



CITY OF SALINAS

COUNCIL STAFF REPORT

DATE: MAY 15, 2018

DEPARTMENT: OFFICE OF THE CITY MANAGER

FROM: ANDREW MYRICK, ECONOMIC DEVELOPMENT MANAGER

TITLE: COMMERCIAL CANNABIS INDUSTRY IN SALINAS

RECOMMENDATION:

Staff recommends Council receive and accept the report.

EXECUTIVE SUMMARY:

Legal commercial cannabis represents a new industry within the City of Salinas. While it is growing, the industry has also been subjected to a combination of a strict regulatory environment coupled with rapidly changing market conditions. New businesses are opening, employees are being hired, and taxes are being paid, but not at the rates of growth that were initially projected back in 2016. Further challenges remain, which may or may not require intervention on behalf of the City.

BACKGROUND/ANALYSIS:

A number of items have come before the Council in recent years regarding the legalization of cannabis and businesses serving that industry. The Table below provides a brief summary of significant milestones in the development of this industry.

Date	Event
January 2016	City of Salinas adopts ordinance regulating cannabis businesses. A maximum of 12 businesses (3 each of Dispensary, Manufacturing, Cultivation, and Delivery) are allowed.
June – July 2016	City of Salinas accepts applications for Commercial Cannabis Permits. 24 applications are received.
August 2016	California passes Medical Cannabis Regulation and Safety Act (MCRSA)
November 2016	Proposition 64 passes, legalizes adult-use cannabis effective January 1, 2018
November 2016	Salinas Measure L passes, establishing a commercial cannabis business tax on specified businesses (Cultivation, Delivery, Dispensary, and Manufacturing)
May 2017	City of Salinas completes initial review of Commercial Cannabis Permits. 9 Permits are recommended for approval (3 each of Cultivation, Dispensary, and Manufacturing). 14 applications are not approved.
June 2017	California passes Medicinal and Adult-Use Regulation and Safety Act (MAUCRSA) implementing Proposition 64.

Date	Event
August 2017	City adopts revisions to commercial cannabis ordinance. Distribution and Testing Laboratories are added as allowable businesses. Number of Permits increased from 12 to 23 (5 each for Cultivation, Dispensary, Distribution, and Manufacturing; 3 for Delivery). No maximum number of Testing Laboratories and Small Distribution.
October 2017	City accepts revised permit applications from commercial cannabis businesses that were not approved in the previous permitting round. 13 permit reapplications are received.
November 2017	City adopts revisions to commercial cannabis ordinance allowing businesses to participate in the adult-use market. Other changes made to streamline processes and align local laws with MAUCRSA.
November 2017	California releases regulations implementing MAUCRSA.
December 2017	City issues 11 additional permits, bringing the total number of permits issued by the City to 20.
January 2018	Proposition 64 takes effect – adult-use cannabis is legal. California begins issuing temporary licenses to businesses.
May 2018	City adopts Ordinance modifying processes for Nurseries and R&D businesses and lowering tax for Nursery-type Cultivation from \$15 to \$2 per square foot.

This Report is intended to provide a snapshot of the industry as it currently exists. However, it is very difficult to determine any trends from the statistics available at this time. The industry has experienced a very high degree of disruption over the past several years, with Proposition 64 passing just as businesses were preparing to adapt to a regulatory regime that was never implemented; businesses then had to adapt to a new statewide regulatory regime that was published only six weeks before it was implemented, and which is still being refined. Further, every local jurisdiction has passed its own rules and regulations governing the industry, and these businesses have had to navigate this while simultaneously adapting to rapidly changing market conditions. In short, this industry is currently in high state of upheaval, and staff cautions against interpreting the data included in this Report as indicative any long-term industry trends.

