

# FINANCIAL FORECAST

## Introduction

The Five-Year Financial Forecast provides a long-term view of revenue and expenditures to assist the City Council in evaluating the impact of policy choices on the long-term fiscal health of the City. This section provides a detailed discussion of the General Fund Five-Year Forecast as well as a summary of projections for selected other major funds supported by special taxes, assessments and fees.

The Five-Year Forecast is useful in identifying potential issues that may arise in the future, which require fiscal planning affecting the current budget. Early planning for projected changes in baseline expenditures is critical to ensuring long-term fiscal stability for the organization. Furthermore, the restrictions imposed by the State to limit local governments' ability to raise revenues, also add to the importance of understanding the long-term fiscal impact of policy decisions.

The forecast should not only identify opportunities or challenges, but it should also serve to explain the underlying conditions contributing to the results. By understanding the specific factors impacting variances in the forecast, policy makers can target budgetary actions appropriate to the nature and scope of specific issues.

## History

The Five-Year Forecast uses as its foundation the City's current baseline budget. As such, the budget policies and practices employed in development of the annual budget are, by extension, incorporated into the City's forecasts. The City's current budget development process raises some concerns related to its applicability in the context of the Five-Year Forecast.

Over the past few months, the Finance Director has undertaken a review of the City's historical budget model and evaluated its methodology and assumptions. In response to specific concerns over the model, an alternative forecast has been developed.

The City's historical budget model uses, as its basis, aggregate citywide expenditure data, by category, and applies a prorated share of expenditures to various funds based on funding availability. The resulting General Fund forecast has therefore been derived by applying a percentage of costs, by program, to the General Fund and projecting future budgets applying the same share of costs to the General fund over the forecast period.

The results presented in this section are derived from an alternative forecast model. The revised Five-Year Forecast, designed to focus on the fiscal condition of individual funds, relies on detailed line item revenue and expenditure data and corresponding forecast assumptions.

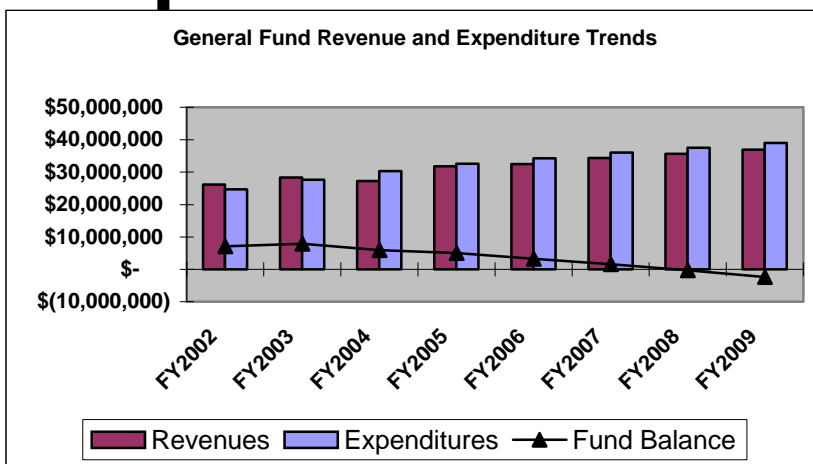
**Methodology**

The following table summarizes selected aspects of the historical and revised financial forecasting model:

