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City of Desert Hot Springs

REPORT ON
CANNABIS CULTIVATION

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Contents

I. INTRODUCTION

At the November 4, 2014 special election, the voters of the City of Desert Hot Springs passed and adopted two (2) taxes in connection with the City's Medical Marijuana Program. The two taxes are summarized in Table 1 below.

Table 1

Measure	Cultivation Tax (Measure HH)	Sales Tax – Dispensary (Measure II)
Tax Structure	A biannual tax of twenty-five dollars and fifty cents ($25.50) per square foot for the first 3,000 square feet of cultivation, and ten dollars and twenty cents ($10.20) per square foot for the remaining space utilized in connection with the cultivation of cannabis.	A monthly 10% tax on proceeds from the sale/provision of cannabis.

Shortly thereafter, City Council adopted ordinances which permit the establishment and operation of medical marijuana facilities in the City, subject to obtaining a conditional use permit and a regulatory permit.

With voter approval, the adoption of ordinance, and a regulatory permit process in place, the City was one of the first in California to establish a cannabis program. Over the years, many municipalities have tried to mirror the structure and success of the City's program. In fact, many local agencies have adopted very similar cultivation and dispensary fees. The City is, however, one of the few in the State that does not charge for cannabis related manufacturing.

Annual cultivation revenues now exceed $2.7 million from ten (10) operational facilities with an average taxable square footage of 24,647. Cannabis revenues have become the City's second largest revenue source and possibly its most resilient revenue source during economic downturns. By aggressively implementing a cannabis approval process and regulatory structure, the City was able to secure a substantial investment in the community from the operators of cannabis facilities. These investments have created employment opportunities and a vital and much needed revenue stream to fund essential services within the City. While the City has had success in anchoring the cannabis industry in Desert Hot Springs, additional opportunities to grow and diversify this economic sector will require the City to make well informed financial and policy decisions. Taking advantage of these opportunities will require patience for the industry to mature as supply chains are created and adjusting to industry growth, creative entrepreneurial City-inspired programs as outlined below, and the discipline to stay the course.

Urban Futures, Inc. (UFI) was engaged by the City to provide a high-level assessment of the fiscal health and stability of the City's cannabis cultivation tax structure, and to provide recommendations for actions to address known and anticipated fiscal impacts from the tax structure changes and economic development opportunities. To prepare this report and analysis, UFI worked with City staff from the following departments Finance, Community Development, Administration and City Attorney and relied on the City's historical data, published financial documents, cannabis cultivation reports and projections, cannabis tax surveys, Conditional Use Permit (CUP) applications and current economic development opportunities.

The analysis, findings and policy considerations are presented in this report for use by City staff and elected officials. The report provides findings regarding the City cannabis taxes (based on surveyed agencies) and policy considerations on tax and operational changes that may improve the stability and sustainability of cannabis revenues and the industry operating within the City. The analysis also suggests the City's investment in the cannabis industry locally would likely lead to significant long-term benefits when compared to modest tax structure adjustments. It is our belief tax structure adjustments would not guarantee additional stable growth within the industry or significant job growth. Furthermore, an adjustment of the tax structure down, as a public policy decision, should identify the public benefit prior to a change in tax structure and an immediate reduction in revenue to the City.

II. SUMMARY CANNABIS TAX STRUCTURE

A. Review of State, Local and Regional Taxes

We began our engagement by building a high-level cannabis tax survey. The survey is a sample limited to local and regional agencies for this report and the analysis was not intended to provide a state-wide view of all municipalities with cannabis taxes. Additionally, because the survey is limited we did not compare land values, utility costs/availability or other municipal taxes impacting cultivation businesses state wide. Instead, the survey developed for this report is intended to serve as an initial assessment tool of the City's cannabis tax structure and to provide a basis for identifying policy considerations which the City Council can consider actions to address constraints and opportunities.