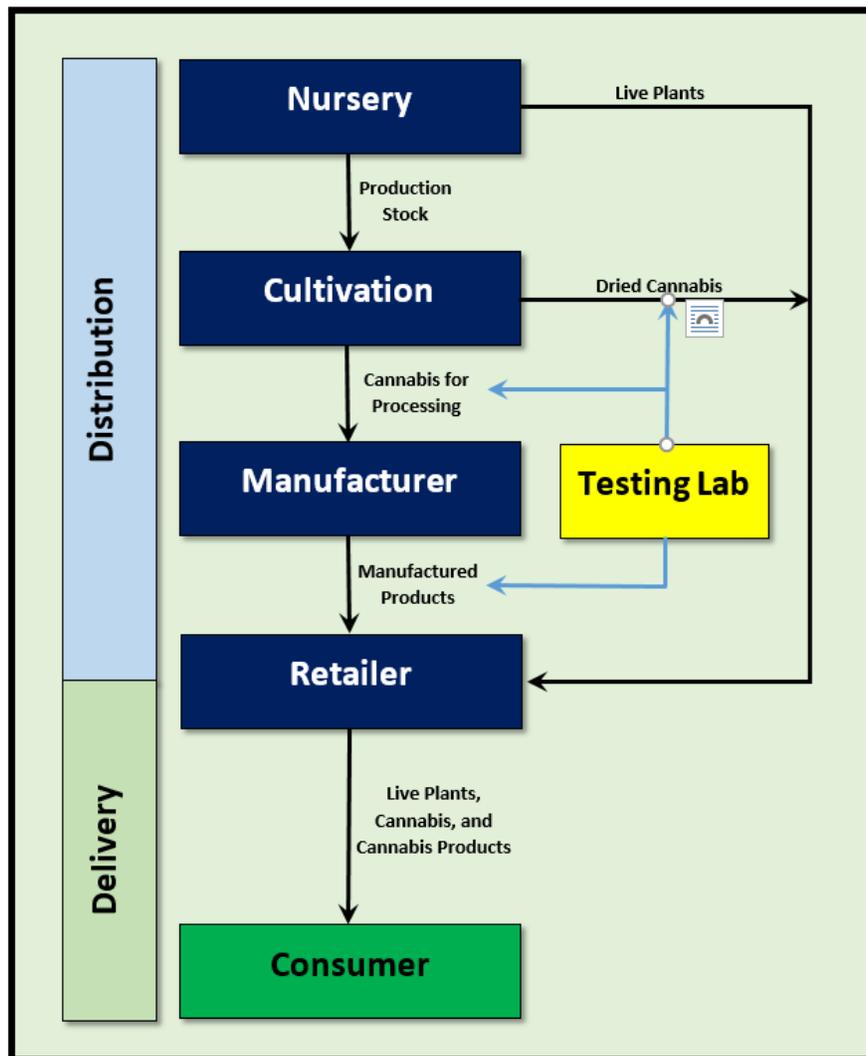
The Commercial Cannabis Industry

Salinas recognizes six primary types of cannabis businesses: Cultivation (which also includes Nursery), Delivery, Dispensary, Distribution, and Testing Laboratory. However, the State of California has identified 20 different subtypes of cannabis businesses, which can be broken down by license types. The following charts describe how these categorizations relate to each other:

Salinas Business Type	Corresponding State License	Role
Nursery (subset of Cultivation)	Nursery (Type 4)	Grows immature plants from cuttings and seeds for internal use or sale to other Cultivation, Delivery, or Dispensary companies
Cultivation	Cultivation (Types 1-5; 14 different subtypes in total)	Growing of cannabis plants for sale to Manufacturing, Delivery, or Dispensary businesses

Salinas Business Type	Corresponding State License	Role
Manufacturing	Manufacturer (Type 6-7)	Processing of cannabis into cannabis product
Distribution	Distribution (Type 11)	Transports cannabis and cannabis product between licensees. Also collects and remits State taxes from other businesses.
Dispensary	Retailer (Type 10)	Sells cannabis and/or cannabis products via a fixed location storefront.
Delivery	Retailer (Type 10)	Sells cannabis and/or cannabis products without a fixed location storefront.
Testing Laboratory	Testing Laboratory (Type 8)	Tests to ensure product safety.

The following chart shows a simplified version of the overall structure of the cannabis industry. The bar on the left indicates the entities that are responsible for transportation between the various parties. Testing Laboratories perform their testing immediately before or after points of transfer.



