

CITY MANAGER'S TRANSMITTAL MEMORANDUM

October 20, 2003

Members of the City Council:

Subject: Final 2003-2004 Budget

INTRODUCTION

Presented for your consideration is the budget for the fiscal year beginning July 1, 2003. The City of Davis is a public corporation with an annual budget of \$107 million for the 2003-04 fiscal year. This figure represents all expenditures planned by the city, including those of the Redevelopment Agency and all internal service charges. The budget serves as the city's primary financial document to guide the City Council and staff through the coming fiscal year. It outlines the major priorities and projects that the city will undertake, as well as noting the accomplishments of the past year. It represents approximately 1.1 million hours of staff work that will be dedicated to every program and service the city offers. In addition, it reflects contracts for maintenance and major construction projects, as well as the materials and supplies necessary to undertake our responsibilities.

The City Council met on May 28, 2003 with the City Manager and Department Heads to assess, modify and approve the goals and priorities for FY 2003-04. Once again, this year's budget model includes strategic goals that have helped to frame the city's priorities and actions. These goals include:

- ◆ Initiate the annual process that identifies and resolves the city's short and long-term financial issues in order to attain a sustainable operating budget that does not rely on new development.
- ◆ Complete planned facilities and improve existing facilities, as needed, in order to maintain current standards and to maximize availability and usage by the community.
- ◆ Provide policy direction and enhancement to increase environmental awareness, develop a sustainable community and improve the use of our renewable and non-renewable natural resources within the community.
- ◆ Review, approve and amend necessary planning, zoning, and regulatory guidelines to ensure the community values and responsibilities are identified, evaluated and addressed.
- ◆ Work cooperatively with other governmental agencies to resolve issues of mutual concern and benefit for the betterment of government.

BUDGET PRINCIPLES

In November 1997, the City Council adopted budget principles specifying certain ideals to be incorporated into future budgets. These principles have guided the development of the city's financial plans for the past several years. The principles direct that a budget be developed that:

- ◆ Is sustainable into the future and not a one-time fix;
- ◆ Does not rely on development to support existing operating revenues;
- ◆ Does not erode the capital budget and capital maintenance activities to support operating activities;
- ◆ Maintains reasonable compensation strategies for employees;
- ◆ Invests in tools and training to increase productivity and maintain a high-quality work force.

BUDGET PREPARATION

The 2003-04 Final budget reflects essentially the same budget as FY 2002-03. Minimizing cost increases while maintaining our city's current standards of service continues to be a challenge.

The 2003-04 final budget does not provide additional resources to departments as suggested by the Expenditure Control Budget (ECB) that was drafted but not implemented two years ago. Because the budget model projections indicate increasing difficulty in maintaining existing service levels, departments were limited to increases only for the following items:

- ◆ Increases in contractual obligations such as service contracts;
- ◆ Additional service demands associated with new facilities being completed;
- ◆ Human resource costs associated with approved Memoranda of Understanding with employee bargaining groups.

MID YEAR BUDGET UPDATE

In February 2003 the Council was provided with a mid year budget update that indicated the General Fund fund balance on June 30, 2002 had increased to approximately \$6.5 million or 23% of planned expenditures for FY 2002-2003. This increase in fund balance was a result of extraordinary revenue changes along with prudent expenditure practices. The increase in fund balance of approximately \$1 million was due primarily to those items listed in *Exhibit 1* below, which again are showing strong results through December, 2002.

Exhibit 1: 2002/2003 Midyear Major General Fund Revenue Estimates

Midyear Revenue Estimate Revisions (Net Changes)	Final Budget	Revised Estimate	Increase/ (Decrease)	% Increase Over Budget
Property Taxes	\$6,744,200	\$6,797,803	\$53,603	0.80%
Sales Taxes	5,560,000	5,600,000	40,000	0.70%
Transient Occupancy Tax	884,200	942,000	57,800	6.50%
Business License Tax	977,000	1,060,000	83,000	8.50%
Municipal Services Tax	1,780,000	1,770,000	-10,000	-0.60%
Motor Vehicle In-Lieu	3,570,000	3,648,000	78,000	2.20%
Totals	\$19,515,400	\$19,817,803	\$302,403	1.50%

It appears that the local economy has improved at a higher rate than was anticipated during the budget compilation period, leading to strong gains in taxes generated by the business sector. In addition, strong car sales in the summer and fall of this current fiscal year have led to a large jump in Motor Vehicle In Lieu Fees during the first half of the year.