The cannabis tax survey is designed to be a politically neutral, fiscal assessment that establishes an agreed-upon common understanding of the status quo: if the City makes no changes to its regulatory practices and there are no significant external regulatory impacts to cannabis cultivators and dispensaries, what is the assumed direction of the cannabis industry in Desert Hot Springs? Working with staff, we collected the necessary data required to understand, aggregate, and perform a brief analysis of the City's cannabis program and its impact of current and future cannabis-related businesses. We worked to ensure a general level of reconciliation between the financial data reported by staff and the survey data used for this report. We also looked to isolate tax variances that can distort an accurate picture of the surveyed cities, namely those that include a tax on manufacturing, and to disaggregate several approved cultivation businesses that are not yet operational.

We are aware of the annual adjustments to cultivation tax rates as required by the Cannabis Tax Law. Effective January 1, 2020, all local cultivation tax rates reflect an adjustment for inflation. The adjusted rate for each category (shown below) represents a roughly 4% increase in monthly and quarterly cannabis tax returns to the State beginning January 1, 2020. For the purposes of this report, we assume this is the only annual adjustment for cultivators within the surveyed agencies.

CANNABIS CATEGORY	2019 RATES	RATES EFFECTIVE 1/1/2020
Flower per dry-weight ounce	$9.25	$9.65
Leaves per dry-weight ounce	$2.75	$2.87
Fresh cannabis plant per ounce	$1.29	$1.35

B. Key Assumptions in Cannabis Tax Survey

The following are key assumptions for purposes of understanding our cannabis tax survey and analysis. The findings in this report reflect cannabis taxes currently in place for the surveyed agencies and only address possible policy considerations for Desert Hot Springs, and otherwise assume a status quo condition that may be untenable as a result of the COVID-19 pandemic.

Cannabis taxes in the survey include taxes assessed by square footage and by percentage of total sales. The indices and variables used by each agency to adjust the tax rate appear to be primarily derived from local and regional policy preferences appropriate for the surveyed agency's own revenue, level of service costs, and other local considerations. Except for the State of California, under or over performance of the cannabis economy has yet to lead to broad changes in cannabis taxes structures. This is due to many factors including the growing maturity of supply chains for cultivators as the legal cannabis industry is still in its infant stages, availability of necessary utility infrastructure and real property zoned for cannabis businesses.

> **The cannabis tax analysis does not address possible impacts from a recession.** There is no reliable method to accurately predict the timing, magnitude, duration and consequence of the next economic contraction or recession, and the impact to the cannabis industry and its various local revenue streams. This is evident during the current COVID-19 pandemic, which is occurring during the drafting of this report, resulting in roughly $500,000 to $600,000 in budget reductions for FY 2020-2021 in the City. Recessions occurring after 1945 have peak-to-trough declines in the Gross Domestic Product (GDP) ranging from a low of 0.3% to the Great Recession's 4.3% decline from 2008 through 2012, with an average of 2.21%. These declines have had varying impacts on local government revenues. Some revenues like the sales tax

(monthly revenues, trued-up quarterly) reflect an immediate impact, while others like the property tax (with an annual lien date) have an effective one-year lag in recognizing economic impacts. In Desert Hot Springs, the City lost over $9 million in property tax revenues during the Great Recession. For long-term liabilities like pensions or adjustable debt, the full impact can take even longer to appear because of amortization or "ramping" provisions.

The City's FY 20-21 Budget assumes no growth in cultivation revenues from the prior year. However, it is prudent to pay attention to cannabis revenues during this period as this will be the first significant economic contraction since the passage of the taxes and implementation of the City's regulatory program. Depending upon the duration of the pandemic and its impact on the local economy, a significant impact may be avoidable to cannabis businesses based on their "essential" status and remain open and operational during the pandemic. As such, and given the importance of annual tax revenues, we believe the City should closely monitor cultivation performance during this pandemic period as a form of "stress-testing" cannabis revenues to measure resiliency and stability as a source of General Fund revenue. A modification of tax rates up or down now would significantly impair the City's ability to understand and predict the impact of future recessions on the cannabis industry.