In addition to these primary business types, there are other types of businesses that may take on a more significant role in the future. These include Research and Development businesses, which conduct research but are not involved in the cannabis market; Waste Disposal companies, which collect cannabis waste, process it to neutralize the active compounds, and then dispose of the waste; and microbusinesses, which are vertically integrated combinations of Cultivation, Manufacturing, and Dispensary business types under 10,000 square feet.

Commercial Cannabis Permits

The City issues two types of commercial cannabis business permits: Commercial Cannabis Permits and Administrative Permits. Commercial Cannabis Permits are applicable to most businesses, including Cultivation, Delivery, Dispensary, Distribution, and Manufacturing. Administrative Permits are issued to Testing Laboratories and Small Distribution (under 500 square feet), and next month will also be issued for Research & Development and Nursery businesses. As of April 30, 2018, the City has issued two Administrative Permits to Testing Laboratories; both businesses expect to be open in the coming months.

The City of Salinas has issued a total of 20 Commercial Cannabis Permits. As of April 30, 2018, four businesses have obtained a Certificate of Occupancy to operate within the City of Salinas:

Business Name	Address	Type
Compassionate Bay Delivery	1051 Terven Avenue	Delivery
Cypress Manufacturing	20 Quail Run Circle	Manufacturing
Cypress Manufacturing	1353 Dayton Street*	Distribution
Emerald Skyway, LLC	1610 Moffett Street	Dispensary

*This business was originally established at 20 Quail Run Circle, but has been approved to relocate to 1353 Dayton Street

Also, as of April 30, 2018, five businesses have submitted applications for permits from the City’s Permit Center, but have not yet obtained final approval:

Business Name	Address	Type
710 Combinator	518 Work Street	Manufacturing
East of Eden	514 Work Street	Dispensary
Flor X	516 Work Street	Distribution
Golden Essentials Delivery	1020 Merrill Street	Delivery
Purple Trilogy	1020 Merrill Street	Delivery

The remaining eleven businesses have not yet submitted applications for a Building Permit. These businesses must obtain Building Permits and pass a final inspection within one year of the date of Permit issuance (noted in the table), or the Permit will be forfeit. These businesses are as follows:

Business Name	Address	Type	Expiration Date
Badfish Gardens	590 Work Street	Cultivation	12/28/18
Canna Cruz	1156 Abbott Street	Dispensary	8/31/18
Cypress Manufacturing	680 Work Street	Cultivation	9/13/18
Cypress Manufacturing	680 Work Street	Dispensary	9/13/18

Business Name	Address	Type	Expiration Date
Emerald Skyway	1610 Moffett Street	Cultivation	9/27/18
Emerald Skyway	1610 Moffett Street	Manufacturing	9/27/18
Flor Cultivation	1156 Harkins Road	Cultivation	8/9/18
Griffin Holistics	1072 Industrial Street	Dispensary	12/28/18
Griffin Holistics	1072 Industrial Street	Manufacturing	12/28/18
Riverview Farms	323 Rianda Street	Distribution	12/28/18
Riverview Farms	323 Rianda Street	Manufacturing	12/28/18

The following table shows the number of businesses by business type in each phase of the process:

Business Type	Open	In Process	No Activity	Total
Cultivation	-	-	4	4
Delivery	1	2	-	3
Dispensary	1	1	3	5
Distribution	1	1	1	3
Manufacturing	1	1	3	5

While there is no statistical data to demonstrate why so many businesses are not yet moving forward on their applications, staff has spoken with several of them. Based on the responses received from these businesses, while in some cases the challenges are internal or organizational, the primary reasons for not moving forward at this point appear to be due to the drastic changes that have occurred in market conditions since January 1, which have been exacerbated by the continued strength of the illegal market as well as the costs of regulatory compliance and state/local taxes. The issues raised are discussed in more detail in the “Industry Challenges” section of this Report.