If you ignore the State's economic debacle, the City of Davis has been experiencing revenue and expenditure patterns fairly close to the beginning budget predictions for the current fiscal year. This is partially due to conservative revenue estimates and the continuance of the "soft hiring freeze" that has been in place for the last two fiscal years.

Development revenue receipts in the General Fund are also on track for the year with revenues being received from the Cantrill Drive complex and the Olive Drive Apartments. This important source of revenues is going to be

tapering off over the next several years and will eventually reach minimal numbers as the City approaches build out.

Property values are continuing to escalate this year and should end the year in the 6% range. This is only half of what was realized last year but will once again provide healthy property tax gains as residential properties change hands and are reassessed at the higher values. Current housing resale rates have been in the 5% range, which is significantly lower than the state average of 12%.

Exhibit 2 below displays the results of FY 2002-03 General Fund revenues and expenditures. According to these estimates, the General fund will end the fiscal year with a Combined Fund Balance Reserve of \$8.0 million or 29% of expenditures. This reflects the positive results of the previous fiscal year discussed earlier, increased revenues of \$875,838, and reduced expenditures of \$265,316. Another key feature is revealed in the year-end estimate, namely the reversal of the original estimate of a (\$909,267) operational deficit. The current prediction is to complete the year with at least a \$231,887 operational surplus.

Exhibit 2: General Fund Budget Comparison

Description	FY 2002/2003 Original Budget	FY 2002/2003 Estimated Results	2002/2003 Difference
Beginning Unreserved Fund Balance	\$6,513,168	\$7,138,576	\$625,408
*Revenues	26,567,530	27,443,368	875,838
*Expenditures	(27,476,797)	(27,211,481)	265,316
Transfers	0	0	0
Transfer to Misc. PERS Reserve	(370,000)	(370,000)	0
Ending Unreserved Fund Balance	\$5,233,901	\$7,000,463	\$1,766,562
Add: F.B. Reserve for Misc. PERS Increases	1,035,000	1,035,000	
Ending Combined Fund Balance	\$6,268,901	\$8,035,463	\$1,766,562
Percentage (Combined F.B./Revenues)	24%	29%	6%
Percentage (Combined F.B./Expenditures)	23%	29%	6%

*Net of Grants and One-Time Designated Rev./Exp. of \$418,342 in FY 2002-03.

While it is difficult to predict the results of departmental expenditures this year, the salary savings experienced to date may lead to further expenditure reductions if they follow past fiscal year-end trends. If so, these savings could amount to 2% of total General Fund expenditures by the end of the year or approximately \$500,000. However, on the other side, in examining the projected year-end estimates, it is important to remember that the ending fund balance can change by as much as \$280,000 for every 1% change in revenues and/or expenditures. A 2% decrease in revenues and a 2% increase in expenditures could leave the ending projections off by over \$1.1 million dollars. All things considered, the year-end results will leave us in a very good position to weather the financial storm that lies ahead with looming state takeaways and rising employee benefit costs.

CURRENT FINANCIAL CHALLENGES/SITUATION

The city continues to face several challenges in the near future. New development, which has in past years provided funds primarily for one-time, capital expenses, will continue to slow as the city reaches full build out. While this meets the community's goals of slowing growth in the city, it translates into fewer revenue dollars for the city to meet capital and general fund expenditure goals.