Taxes from the survey tell only part of the story. As sited above, cannabis revenues and industry performance have yet to be stress-tested through an economic downturn. Despite the limited history of tax collection and long-term trend analysis, it is imperative for the City to monitor cannabis tax revenues closely and maintain a positive relationship with local businesses by keeping lines of communication open and offering to meet with local industry leaders on a regular basis. Industry changes, either through revenue augmentation or new business practices, often takes years to accomplish and see financial results. Thus, it is important for the City to maintain a long-term financial and public benefit perspective when making strategic decisions regarding cannabis business regulations and taxes. It is highly probable given the number of CUP amendments to convert cultivation square footage into distribution square footage supply chains are still developing and must be given time for full implementation before regulatory adjustments impacting City revenues and services are considered. This is one of the advantages the City has with its established program versus others just starting.

It's possible municipalities within the survey will amend fees and taxes for cannabis businesses in the future for three reasons: 1) newly established cannabis programs in cities like Lake Elsinore and San Bernardino now include incentives for cultivators to open businesses in those cities; 2) annual inflationary adjustments by the State could impact future tax schedules; and 3) the impacts of COVID-19 may lead to significant closure of businesses operating within cannabis cultivation zones leaving a surplus of vacant facilities. Because cannabis cultivation facilities are high revenue generators requiring a very low level of services, surplus facilities may become an economic development target for municipalities seeking to restore reduced services through new cultivation tax revenues.

Cannabis tax revenues may adjust for the growing cost of City services. Most City established fees and taxes are derived from state, county and local voter approved measures. The taxes established for cannabis were voter approved and implemented by ordinance and may adjust by an annual consumer price index (CPI). The City has adjusted cannabis taxes by CPI once since inception, and according to staff, does not plan an adjustment for FY 20-21.

Because the City must compete state wide for cannabis cultivation businesses, economic development programs focused on building local supply chains can become a pillar of the City's economic development program to support, grow and sustain a healthy cannabis industry within the City limits. City staff, as well as consultants, continue to allocate significant amounts of time and resources to the cannabis industry. In fact, the City has hired an economic development manager to focus on development opportunities city-wide while staff within the City Manager's Office continues to focus on cannabis opportunities. For example, City staff has attended the International Council of Shopping Centers (ICSC) conference in Las Vegas, hosted numerous developer meetings with cannabis prospects, and is pursuing opportunities to expand business opportunities for existing cultivators and dispensaries. The City is allocating well over $100,000 annually from the General Fund to enhance and sustain community services targeted at growing the cannabis industry. A continued, and focused, reinvestment back into cannabis will drive new opportunities in the future. As supply chains expand and mature, existing businesses can grow and new cultivation business will open. Based on trend analysis provided in the report, the growth opportunity for the City is likely to be led by manufacturing opportunities as cultivators find buyers facilitating expansion.

C. Cannabis Tax Survey – Regional and Local Agencies

The table below contains the cities used for the tax survey. As noted in Section II above, the surveyed cities have a variety of tax structures. For example, the surveyed cities in Riverside County tax retail as a percentage of revenues and cultivation by square footage. Based on the survey, Desert Hot Springs is within the average and competitive for retail sales when compared to other Riverside and Coachella Valley cities. The City, however, has a unique tax structure for cultivation of twenty-five dollars and fifty cents ($25.50) per square foot for the first 3,000 square feet of cultivation, and ten dollars and twenty cents ($10.20) per square foot for the remaining space utilized in connection with the cultivation of cannabis. Based on the average square footage cost of $12.27 the City is competitive, but the $25.50 for the first 3,000 square footage may be viewed as an outlier and discourage new investment. When combined with a zero tax for manufacturing, labs and distribution, this is important when considering the following:

- The average square footage of an operational cultivation facility is 24,674 square feet reflecting a reduction in cultivation square footage and increased manufacturing;
- The average square footage may increase as new cultivators with approved CUPs are online, but remains unknown; and
- The average square footage cost is below the $13.25 average within the Coachella Valley, driven primarily by several larger cultivation facilities (i.e., those over 30,000 square feet).