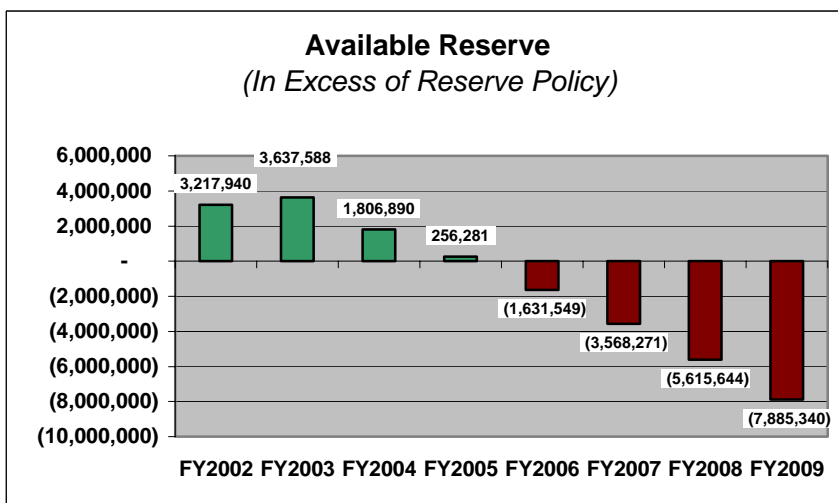
	<i>Historical Model</i>	<i>Revised Model</i>
<i>Fundamental Approach</i>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Estimates General Fund share of Citywide budget; assumes constant %</li> <li><input type="checkbox"/> Presents General Fund “share” of surplus/deficit</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Defines General Fund budget; severs ties to other funds</li> <li><input type="checkbox"/> Focus: Can General Fund support <i>current</i> program service levels?</li> <li><input type="checkbox"/> Forces each fund to independently balance revenues and expenditures</li> </ul>
<i>Budgetary Approach</i>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Current services funded from available/existing sources, then</li> <li><input type="checkbox"/> General Fund contributions established to fill funding needs</li> <li><input type="checkbox"/> General Fund contribution to Special Tax / Fee-supported programs increases over time</li> <li><input type="checkbox"/> Inconsistent with baseline assumptions used to develop forecasting model</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Revise approach to “fund” programs at baseline level within baseline funding of General Fund</li> <li><input type="checkbox"/> Program funding shortfalls to be addressed by operating departments during budget development process</li> <li><input type="checkbox"/> Balancing measures to be developed at program level</li> </ul>
<i>Expenditure Projections</i>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Aggregate personnel cost increases prorated to General Fund</li> <li><input type="checkbox"/> “Flat” projections for non-personnel costs</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Detailed projections within fund for each line item (salaries, overtime, retirement, health insurance, etc.); separate tracking of sworn Police and Fire personnel costs</li> <li><input type="checkbox"/> Establish baseline for all internal service budgets and charge-back rates</li> <li><input type="checkbox"/> Review accrual rates for insurance and liability costs.</li> <li><input type="checkbox"/> General Fund transfers limited to mandates and policy-based subsidies</li> </ul>
<i>Revenue Projections</i>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Aggregate growth rates +/- specific development impacts New housing Commercial square feet Hotel Occupancy</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Focus on trends in major revenue sources; adjust for known events</li> <li><input type="checkbox"/> Assess sensitivity of projections to specific assumptions</li> </ul>
<i>Updates</i>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Annual Update with Budget</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Quarterly updates</li> </ul>

### Summary of Five-Year Forecast

- General Fund revenues are projected to grow at a rate of 2.2% to 3.9% per year; total revenue growth of \$5.17 million over five-year period FY 2005 through FY 2009.
- General Fund expenditures are projected to experience annual increases ranging from 4.0% to 5.3% per year; total General Fund expenditures expected to increase by \$6.38 million over five-year forecast period.

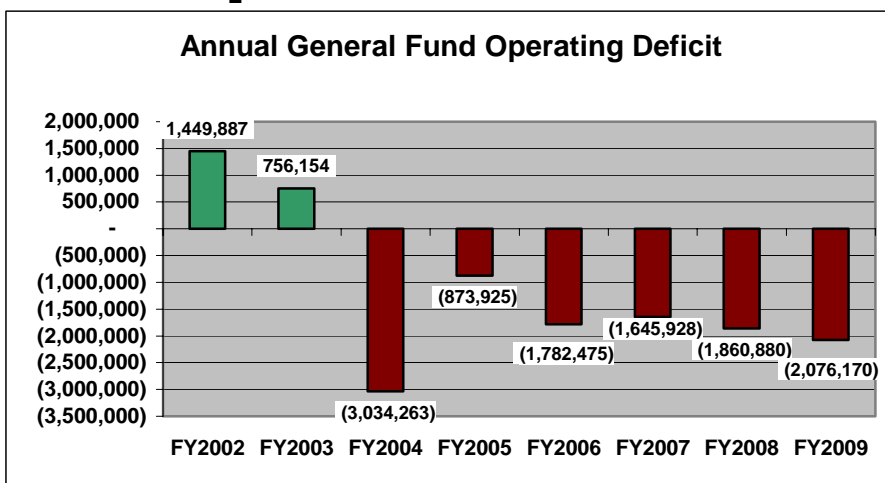


- General Fund reserve projected to decrease from \$5.02 million (15.8%) in FY 2005 to \$3.24 million (10.0%) in FY 2006 and \$1.59 million (4.6%) in FY 2007; suggests the need for up to \$1.63 to \$1.78 million in General Fund balancing measures be developed over the next two years.



