MEMORANDUM

October 7, 2022

TO: MEMBERS, PORT COMMISSION
Hon. Willie Adams, President
Hon. Kimberly Brandon, Vice President
Hon. John Burton
Hon. Gail Gilman
Hon. Steven Lee

FROM: Elaine Forbes
Executive Director

SUBJECT: Informational presentation on financial matters including a proposed amendment to the Port's operating reserve policy

DIRECTOR'S RECOMMENDATION: Information Only – No Action Required

EXECUTIVE SUMMARY

The dramatic revenue reductions caused by the COVID-19 pandemic created unprecedented pressures on the Port. In Fiscal Year (FY) 2021-22, the Port's revenues were less than its expenses, resulting in an operating loss. Due to this loss, the Port failed to meet a debt coverage ratio requirement for its revenue bonds, and as a result hired a consultant to recommend financial adjustments to improve its coverage ratio. These recommendations include adjusting tenant rent as the market recovers, reducing costs incurred for services by the Fire Department, reviewing operating efficiencies with other City departments, and improving various internal financial practices.

In addition to the analysis to improve its debt coverage ratio, Port staff reviewed the Operating Reserve Policy, created in 2008, which requires reserves equal or greater to 15% of annual expenses. Staff recommends updating the policy to reflect actual Port practices and the risks unique to the Port enterprise by increasing the reserve requirement to 50% of annual expenses.

While the recent award of $117 million in stimulus from the State of California has provided a needed short-term reprieve from the financial impacts of COVID-19, the return of tourism and the improvements discussed in this report will improve the long-term financial strength of the Port.

BACKGROUND

The Port is proud of its strong ‘A/Aa3/A’ bond ratings. Rating agencies regularly review Port finances, and often cite our large fund balance and strong fiscal policies as critical components of their rating. While our ratings are stable[1] and the Port has made all debt service payments on time and in full, the revenue losses due to the COVID-19 pandemic caused the Port to fail one of its two debt service coverage ratio requirements for the first time in its history.

Under the bond indenture, which is our agreement with bond holders, the Port must meet the following two coverage ratio requirements:

1. The Port’s operating income (revenues less expenses) must be at least equal to or greater than 1.0x the Port’s revenue bond debt service, and

2. The Port’s operating income plus amounts in fund balance[2] must equal or be greater than 1.3x the Port’s revenue bond debt service.

In FY 2020-21, the first full fiscal year of the pandemic, the Port failed to earn positive operating income and therefore failed the first coverage requirement. However, because of the Port’s large fund balance, the Port satisfied the second requirement.

Of critical importance, this initial ratio failure was not an event of default. Under the bond indenture, the coverage failure in FY 2020-21 required the Port to hire a consultant to review its operations and provide recommendations to improve its coverage ratio.

COVERAGE IMPROVEMENT RECOMMENDATIONS

In January of 2022, the Port retained Keyser Marston to provide the analysis required by the indenture. In June, Keyser Marston issued a report which made a number of recommendations, which Port staff placed into 3 categories as shown below.

1. Adjust as the Market Recovers
    a. Phase out rent concessions as market conditions improve
    b. Consider rent increases in sectors less impacted by COVID-19, such as parking, storage, and lay-down space

To phase out rent concessions and increase rents, Port staff is dependent upon the real estate market allowing for such adjustments. In the parameter rates adopted by the Port Commission in August 2022, staff eliminated the rent concessions for shed spaces

[1] Last affirmed at by Fitch in May 2022: https://www.fitchratings.com/research/us-public-finance/fitch-affirms-port-commission-of-san-francisco-at-a-outlook-stable-06-05-2022
[2] The bond holder agreement refers to a Revenue Stabilization Fund in the coverage requirement. The Port’s fund balance serves as the Revenue Stabilization Fund; therefore, this report uses the more common term fund balance.

but retained concessions for new office leases of at least three years. As conditions improve, staff intends to continue increasing rates wherever possible. Any changes to the parameter rent schedule will be subject to Port Commission approval.

2. Inter-agency savings
    a. Reduce fireboat expenses by following the agreed formula in executed MOU with the Fire Department
    b. Review the overhead costs charged by the City Attorney for possible efficiencies.

Port staff will begin conversations with the appropriate departments in light of Keyser Marston's recommendation and will report the results to the Commission.

3. Internal financial practices
    a. Review the process for categorizing expenses as operating or capital for the purposes of financial statements and coverage calculations
    b. Use stimulus funding to reduce operating expenses to improve coverage calculations
    c. Explore revising the bond holder agreement to modify coverage requirements

Port staff has begun to initiate the recommendations in this category. Staff has already (a) reviewed internal practices for categorizing expenses, and will implement those improvements when calculating the FY 2021-22 debt coverage ratio, (b) allocated stimulus in the FY 2022-23 and FY 2023-24 budget to offset operating expenses, further improving the Port's coverage ratio and (c) discussed the possibility of refinancing the Port's debt to change the coverage ratio calculation. In consultation with the City Attorney and bond counsel, staff determined that revising the bond holder agreement would be unfavorable because the change would be anomalous in the market and might raise concern by the rating agencies.

OPERATING RESERVE AMENDMENT

In February 2008, the Port Commission adopted the Port's current Operating Reserve Policy through Resolution No. 08-12, requiring an operating reserve of at least 15% of annual operating expenses equal to at least two months of essential expenses. At the time of adoption, the Port's policy followed the recommendation of the Government Finance Officers' Association (GFOA).

The Port's fund balance serves as its operating reserve and has far exceeded the minimum 15% in every year since 2008. At the end of FY 2018-19, prior to the COVID-19 pandemic, the Port's fund balance equaled 67% of annual expenses. During the pandemic, fund balance dipped as low as 50% of annual expenses (end of FY 2020-21) but is now on an upward trajectory due to the Port's successful application for $117 million in stimulus funds.

Since adoption of the Operating Reserve Policy, the GFOA amended its best practices guidelines to no longer recommend a specific percentage, but instead recommend a level of reserve that takes into account each public entity's own unique circumstances.

Given the economic uncertainty that COVID-19 imposed upon the Port and the need to utilize fund balance to offset revenue losses, the Port contracted with its financial advisory firm Backstrom, McCarly, Berry & Co., LLC to review its Operating Reserve Policy. On March 5, 2021, Backstrom issued the following recommendation:

> *We recommend building and maintaining the operating reserve at least equal to 6 months of the operating budget when businesses re-open and the local economy returns to normalcy. Until then and while this crisis endures, a strategy to maintain a reasonable unrestricted fund balance of 2 to 3 months to ensure that the Port has the budget resources to maintain operations in a scenario that requires the Port to seek BOS approval to reappropriate portions of its large unspent capital funds.*

Port staff proposes implementation of this recommendation, revising the Port's mandatory operating reserve to a minimum of 50% of annual operating expenses (or six months), and during any economic crisis to ensure the reserve falls to no less than 25% (or three months).

CONCLUSIONS

While the recent award of $117 million in stimulus from the State of California has provided a needed short-term reprieve from COVID-19, the return of tourism and the policy improvements discussed in this report will support financial stability and improve the long-term financial strength of the Port.

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