITED 2017	**CY 2018**	**BY 2019**	**BY+1 2020**	**Change**	**% Change**
Personal services	$ 47,998	$ 51,500	$ 53,996	$ 55,334	$ 7,336	15.3%
*Budgeted**	*34,856*	*37,832*	*39,782*	*40,551*	*5,695*	*16.3%*
*Net change in OPEB & pension***	*13,142*	*13,668*	*14,214*	*14,783*	*1,641*	*12.5%*
Non-Personnel	*39,700*	*46,613*	*51,318*	*50,892*	$ 11,192	28.2%
Contractual services	*11,660*	*8,419*	*6,212*	*5,060*	*(6,600)*	*-56.6%*
Utilities	*2,833*	*1,823*	*2,369*	*2,456*	*(377)*	*-13.3%*
Materials and supplies	*1,853*	*1,736*	*1,633*	*1,648*	*(205)*	*-11.0%*
General and administrative	*4,345*	*12,140*	*7,145*	*6,949*	*2,604*	*59.9%*
Interdepartmental Services	*19,009*	*12,843*	*19,759*	*20,118*	*1,109*	*5.8%*
*Programmatic Projects****	*-*	*9,652*	*14,200*	*14,660*	*14,660*	*100.0%*
Capital Projects - Planning ^	-	6,500	28,940	12,060	12,060	100.0%
Subtotal	$ 87,698	$ 104,613	$ 134,254	$ 118,286	$ 30,588	34.9%
Depreciation & Amortization	24,191	22,465	21,931	22,862	(1,329)	-5.5%
Non-budgetary accrual adjustments	2,186	(7,158)	1,038	1,038	(1,148)	-52.5%
Total Opps. & Maintenance	**$114,075**	**$ 119,920**	**$ 157,224**	**$ 142,186**	**$ 28,111**	**24.6%**
Average					*$ 9,370*	*8.2%*

** Assumes 3% of personnel costs are capitalized or positions are held vacant*
*** Applies CPI to current liability; this is a variable line item that is very difficult to estimate.*
**** Project-based costs have not been audited and are reflected in their project detail.*
^ Funding supports planning and design phase of capital, which is reflected an an operating expense.

<u>Continued Growth in Pension and OPEB Obligations (Risk)</u> – In recent years GASB has required governments to adjust their financial statements to reflect unfunded obligations for pension and retiree health care benefits. The adjustments, including $13.1 million in FY 2016-17, have significantly increased the Port's liabilities with ongoing impact to the Port's operating expense calculations. The Controller's Office has indicated to departments that another such adjustment may be required to be applied to the current and ongoing fiscal years. While they do not have a current budget impact, these non-cash liabilities reduce the Port's net income and balance sheet.

<u>Shipyard (Opportunity/Risk)</u> – The Port has issued a Request for Proposals seeking a new operator for the shipyard at Pier 70 with a lease of at least ten years. The Port is in the midst of this process and anticipates Port Commission approval of a candidate in

[3] Programmatic projects are not budgeted at the expenditure type detail, whereas the Port's financial statements report on actual expenditures. **Table 7** reflects the programmatic projects but rolls them into "non-personnel" with the assumption that expenditures will occur in this broader category.

late September, and a signed lease agreement by the end of December 2018. Once the lease is executed, the Port may benefit from additional non-operating contributions to capital that will improve the Port's assets and financial position. Alternatively, if the Port does not secure an operator, it will face a significant decision about how to maintain a facility with considerable ongoing operating and capital costs and no income stream. Currently, the Port is spending approximately $188,000 per month to maintain the shipyard in a steady state.

Non-Operating Income and Expenses

As the review of the Port's prior financial statements showed, and as very clearly articulated through the Port's Ten-Year Capital Plan, external funding sources are a critical aspect to improving the Port's financial position and are the primary strategy for the Port to complete enhancement projects. In the current year and proposed budgets, the City's General Fund and other departments are contributing to the Mission Bay Ferry Landing Project and the Seawall Program. Additionally, the Port is seeking $24.7 million from Regional Measure 3 in the June 2018 election to support the Mission Bay Ferry Landing and a proposed $425 million General Obligation Bond in the November 2018 election to support the Seawall Program. Together, these sources are projected to increase total non-operating income by $20.6 million, as detailed in **Table 8** below.