Impacts on City Resources

In September 2017, the Council adopted ongoing monitoring fees to compensate the City for the ongoing costs relating to monitoring of commercial cannabis businesses and the enforcement of regulations. These fees are intended to cover services for which fees are not typically charged, and that would go beyond the services typically rendered to businesses.

As of April 30, 2018, the City has collected \$23,144 in fees for Police Department services from three businesses (the City is currently working with one open business to submit the payment of fees). So far, the Police Department has responded to a total of 15 calls for service at the approved locations. Most of these calls relate to minor crimes, such as trespassing or responding to an alarm, and the volume of calls received appears to be roughly in-line with those that would be expected from a non-cannabis business. It will require more time and additional businesses operating to determine whether this level of activity will be standard or is anomalous.

The City has also collected \$2,022 in fees for the Legal Department and \$6,162 in fees for the Administration Department. While individual hours are not being tracked, both of these Departments have been actively engaged with the businesses and with responding to their needs as they attempt to navigate the City’s regulatory system.

The Permit Center has also seen increased activity. As of April 30, 2018, seven businesses have applied for Building or Administrative Permits to operate their commercial cannabis businesses, and one Building Permit and one Administrative Permit have been approved, with the remaining applications still under review (Cypress Manufacturing’s Distribution and Manufacturing operations were already legally operating and did not need to obtain new land use entitlements to operate). Code Enforcement has investigated one ongoing incident regarding odor emanating from an operating business. Although the matter took some time to resolve, the business was cooperative, and did install a new air filtration system. Since the new system was installed, the complaints have ceased. The Permit Center has previously established fees and procedures that are applicable to all businesses.

Employment/Community Impacts

Since only a handful of businesses are now open, it is difficult to know whether the existing businesses will be representative of the industry. Several businesses have reported existing or projected employment numbers. Cypress Manufacturing reports that as of March 31, 2018, they employed 34 individuals (26 of which are from the Salinas area), with a mean annual wage of \$39,768. Other businesses that are not yet open have indicated that they will hire between 10 and 25 employees each, with average wages estimated between \$15 and \$22 per hour – the accuracy of these numbers can be confirmed once these businesses open. Staff anticipates that a more comprehensive summary of employment numbers, as well as summaries of any charitable contributions or other types of community benefits, in a later Report.

Tax Revenue Collected

Measure L, adopted by the voters of Salinas in November 2016, requires certain commercial cannabis businesses to pay a commercial cannabis business tax every quarter, beginning January 1, 2017. Business are responsible for paying this tax regardless of their permit status. The following Table provides the rates that are currently due for each business type, as well as the rate that would be applicable starting in 2020:

Business Type	Current Rate	2020 Rate
Cultivation	\$15 per square foot	\$25 per square foot
Delivery	5% of Gross Receipts	10% of Gross Receipts
Dispensary	5% of Gross Receipts	10% of Gross Receipts
Distribution	N/A	N/A
Manufacturing	5% of Gross Receipts	10% of Gross Receipts
Nurseries*	\$2 per square foot	\$5 per square foot
Testing Laboratory	N/A	N/A

*Although Nurseries are a type of Cultivation, they are taxed at a different rate

Taxes for January – March (Q1) 2018 were due by April 30, 2018. The City has received cannabis revenues as detailed in the Table below. The City will oversee assessments of these businesses to ensure that the taxes have been calculated and paid correctly. The City is also currently exploring

ways to increase the collection of taxes from unpermitted or out-of-town businesses making deliveries in Salinas.

Business Name	Business Type	2017	Q1 2018	Total
Compassionate Bay Delivery	Delivery	\$14,955	\$4,357	\$19,312
Cypress Manufacturing	Manufacturing	\$222,096	\$69,062	\$291,158
Emerald Skyway	Dispensary	-	\$41,854	\$41,854
Golden Essentials**	Delivery	\$2,185*	\$5,462*	\$7,647*
Total:		\$239,236	\$120,735	\$359,971

*These numbers include a 25% penalty for late payments.