### Operating Shortfalls / Structural Deficit

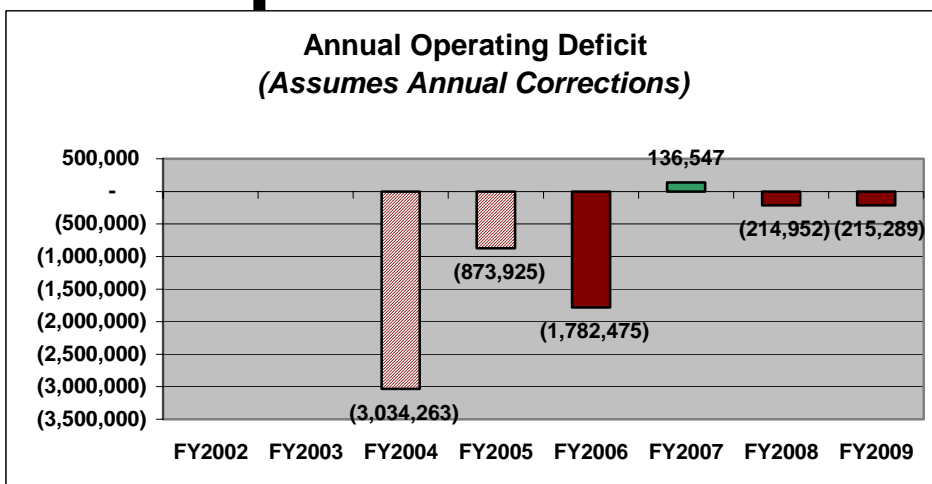
- Annual operating deficits expected to increase from \$1.78 million in FY 2006 to \$2.08 million by FY 2009.



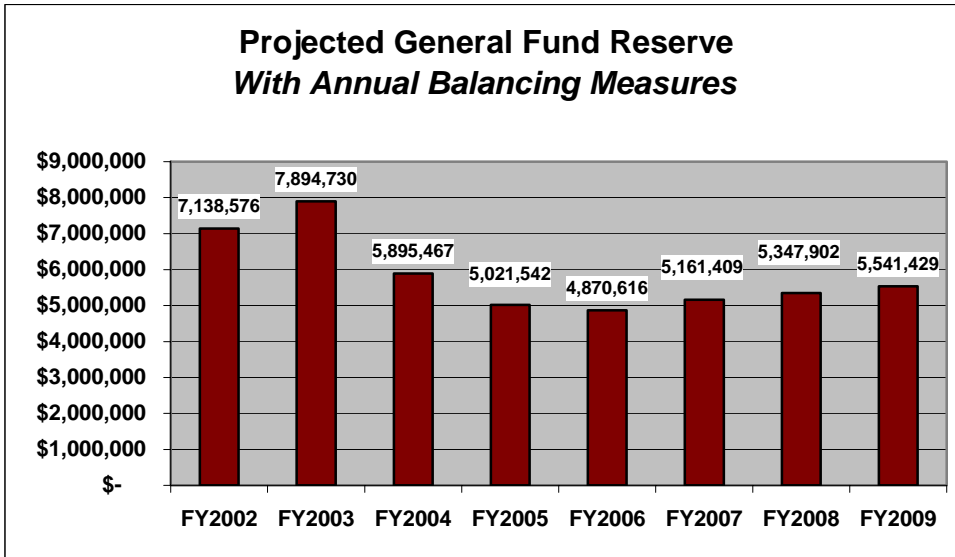
- General Fund reserve has largely “absorbed” FY 2004 and FY 2005 operating shortfalls, including an estimated \$2.2 million in state budget impacts.

#### Balancing Measures

- General Fund balancing measures totaling \$1.78 million will be required in order to balance FY 2006 operating deficit and retain 15% reserve level. Assuming recurring measures are implemented, future shortfalls are reduced to approximately \$250,000 per year in FY 2008 and FY 2009.