Table 8: Projected Non-Operating Income and Expenses, FY 2017-18 to FY 2019-20

	AUDITED 2017	CY 2018	BY 2019	BY+1 2020	Change	% Change
Non-Operating Income/(Expense)	$ 970	$ 6,500	$ 28,940	$ 12,060	$ 11,090	1143.3%
*Mission Bay Ferry Landing, City Funding**	-	*3,500*	*11,000*	-	-	*0.0%*
Mission Bay Ferry Landing, RM3^*			*12,940*	*12,060*	*12,060*	*100.0%*
*Seawall Program, City Funding**	-	*3,000*	*5,000*	-	-	*0.0%*
Grants & Other Contributed Capital	1,822	-	-	11,353	9,531	523.1%
*Seawall Program, GO Bond^*	-	-	-	*11,353*	*11,353*	*0.0%*
Subtotal, Non-Operating	**$ 2,792**	**$ 6,500**	**$ 28,940**	**$ 23,413**	**$ 20,621**	**738.6%**

DISCUSSION & FINANCIAL STRATEGIES

Looking back at the prior five fiscal years, the Port's net financial position gradually improved but showed signs of operating weakness due to growing personnel obligations and depreciation estimates. Staff projects that financial trend will continue and lead to a decline in the Port's net position. Including depreciation, expenditures are projected to significantly outpace revenues with each of the next three fiscal years.

The Port sees many opportunities to improve this outlook, but also sees risks – including the likely onset of an economic decline – that could further challenge the Port's financial position. To address these trends, the Port must actively leverage its financial and management tools. Four examples of strategies recommended by staff are detailed below.

Continue to Manage Operating Expenses

As the Port continues to experience increases in personnel expenses, including collectively bargained salary and mandatory fringe benefit costs, professional services and charges for services from other City departments, Port staff must manage these expenses very closely, ensuring that they are directly tied to core Port operations and delivery of key initiatives. The proposed FY 2018-19 and 2019-20 budget includes expenditures in strategic areas including California Environmental Quality Act (CEQA) approval of the updated Waterfront Land Use Plan and project-funded staffing to support delivery of the Pier 70 and Seawall Lot 337 development projects. In addition to careful budgeting, the Port has begun an update of its nexus study, a tool staff uses to ensure that payments to other City departments cover only those services requested and consumed by the Port and that those payments reflect the true cost of service. The nexus study helps staff to manage the ongoing flow of resources out to the City and ensure that they support Port operations.

Further Diversify Revenue Streams

In its recent rating of the Port's debt portfolio, Fitch Ratings found that the Port's revenue portfolio was relatively diverse.[4] By relying on a balance of leasing, parking, and maritime activities, the Port has shown that it can adapt to changing conditions, such as a recession or elimination of an individual business line. However, Port staff is exploring ways to improve the structure of current income streams, collect fees that sufficiently recover for the cost of delivering services, and identify new sources of income to supplement the Port's revenue base.

The Port believes that the Southern Waterfront currently presents the greatest area of opportunity for revenue growth and diversification. Port staff is actively pursuing a strategy of eco-industrial development at Piers 80-96. The development of the automobile cargo business and the potential for lease revenue offered by the Backlands demonstrate that the Port can successfully identify and move into new lines of business through both its Maritime and Real Estate Divisions. While the Southern Waterfront offers the ripest area for growth, this analysis illustrates the need for the Port to continue its efforts to expand revenue opportunities throughout its portfolio.

Maintain and Expand External Funding Sources

In light of its estimated $900 million capital backlog the Port has long understood that it must pursue external funding sources to address deferred maintenance in its facilities and support improvements to its assets. Its success in gaining access to the City's General Obligation Bond program for improvement and development of parks and open

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[4] Each year the Port's rating agencies, Fitch Ratings as well as Standard & Poor's (S&P), review the Port's financial condition for bondholders. In February 2018 Fitch determined an A Stable rating for the Port on $52.9 million revenue bonds. See, "Fitch Affirms Port of San Francisco, CA's Revenue Bonds at 'A'; Outlook Stable," *American Journal of Transportation*, https://www.ajot.com/news/itch-affirms-port-of-san-francisco-cas-revenue-bonds-at-a-outlook-stable.

spaces demonstrates that the Port can persuade both policy makers and voters to include the Port when allocating Citywide capital resources. Port staff will continue to pursue GO Bond, General Fund, grant funding and other external sources to work through its capital backlog and improve facilities both for the benefit of the public and to create leasing opportunities.