**Golden Essentials began operations without obtaining all necessary approvals.

Although some revenues were collected for 2017, the scale of the January 1 changes means these are unlikely to be representative of future trends. The businesses operating during Q1 2018 paid a total of \$120,735, although this amount is actually \$119,642 if penalties for late payments are excluded. This equates to \$478,568 annually, although there are a number of factors that could cause significant shifts in these numbers. For example, if more businesses open and are successful, this number would increase. Similarly, if businesses struggle or fail, this number would decline. These numbers would also be impacted if the tax rates charged to these businesses were lowered.

Potential Challenges

The industry faces a number of challenges as it moves forward. Staff has identified several challenges that the City will examine to determine whether intervention of some type is necessary. These range from market conditions, costs of operation, and competition from illegal businesses. Please note that this analysis is based upon conversations with businesses, and have not been independently verified.

The costs of start-up, coupled with lower-than-expected margins, have played a role in slowing or stopping the establishment of new businesses. As noted earlier, 11 out of the 20 approved businesses have not yet applied to obtain the land use permits necessary to make their permit effective. When asked about the reasons why they have not yet initiated this process, the most common reason cited was the capital costs of start-up, as the margins now being generated make it difficult to impossible to obtain financing for new businesses; this is particularly true for Cultivation, as raw cannabis is currently being overproduced in the State, but also creates challenges for Manufacturing as well due to equipment costs. Dispensaries face significant risks from competition from the illegal market, and there is concern that the legal Salinas market may not be able to support five dispensaries if that matter is not resolved. Distribution does not face the same level of up-front costs as other business types, and does not face local taxes – however, it is by nature a low-margin business requiring a high-level of regulatory expertise, and is thus unattractive to many. Delivery businesses, which enjoy higher margins and do not face the up-front costs of the other businesses, appear to be in the best position at this point, although they share the concerns about the illegal market.

The illegal market is, broadly speaking, probably the greatest threat to the legal industry. Since January, the number of illegal Delivery businesses has proliferated. These businesses do not typically collect or remit required sales taxes and/or commercial cannabis business taxes

(commercial cannabis businesses are responsible for paying local taxes whether or not they are permitted). These businesses take advantage of apps such as WeedMaps, which enable people to easily find Delivery companies and order cannabis, and have minimal costs since they do not maintain a storefront. The easy availability of “illegal” cannabis makes it challenging for legal businesses to compete on price, resulting in a reduced market share.

Another commonly mentioned concern is overtaxation. In addition to City taxes, businesses are also responsible for a \$9.25/ounce tax on dried cannabis and a 15% excise tax (both from the State), as well as Federal and State income taxes, payroll taxes, permit and license fees, etc. These additional costs add up, and, again, are not borne by the illegal industry. The County of Monterey has recently begun to question its tax structure (which is at about the same level as the City’s), and is considering whether taxes should be reduced. City staff is monitoring this to determine whether any action on the part of the City would be prudent.

A final, much broader threat is the “enclosed market” structure created by the State. Under State law, legal businesses can only do business with other legal businesses, and may not sell out-of-state. This creates a weakness where the failure of one component could break the supply chain and cause the entire system to fail. For example, one threat facing the industry is the falling price of raw cannabis: while the falling price of cannabis would theoretically be good news for Manufacturers and Retailers that purchase them as supplies, the low price could drive Cultivators out of business, which would then in turn reduce the supply and potentially disrupt the ability of other businesses to obtain the raw materials they need. Normally, in this case, one would expect that the market would adjust, by either reducing supply or increasing demand, and prices would self-correct. However, the competition from the illegal market makes it difficult for the legal market to absorb price increases, and the regulatory regime makes it hard for the market to adapt by significantly increasing the time and costs for new businesses to enter. The result is that the entire system is very sensitive to shocks to any part of it, and will have trouble to adapt. This is a statewide issue and will be influenced by the actions of many parties, but is important to understand as the industry moves forward and policies are examined.

CEQA CONSIDERATION:

This Report is informational only and does not constitute a “project” under CEQA.

STRATEGIC PLAN INITIATIVE:

This item does not specifically relate to one of the Council’s Strategic Plan or Goal.

FISCAL AND SUSTAINABILITY IMPACT:

This Report is informational only.