Another significant issue revolves around the dramatic increases in employee related costs in three areas: health insurance, retirement and workers' compensation insurance. The first of these, health insurance, has seen large increases in the last few years due to the general state of the health care industry itself. As you can see from *Exhibit 3* below, the cost increase for the coming budget year will be \$653,127, reflecting an anticipated 18% increase. In the past five years, health care premiums have increased an alarming 66.6%. Cal-PERS administers the contracts for the City and has plans to soften future rate increases by negotiating longer-term contracts with the providers but, for the time being, there are still no definite plans to reverse this financially painful trend.

Exhibit 3: Comparison of Health Insurance Changes

Fiscal Year	Monthly Amount	% Increase	Number of Employees	Total Cost	Increased Cost
1998-1999	\$ 428.57		377	1,938,851	
1999-2000	478.56	11.66%	404	2,198,883	260,032
2000-2001	525.75	9.86%	409	2,464,577	265,694
2001-2002	546.44	3.94%	416	2,676,186	211,610
2002-2003	673.95	23.33%	415	3,038,771	362,585
2003-2004*	794.09	17.83%	415	3,580,584	541,813
Totals		66.62%			\$ 1,641,734

* FY 2004-2005 Cost is estimated to be a 15% increase.

Another troubling expenditure increase is directly linked to both the state and federal recession, namely our state-contracted employee retirement account with Cal-PERS. Due to the length and severity of the recession, stock market prices and the corresponding drop in investment earnings, we have seen our well-funded *miscellaneous employees* account go from a 99-year-fully-funded scenario down to a one-year-until-payment scenario. The steepness of the decline in investment earnings has also affected the police and fire accounts at Cal-PERS leading to large rate increases, as shown in *Exhibits 4 & 5* below.

Exhibit 6: Comparison of Workers' Compensation Changes

Fiscal Year	Total Cost	Increased Cost	% Increase
1998-1999	\$ 838,249		
1999-2000	590,803	(247,446)	-29.52%
2000-2001	568,946	(21,857)	-3.70%
2001-2002	740,202	171,256	30.10%
2002-2003	1,226,440	486,238	65.69%
2003-2004	1,451,078	224,638	18.32%
Totals	\$ 5,415,718	\$ 612,829	80.89%

In the previous year, in order to fill the gap between inadequate revenues and rising expenditures in providing community services, in March 2002 Davis' voters passed a special tax referred to as Measure D. Measure D is a city parcel tax measure that renewed the existing Park Maintenance Tax, Measure M, approved by the voters in 1998. Measure D has generated approximately \$1.3 million this year, the same as Measure M, and is used to support a portion of costs needed to supply a basic level of maintenance at community parks, greenbelts, open space, pools and related public facilities. Because Measure D is a special tax, it can only be used for the specific purposes referred to above. Measure D automatically expires in three years (June 2006) but can be rescinded by the City Council prior to June 2006 if the voters approve another type of revenue measure to replace Measure D.

Also in the past fiscal year, the Finance and Economics Commission (now the Finance and Budget Commission (FBC)) recommended to the City Council a budget strategy that included several goals for stabilizing the General Fund and promoting necessary increases in services to the public. These valuable recommendations are becoming even more important today, and are updated for your consideration below:

1. Initiatives to be pursued by city as partial answers to its on-going financial challenges as part of a comprehensive budget strategy include: economic development to stop sales tax leakage; cooperative efforts with UCD; maximizing volunteer resources of non-profits, neighborhoods and students to provide services and/or cut city costs; and continuing deliberative dialog with the community.
2. Secure enactment of special legislation authorizing a 1/4 or 1/2-cent sales tax (same as West Sacramento). Place on ballot no later than March 2004 as a majority vote general tax.
3. Complete drafting a model UUT ordinance, and determine developed square footage for all properties lacking that information, in the event that a UUT or square footage parcel tax is needed to supplement city revenues in the future.
4. Incorporate "previous service level commitments and MOU/PERS anticipated increases" into 2003-04 base budget.
5. Defer consideration of the following service level increases until after a 1/2 cent sales tax or equivalent revenue measure is approved on or before the March 2004 ballot, financial conditions permitting:
 - ◆ Added police officers
 - ◆ Fire Station #4
 - ◆ Mace Ranch area parks (except for park improvements comparable to initial Walnut Park development).