To that end, the Port is actively pursuing other local, state, and federal sources to fund the Mission Bay Ferry Landing and the Seawall Program. Additionally, the Port has a strong history of working with development partners to leverage external funding to rehabilitate aging infrastructure, including projects with the Exploratorium at Piers 15-17, Orton Development at the Pier 70 - 20th Street Historic Buildings Site, and Forest City at the Pier 70 Waterfront Site.

The proposed Request for Interest (RFI), is a critical next step to engage additional private partners in the improvement of Port assets.[5] This effort to solicit feasible improvements to 13 of the Port's historic assets has the potential to address facility renewal needs as well as protect and activate the Embarcadero Historic District, so the public can enjoy these valuable resources.

Also, with the establishment of a new Capital Improvement Program, as described in **Item 13A**, the Port has prioritized capital projects that staff may seek external funding to support. Port staff will monitor grant opportunities and other fiscal tools that may be used to bring additional resources to the table. Port staff expects that these combined efforts will increase grants and other contributed capital and help to improve the Port's financial position over time.

Prioritize Project Delivery

The financial statements and forecast show that the Port's "current and other assets" have grown over time, of which $154 million is the Port's cash balance. With several years of sustained revenue growth and the Port's policy to allocate 20-25% of operating revenues for capital, the Port has actively increased capital funding. However, capital projects require environmental work, permitting and design to complete delivery. As capital funding increased over time, the Port did not add engineering staff to tackle this growing workload. As a result, $91.5 million (59%) of the Port's cash balance is designated to the Port's existing capital program. This balance will further increase with the next capital appropriation for FY 2018-19. While this cash is reflected as a Port asset, until it is converted to actual improvements in facilities, investments will not outpace the depreciation and amortization of fixed assets. Also, by not delivering projects, the Port may lose existing income and will forgo revenues from new leasing opportunities that will enhance operating revenues substantially.

[5] See, Port Commission Item 12A, "Request Authorization to Issue a Request for Interest from Prospective Master and Smaller Tenants for Public Oriented Concepts for Historic Pier Facilities in the Embarcadero Historic District. (Resolution 18-31)," at: https://sfport.com/sites/default/files/Commission/Documents/Item%2012A%20RFI%20authorization.pdf

To address this challenge, Port staff has developed a staffing strategy to deliver its capital improvement program. One major step in this effort is the proposal included in the FY 2018-19 and 2019-20 budget to establish a new Project Management Office (PMO). The PMO will include staff specifically tasked with the delivery of capital projects, to increase the number of projects completed annually. Additionally, staff is currently evaluating alternative project delivery options, such as new models for contracting (e.g. design-build) that may improve efficiency in time and cost. The proposed RFI for historic structures, noted above, is another a delivery option that will enable the Port's project partners to complete projects.

As the Port enhances its delivery of capital projects and works through its deferred maintenance backlog, it will convert cash into increased value in capital assets, improve public access to facilities and create new opportunities for lease revenue.

CONCLUSION

The Port's financial forecast for the current and next two fiscal years reflects a declining financial position. As stated in this analysis and financial reports before it, the Port must continue to control operating expenditures, identify and pursue opportunities for additional revenue generation and leverage relationships with private sector investor-partners and public agencies to create strategic opportunities to improve its financial outlook. While there are a variety of key development initiatives that the City will actively pursue, the Port must also focus on projects that deepen its revenue base to support both growing operational demands and the critical repair and replacement demand of the Port's waterfront infrastructure, including the Seawall. The Port Commission and staff will need to make difficult decisions and remain vigilant in implementing policies and procedures to protect the Port's assets and financial stability for generations to come.

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