<table>
<tr><th rowspan="2">City</th><th colspan="2">Retail</th><th colspan="2">Cultivation</th><th colspan="2">Manufacturing</th><th colspan="2">Distribution</th><th colspan="2">Lab Testing</th><th rowspan="2">County/Region</th></tr>
<tr><th>M</th><th>C</th><th>M</th><th>C</th><th>M</th><th>C</th><th>M</th><th>C</th><th>M</th><th>C</th></tr>
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<tr><td>Lake Elsinore</td><td colspan="10">Developer Agreements</td><td>Riverside</td></tr>
<tr><td>Moreno Valley</td><td colspan="2">8%</td><td colspan="2">$15/sq. ft</td><td colspan="2">8%</td><td colspan="2">8%</td><td colspan="2">UN</td><td>San Bernardino</td></tr>
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<tr><td>West Hollywood</td><td>0%</td><td>7.50%</td><td>0%</td><td>7.50%</td><td>0%</td><td>7.50%</td><td>0%</td><td>7.50%</td><td>0%</td><td>7.50%</td><td>Los Angeles</td></tr>
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<tr><td>Bellflower</td><td colspan="2">5%</td><td colspan="2">$15/sq. ft</td><td colspan="2">5%</td><td colspan="2">5%</td><td colspan="2">5%</td><td>Los Angeles</td></tr>
</table>

La Puente	10%		10%		10%		10%		10%		Los Angeles
Culver City	5%	6%	$12/sq. ft		4%		2%		1%		Los Angeles
Lynwood	2-2.5%		$10-12.50		2-2.5%		2-2.5%		2-2.5%		Los Angeles
Carson	N/A		$25/sq. ft		18%		18%		18%		Los Angeles
Pomona	6%		$2-10/sq. ft		4%		3%		3%		Los Angeles
San Diego	0%	5%	0%	5%	0%	5%	0%	5%	0%	5%	San Diego

M= Medical; C= Commercial

The above survey does have its limitations. For example, the survey does not take into consideration several other factors necessary to fully evaluate the City's competitiveness including:

- Square footage used for non-taxed services;
- Application and regulatory fees;
- Annual State inflationary adjustments;
- Cost of real property;
- Local tax structure;
- Available utilities; and
- Zoning area and available buildings to reuse as cultivation facilities (i.e., supply and demand)

Despite the survey limitations, we believe staff's regulatory experience and ability to focus on cannabis opportunities has kept the City competitive when considering all the factors above. As cultivation and manufacturing grows state wide, the City will need to review its structure to remain competitive while meeting funding needs for current and desired city services.

SUMMARY OF FINDINGS

III. POLICY CONSIDERATIONS FOR FISCAL AND CANNABIS INDUSTRY SUCCESS

As stated in the introduction, annual cultivation revenues in the City exceed $2.7 million. Total revenue, however, is only one measure of success. The important drivers beneath the annual revenue figures are leading indicators of operational and fiscal health of the City's cannabis cultivation industry and tax base. Those drivers include the following:

1. number of operational facilities;
2. average annual taxable cultivation square footage;
3. quantity of flowers grown per square foot; and
4. average price of flowers.

A. Understanding Saturation Indicators

The legal marijuana industry in California and the United States has come an exceptionally long way in just a few years. Initially, only a handful of states allowed medical marijuana when prescribed by a physician, and a Gallup survey found that just one out of three Americans supported legalizing marijuana at the national level. Today, two out of three Americans surveyed by Gallup favor legalizing marijuana nationally, 33 U.S. States have given the green light to medical marijuana (including ten (10) that also allow recreational cannabis), and Canada has become the first industrialized country worldwide to legalize adult-use cannabis.