- ◆ Walnut Park pool
 - ◆ New greenbelts/streetscape extension
6. Make no General Fund contributions to traffic calming, street maintenance and facility replacement; seek alternative funding for these projects which formerly were funded by Construction Tax.
 7. Maintain a 15% reserve in future years for contingencies and economic/State budget uncertainties.
 8. Long-term financial plan should incorporate additional cuts in future years as needed to meet reserve target.
 9. Staff to develop back-up plan in the event State takes away resources for cities in its 2003-04 budget. Assume partial loss up to State "backfill" of vehicle license fee (VLF) no longer collected, but still paid to local agencies; defer implementation pending outcome of State budget.

The renamed Finance and Budget Commission continues work on the 5-year budget forecasting model and the 5-year capital improvement program. The 5-year budget-forecasting model focuses on the General Fund, Park Maintenance Tax and Public Safety Fund. At the time of this report, the forecasting model was projecting a combined deficit for these 3 funds.

The FBC has discussed various alternative revenues that could be considered by the city and has recommended that the City move forward with a ½ Cent Sales Tax Override initiative on the March 2004 General Election Ballot. These revenues are critically needed to meet rapidly rising operational costs and to supply additional funding for additional police, fire and parks maintenance services. The Sales Tax Override is forecast to generate \$3.0 million dollars in FY 2004-05 if approved.

Another alternative revenue the Finance and Budget Commission has considered is a utility user tax. Various utilities and various alternate rates of tax have been reviewed by the FBC. Staff has provided the FBC with a number of different scenarios and assumptions and run the budget model to show the impact of each of the different scenarios identified so far. The FBC continues to discuss these alternatives.

The challenge facing the city continues to be that General Fund revenues are estimated to realize flat growth. Projections indicate a decline in new residential development, which will impact property tax revenues and a continuing slow economy, which leads to conservative projections in sales tax, transient occupancy tax and motor vehicle in-lieu revenues. There are future General Fund expenditures projected to increase including new facilities, such as Walnut Park, and Mace Ranch Park. The current projection of park tax revenues will not cover expenses for these facilities maintenance and operations. There continues to be a pent-up need for service expansions including additional police officers and a fourth fire station. These needs cannot be addressed without extensive analysis of ongoing maintenance and operations cost. The availability of revenues for these needs must be found or a correction must be made.

Although the FY 2001-02 fund balance ended higher than anticipated and the FY 2002-03 operational results have gone from "red to black," the forecast is still that the city's future projected expenditures will continue to outpace revenues and will result in a drawing down of reserves. According to the five year budget model, the reserves could be fully depleted within the next 3 years unless another large revenue source is realized.

Summary of the General Fund Budget Requests.

Exhibit 7 summarizes the Budget Requests for the General Fund in the coming year and compares the change with the previous year's Estimated Actual results (not the Ending Budget that includes a number of Council authorized budgetary adjustments). As you can see, even though we have experienced a modest revenue increase (net of one-time Grants of \$2.3 million), the amounts have not kept pace with the large expenditure increases that we have predicted in the past and, most recently, in the Five-Year Budget Model.

Most of the expenditure increases, outside of one-time revenues to cover capital projects, such as the Public Safety Communications System, result from increases in employee related health, retirement, workers' compensation, dental premiums, and increases per labor contracts.

It is important to note that all of the associated employee benefit cost increases and the DPOA MOU have been included in the budget request for next year. The Davis City Employees Association(DCEA), Program, Support and Administrative Employees Association(PSAEA), the Individual Management Employees, the Individual Department Heads, and the Davis Professional Firefighters Local 3494(DPFA), have all negotiated new MOU's with the City. DCEA, PSAEA, Management and Department Heads each received a 2% COLA. DPFA received a 10% increase in total compensation.