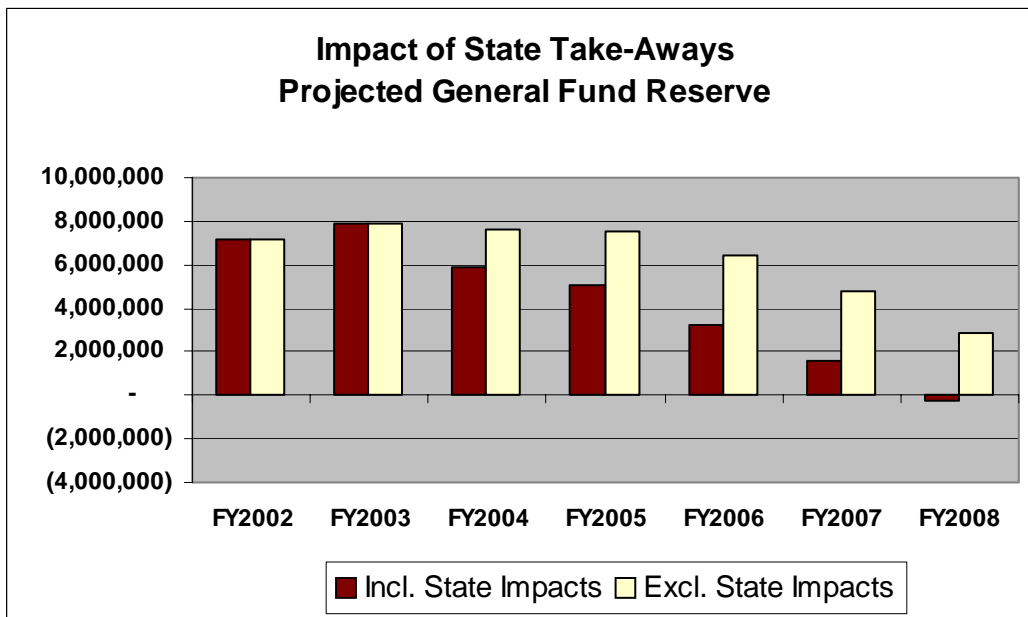


Assuming adoption of recurring measures, General Fund reserve grows, maintaining 15% policy reserve level.

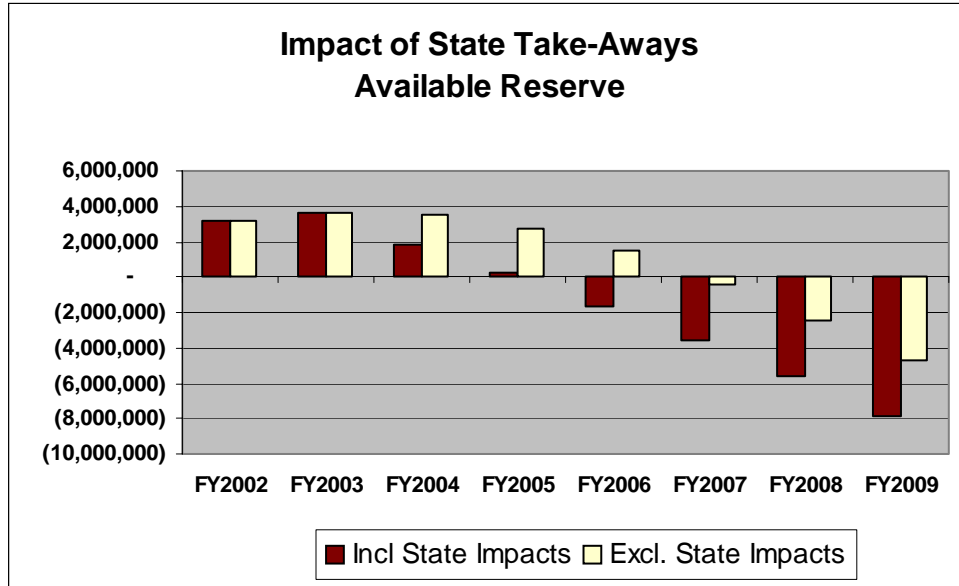


#### State Budget Impacts

- State budget impacts, totaling \$2.8 million in lost revenue from FY 2005 through FY 2007, are expected to subside in out-years of forecast; \$1.6 million in FY 2005 Vehicle License Fee (VLF) payments may be re-paid in FY 2007; Governor's planned shift of \$661,000 in annual property tax revenues is now proposed for two-years only; possible relief in state mandated program costs on the horizon.