Everything would seem to align with significant growth for the cannabis industry in the City, but the supply chain for cultivators must avoid a looming reality. Growers are still in the process of building out their capacity. With 46 pending cultivators with CUP approval in Desert Hot Springs, cannabis growers are still in capacity expansion mode for the recreational market. Without the identification and implementation of performance measures, policy decisions aimed at increasing cannabis opportunities go unmeasured and could negatively impact supply chains supporting current demand. Left unchecked a state wide push for more cultivation will lead to oversupply, a steep decline in cultivation revenues, and ultimately a failing cultivation business.

With ten (10) operational cultivation facilities, the local cultivation market would appear to reflect no appearance of saturation or risk of oversupply. However, recent CUP amendments raise question as to why cultivation square footage is being converted to manufacturing, which is not taxed under the City's tax structure. Anecdotal evidence suggests the City's tax structure is the leading basis for the CUP amendments and slower pace of new cultivation businesses. However, there is sufficient evidence to suggest as more cultivation facilities go live state wide, and supply chains grow, manufacturing is or will soon be a growing opportunity locally which could lead to a declining square footage for cultivation. While this is not an eminent threat, a trend is beginning to emerge, and the City should begin working with cultivators now to develop a growth plan beneficial to both parties.

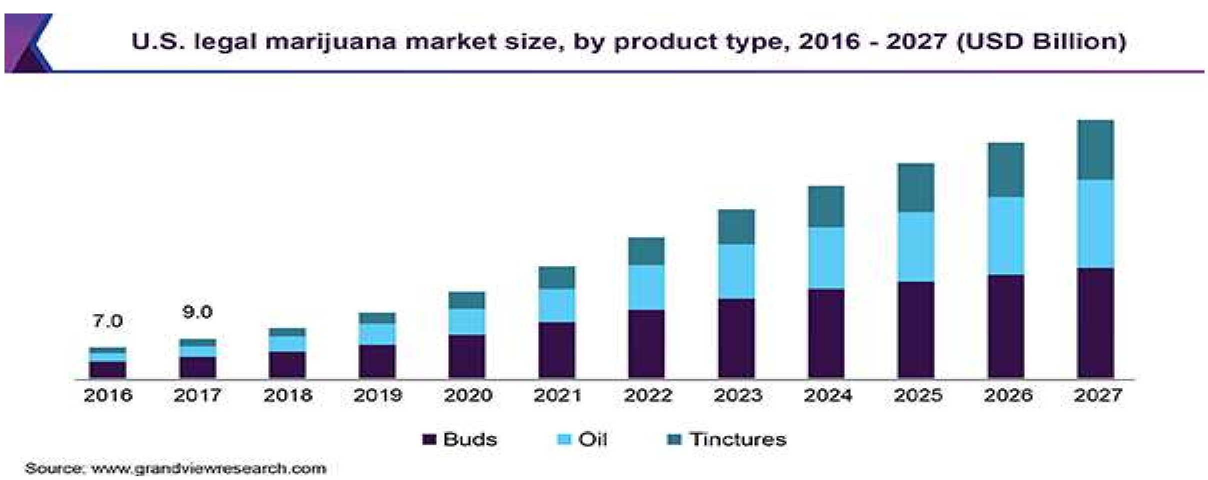
B. Creating a Cultivation Inventory Index

We believe the City can expand existing cultivation, manufacturing, distribution and lab businesses in the City by working with cultivators to develop a cultivation inventory index that accounts for and measures the quantity, price and the end use (buds, oils and/or tinctures). Taking this a step further, the inventory index could ensure local cultivators have a diversity of product available for distribution/manufacturing/labs while pursuing the highest quality of products and those in greatest demand. Additionally, the index could be used for the City for economic development purposes with the goal of expanding supply chains and product innovation for local cultivators. By measuring and expanding demand for various products, cultivators will have sustained pricing which is key to future business growth and for the City to have revenue resiliency. Additionally, the cannabis inventory index could lead to economic gains through a branding of "Grown in Desert Hot Springs" cannabis and new demand through a City wellness program linked to local spas. A win-win for the City and its local businesses.