Exhibit 7: General Fund Budget Comparison

Description	FY 2002-03 Estimated Actual	FY 2003-04 Request	Change
Beginning Unreserved Fund Balance	\$7,138,576	\$7,000,463	(\$138,113)
*Revenues	27,443,368	28,089,514	646,146
*Expenditures	(27,211,481)	(30,051,341)	(2,289,657)
Transfers	0	0	0
Transfer to Misc. PERS Reserve	(370,000)	0	370,000
Ending Unreserved Fund Balance	\$7,000,463	\$5,038,636	(\$1,961,827)
Add: F.B. Reserve for Misc. PERS Increases	1,035,000	1,035,000	
Ending Combined Fund Balance	\$8,035,463	\$6,073,636	(\$1,961,827)
Percentage (Combined F.B./Revenues)	29%	23%	-6%
Percentage (Combined F.B./Expenditures)	29%	22%	-7%

*Net of Grants and Designated Rev./Exp. of \$418,342 in FY 2002-03 & \$2,734,779 in FY 2003-04.

The Grants and Designated Revenues that are reported as matching revenues and expenditures in the General Fund were removed from the summary lines. This information was excluded from *Exhibit 7* in order to provide a better comparison of the two budget years. The note at the bottom of *Exhibit 7* indicates the amounts of the Grants and Designated Revenues that were eliminated. This illustrates how the large difference between the two years would affect the comparative numbers.

There is also another troubling statistic in the resulting "Percentages" at the bottom of *Exhibit 7*. During the past three years, the City has added almost \$2.0 million to the Unreserved Fund Balance and another \$1.0 million to the Designated PERS reserve to cover future rate increases. The Combined Fund Balance has grown to almost \$8.0 million and represents 29% of last year's expenditures. Unfortunately, if the estimates hold true for the coming fiscal year the Combined Fund Balance could drop to only \$6.5 million or 22% of FY 2003-04 expenditures even with the budget being maintained at the "status quo". This trend has been examined in the Five-Year Budget Model and is expected to continue at an increasing rate.

Impacts of Proposed State Budget

As we are all aware, the state's fiscal condition, which has gone from an \$8 billion surplus to a \$38+ billion deficit in the last two years, weighs heavy on all local government. The Governor submitted his May Budget Revision earlier this year and according to him, the budget is another balancing act between cuts, borrowing and tax increases. The Governor proposed a combination of spending reductions, revenue proposals, and fund shifts, loans, accelerations, transfers and deferrals to balance the budget.

The proposed State budget has "triggered" the reinstatement of the Vehicle License Fees (VLF) for state car owners and has not indicated that they plan to circumvent the allocation of the VLF to cities. Admittedly the VLF is a vital source of revenue for local governments, but there are other areas where the cities could lose. Included in other impacts to the city is the elimination of booking fee reimbursements. The booking fee reimbursements to cities simply reimburse cities for charges imposed by counties per state authorization therefore they do not provide fiscal assistance to cities. It is estimated that booking fee expenditure for 2003-04 will be \$80,000 only 10% of which will be recovered from booked people.

Local governments continue to be concerned about the potential for continuing shifts from the State to local government. In response to this growing concern, a coalition has been formed called LOCAL (Leave Our Community Assets Local). For the past two years, a contingency of local government officials went to Sacramento to talk to legislators and convey that cuts to local government result in real impacts to the services provided to local citizens. LOCAL includes police and fire chiefs, local business people, health, labor, senior citizens and community representatives joined with elected and appointed officials from special districts, counties and cities. The coalition continues to grow and continues to pressure legislators to realize the impacts of cuts to the local governments.

The gubernatorial recall, which has resulted in the removal of the current governor, has presented additional uncertainty to the financial relationship between State and local government. The imminent change in state government and the uncertainty associated with the new administration makes it impossible to know the specific state actions and how they may impact the City. Therefore, as we review the final budget for 2003-04, we should remember that all of the propositions contained therein may change or be subject to change beyond our control.

Respectfully submitted,

James W. Antonen
City Manager