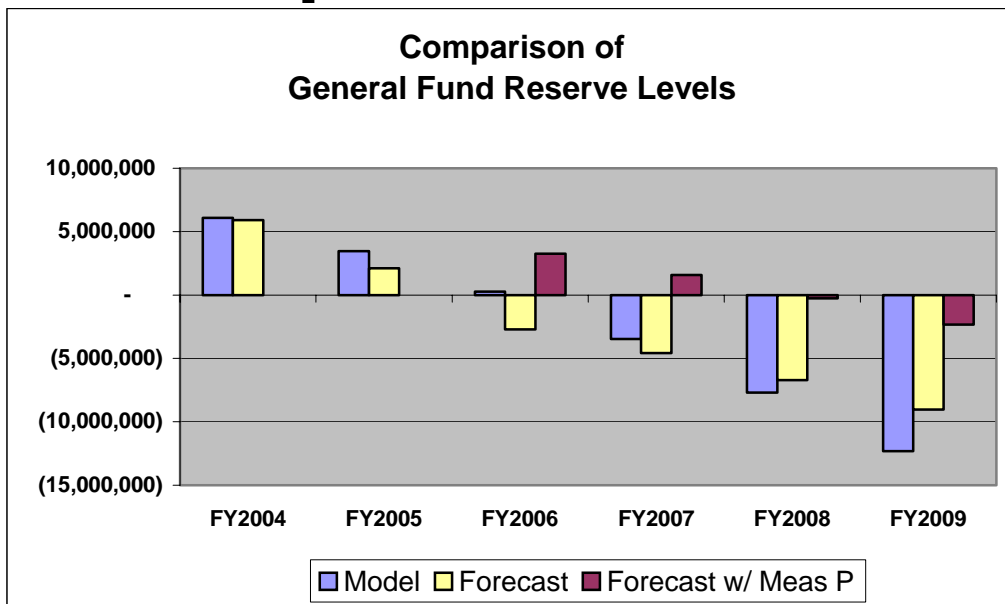


In the absence of State budget impacts, General Fund reserve capable to absorb operating shortfalls through FY 2006. Proposed repayment of FY 2004 VLF backfill would restore \$1.6 million to fund balance and provide funding for one-time needs beyond FY 2007.



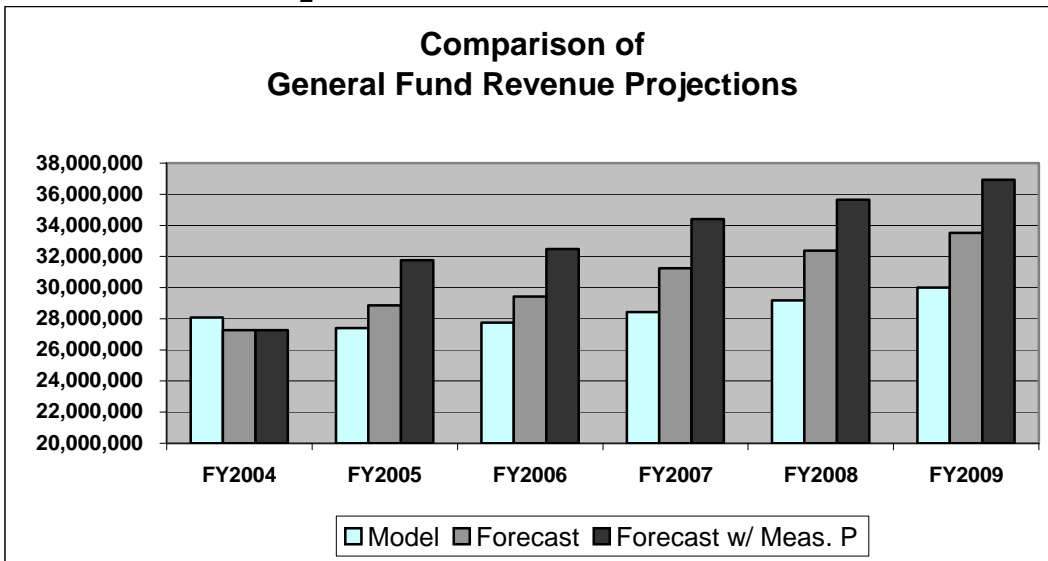
### Comparison to Prior Year Model

Revised Forecast shows increased draw-down of reserves through FY 2007; however improved revenue forecast results in improved long-term forecast.



**Impact of Measure P**

- ❑ Successful passage of Measure P (1/2 cent Sales Tax) expected to provide roughly \$3 million boost in General Fund revenues.