C. Understanding Cannabis Beyond the Regulatory Environment

The United States legal marijuana market has an estimated value of $15.6 billion and is expected to expand at a significant compound annual growth rate (CAGR) over the next ten (10) years.[1] Not surprisingly, the use of cannabis for medical purposes is the leading demand, equal to 71% of all revenue in 2019. However, demand for recreational use is growing. In fact, according to a recent Grant View Research report studying legalized cannabis, by 2027 adult-use is expected to emerge as the fastest-growing segment. Adult-use or recreational cannabis is defined as any use of cannabis apart from medical purposes. Such growth presents an opportunity and challenge for the City. With 46 CUP-approved cultivation facilities in the waiting, the City is ready for the next wave of growth. However, because cannabis cultivation businesses are allowed throughout California, competition among cultivators is not limited to local or regional markets for new customers and the City's cannabis tax structure and revenue objectives should be reviewed on regular basis.

Based on product type, the legal marijuana market is segmented into three (3) categories: buds, oils, and tinctures. As depicted in the chart below, buds segment dominates the market in demand and annual revenue, while the oil segment is likely to outpace the growth of buds over the next ten (10) years.



[1] Grant View Research: Legal Marijuana Market Size, Growth, Industry Report 2027

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According to the Cannabis Business Times, economies of scale will be more important than ever in 2020 and beyond. As more sophisticated growers enter the market, larger facilities will be the new normal. We see this trending based on the City's cultivators with approved CUPs but are not yet operational, as many include significant cultivation square footage. As larger facilities come online, successful small cultivators will find ways to differentiate their brand to retain premium prices. Cultivators will seek out sustainable products such as "cause brands" with a social purpose to draw in savvy customers, develop brand followings, and demand green and ethical products. For the small cultivators, cannabis tourism would help build the brand and expand visibility.

As cultivators continue to modify business plans seeking to create profit stability, anticipated growth in the oils and tinctures market will result in a shift from taxable cultivation square footage to non-taxed manufacturing uses. We believe we are starting to see this in Desert Hot Springs. While the high demand of buds will remain strong as smoking is more economical and in greater demand than oral products or tinctures, to balance out business risk cultivators may seek advantages to keep profits high and reach new customers. We do not think this is an immediate threat, and could be viewed as an opportunity, as competition among the existing cultivators is high and few have the resources to venture into large-scale manufacturing of medicinal cannabis. This current situation creates three (3) favorable opportunities for the City: 1) The City could play a key role in linking local cultivators with research funding for the industry which plays a vital role in encouraging to launch innovative products; 2) A growing manufacturing segment would create new cannabis economy and job growth opportunities in the City without the risk of relying on bud cultivation and risk of saturation; and 3) The City is well positioned to create a cannabis tourism market by partnering with the spas and local cultivators.

IV. CONCLUSION

In order to maintain fiscal stability and cannabis revenue sustainability for the General Fund, the City will need to look beyond a regulatory stance to cannabis cultivation and seek to create an entrepreneurial approach to cannabis industry development. Understanding the industry better is key to avoiding pitfalls such as oversaturation which occurred in Oregon and Colorado as they raced to open cultivation facilities. Because the State of California is not measuring oversaturation or cultivator risk, the City must play a role in developing supply chains and product demand from local cultivators which will require time and additional business development to occur locally, state wide, and nationally.