**Further Refinements**

- ❑ Need to refine break-down of line-item expenditures within each fund – particularly those funds where five-year forecasts are contemplated.
- ❑ Need to establish clear policy direction on role of General Fund in support of special-revenue funded programs including Special Taxes and fee revenues.
- ❑ Need to establish policy governing General Fund transfers. Should individual funds be required to implement program-specific balancing measures?
- ❑ Need to establish complimentary five-year forecasts for selected Special Tax and Enterprise Funds, including: Parks Tax, Public Safety Tax, Gas Tax, Sewer, Storm Sewer, Sanitation and Internal Service Funds.
- ❑ Need to review Council reserve policy to re-affirm reserve levels as well as articulate appropriate uses of General Fund reserve to address economic uncertainties, emergencies and smooth-out impacts of potential balancing measures.

## Five-Year Forecast Assumptions

The Five-Year Forecast is based on a number of assumptions. Many factors which drive the forecast are beyond the control of the City, such as inflation, federal and state spending cuts, state wide initiatives, short-term tax shortfalls, and unforeseen emergencies. These assumptions impact revenue and expenditure projections and variations can cause wide swings in budget balancing strategies.

### Inflation

In any scenario, inflation is an important factor that must be considered. Inflation has an impact on City revenues and expenditures. Inflation sensitive revenue, such as sales and business license taxes, make up a significant portion of the General Fund budget. Salary and benefit costs are also driven by annual cost-of-living increases. Salary increases not only impact the General Fund, but other major fee and tax supported programs. Since the revenue base for many funds has no natural growth, program cost increases will drive the need for possible tax and fee increases.

The City of Davis uses as its inflation index, the Consumer Price Index for the Bay Area. This index has increased an average of 3.25% over the last six years. For the purposes of this forecast, a 3.0% annual inflation rate is used throughout the five-year planning timeframe.

#### CONSUMER PRICE INDEX Change from previous year

<u>YEAR</u>	<u>% INCREASE</u>
1998	3.1
1999	4.6
2000	3.8
2001	5.8
2002	2.1
2003	<u>0.8</u>
6-Year Average	3.25%

### Population

Based on data from the State Department of Finance, 2000 Census, population is projected to be 63,984 for FY2004-05 and remain relatively flat. Some revenues, such as Motor Vehicle In-Lieu, are based on population. To the extent that this revenue source is allocated based on proportionate state-wide population, as the state population grows, the City's relative share of this revenue is projected to decrease over time.

**Expenditure Baseline**

The expenditure baseline for the Five-Year Forecast is the Adjusted FY2003-04 budget. The forecast projects expenditures as a result of anticipated changes based, in large part, on a number of assumptions highlighted below:

- a) FY 2003-04 staffing levels and associated costs
- b) Increases for salary and benefits (total compensation) are estimated consistent with negotiated contracts:

	FY04-05	FY05-06
Civilian:	3.0%	
Fire:	11.5%	
Police:	3.0%	3.0%

*Provision for increases commensurate with inflation at the end of contracts*

- c) No inflationary increases for non-personnel costs

*The following section summarizes the significant changes in General Fund expenditures over the period of the Five-Year Forecast.*

**Personnel Costs**

Salary and benefit costs make up approximately 70% of the discretionary General Fund budget . Every 1% increase in total compensation costs approximately \$415,000, on an all funds basis, and approximately \$240,000 to the General Fund.

The Five-Year Plan provides total compensation (salaries and benefits) increases of 7.1% to 5.4% per year, representing an increase of \$8.1 million over the Five-Year Plan. Of concern is the fact that the City's projected revenue growth is not expected to keep up with increases in personnel costs. In the event of a protracted rise in inflation, combined with a continued sluggish economic growth, out-year fund projections could be significantly impacted.

**Health Insurance**

Costs are projected to grow 15% for FY 2004-05 and the forecast assumes annual increases of 12.5% thereafter. The City's General Fund is projected to pay out \$4.5 million in FY 2004-05 and \$5.2 million in FY 2005-06 for health insurance premiums.

**State Retirement System (PERS)**

Retirement rates are set annually by the California Public Employees' Retirement System (CalPERS). The rates established for FY 2004-05 reflect a significant increase over FY 2003-04 rates due primarily to the poor performance of the CalPERS investment portfolio in recent years.