We understand policy makers will be asked to implement regulatory changes to help local industry growth. However, because the industry is in its infant stages policy considerations must be measured and have a public benefit in mind. In some cases, the risk of an unmeasured approach can be summarized by certainties against unknowns. For example, if the City amended the cultivation tax from $25.50 for the first 3,000 square feet to $15.00 (the same as Coachella and Cathedral City) or to $10.20 (i.e., the current cultivation tax facilities in excess of 3,000 square feet), the City's annual cultivation revenue would decline by $315,000 or $459,000 respectively. The loss of revenue from operational cultivators will have one or more of the following impacts:

- Reduce reserves in a time when reserves are already being allocated to address pandemic impacts;
- Reduce City services previously funded by cannabis revenues;
- Alter the City's investment strategy for reserves as determined with the City Hall financing; and/or
- With a further decline in the City's reserves from COVID-19 and possibly impair the City's A+ credit rating increasing the cost of obtaining capital.

One or more of the above impacts are certainties. What is unknown, and cannot be substantiated at this time, is if a cultivation tax reduction would lead to additional cultivation businesses and stable City revenues. Because public services may be negatively impacted, and a such a reduction would not require a public vote (i.e., the City has administrative authority), it is imperative a public benefit be identified prior to such a policy change.

An alternative to reducing the current tax structure under the City's administrative authority, is to further study the City's cannabis tax structure with a long-term view and to establish fees and taxes which promote the addition of cultivation facilities while also taking into account anticipated trends in the cannabis industry. Specifically, a cannabis program with the objective to offer opportunities to small and large cultivators while also seeking a tax and fee program which does not impair the City's ability to provide much needed services to residents, businesses and visitors. It's possible, from time to time, taking a long-term view of the City's cannabis tax and fee program will require voter approval for amendments.

For these reasons, and the policy considerations cited above, we believe a long-term program view and continued investment in the local cannabis industry would produce measurable results, create steady job growth, and facilitate local industry and fiscal stability. This conclusion is reached for several reasons:

1. Local cultivators have implemented a variety of pricing strategies to determine margins and profitability, which gives them an edge over cultivation facilities yet to open. Cultivators implement pricing strategy with a pricing model**.** The model essentially provides instructions or rules for setting prices and creating margins based on existing supply chains and successful business development

opportunities which facilitate growth. This is important to the success of each cultivator in a growing competitive market and one the City can play a key role in;

2. The City has a role to play in building a supply chain and local demand through local businesses, economic development programs, and a cultivation index protecting local cultivators from oversaturation via state wide competition. The City has the tools and expertise to engage new businesses that expand the cultivation and distribution network for local cultivators including local spas, future manufacturing, distribution and lab testing opportunities; and

3. The City has an expansive area available for cultivation and other cannabis industry businesses with some of the lowest real property costs in Southern California. Additionally, the City has roughly 46 approved cannabis cultivation businesses with regulatory approvals yet to be open. As the City builds its cannabis brand, new cultivators will have the benefit of a City program engineered to grow and sustain cannabis businesses in the City.

The policy considerations in this report will assist the City in taking the next step to move beyond the standard regulatory stance taken by local governments collecting cannabis tax revenues. A key is to collaborate with local cannabis businesses and to develop systems and programs that facilitate sustained growth and opportunity. Today, the concepts in this report may seem unjustified or challenging, yet we all accept the notion that preparation leads to opportunity. This same concept created the City's proposed tax structure in 2014 which is now the standard in Coachella Valley. The City can continue to lead through the creation of ideas, industry knowledge (i.e., preparation) and a commitment to try new and innovative concepts (i.e., opportunity) while accepting the industry is still in its infant stages and there is no history to guide us forward. Simply modifying the tax base, or approving more facilities, without a plan of engagement, an identified public benefit and solid industry knowledge could lead to unintended consequences and the loss of an opportunity to partner through a commitment of engagement, transparency and entrepreneurial spirit with the cannabis industry. Creating a Desert Hot Springs cannabis brand is an innovative idea, but one we think the City can achieve and remain an industry leader in this space.