The following table summarizes the CalPERS rates used in the Proposed Budget: and Five-Year Forecast:

		ACTUAL		EST.
		FY 03-04	FY04-05	FY05-06
Police	(Sworn)	6.40%	22.6%	26.40%
Fire	(Sworn)	15.30%	20.07%	23.08%
Civilian	(Misc.)	7.00%	10.04%	12.20%

*Note: Rates for Fire Plan reflect cost of 3@50 benefit enhancement. Rates for FY05-06 based on assumed investment return of 8.25%*

The increased PERS rates result in a total General Fund cost of \$1.7 million for FY 2004-05, an increase of roughly \$400,000 over FY 2003-04. Costs are expected to continue to rise as a result of increasing salaries and contribution rates, reaching an estimated \$2.5 million by FY 2008-09.

In addition, the City may be subject to CalPERS's proposal to merge plans with fewer than 100 members into statewide "risk pools". Our current Police and Fire plans are subject to mandatory pooling unless the City is successful in seeking a special exemption. Based on a preliminary analysis of the "risk pool" proposal, it is likely that the City's cost for Police and Fire retirement may increase as a result of the risk pool. Staff will be working with PERS and the affected bargaining units in an effort to minimize any risk of further rate increases in this area.

**General Fund Reserve**

The Five-Year Plan reflects a continuation of the Council's policy to maintain a General Fund Reserve equal to 15% of projected revenues. This level of reserve has enabled the City to largely absorb the impact of a one-time loss of state revenues as well as support recent budgets with significant annual operating shortfalls (expenditures in excess of revenues).

The General Fund reserve is intended to buffer against downturns in the economy, reductions in State and Federal funding, and could be used to buffer the impacts of potential budget balancing measures.

Over the next fiscal year, direction from the Council will be sought with respect to articulating a formal reserve policy. It is important that the City establish clear parameters for the desired level of reserve as well as appropriate uses of reserve funds.

## General Fund Revenues

The City's General Fund revenues are a function of both its economic base and its revenue structure. The amount of money available to fund services and programs through the General Fund is determined by the dollars generated by the City's economic base and the City's revenue structure (i.e., the fees and rates applied like business licenses.). The General Fund provides funding for such services as police and fire protection, parks, recreation, community development, as well as most of the administrative and support functions of City government. The General Fund provides the only fully discretionary revenue available to the Council and citizens to directly support changing local priorities.

There are numerous sources of General Fund revenues. However, there are 6 sources that the City uses throughout the year as key indicators of the health of overall General Fund revenue: real property tax, sales tax, business license fees, motor vehicle in-lieu taxes, transfer occupancy (hotel) tax, and fee revenue. In FY 2003-04, these indicator revenues comprised 77% of the total General Fund revenue.

### General Fund Major Revenue Sources

The City's ability to maintain the flow of revenue into the General Fund consistent with inflation and other increasing pressures has been severely limited by various voter initiatives over the last 20 years. This trend began in 1979 with Proposition 13, and continued with the State-wide Proposition 218. The effects these voter initiatives have had on the City's General Fund have been further compounded by the State's shift of local property tax revenues away from cities to school districts (ERAF) and the State General Fund.

The projection of revenues into the future is based on past performance and analysis of actual current private and public sector activity. This includes such private sector activities as housing trends, employment, property turnover and business growth; and public sector developments such as policy shifts at the local, state and federal levels.

Revenue projections are inherently dependent on a number of assumptions, which vary from revenue source to revenue source. The assumptions used to project the General Fund Revenues in the Five-Year Strategic Plan are as follows:

- *Real Property Tax* – The State Constitution (Proposition 13) sets the base property tax rate at 1% of assessed value. The City receives approximately 18% of the property tax generated in Davis, with the majority of the revenue going to the State. Property tax receipts are projected to grow at a rate of 4%-6%. This rate is mostly influenced by the recent spike in real estate sales prices and continued number of properties sold in the City. The growth rate anticipates moderation of the real estate market over the Five-Year Forecast. New housing development marginally impacts property tax revenues. While the forecast does not assume a specific target for new development, an estimated 250 new housing units could be expected to generate approximately \$225,000 in increased property tax revenues per year, or a cumulative increase of \$1.4 million over a five-year period. This figure does not reflect any of the increased costs that would accompany significant new development.

- *Sales Tax* – Sales tax revenues are derived from the tax imposed on sales of goods and services transacted within the City. An increase in the local sales tax rate from 7.25% to 7.75% was approved by voters in March of 2004. Of the 7.75% tax rate, the City will now receive approximately 1.5 cents, or 19.4% from the sales tax generated in the City. Sales Tax revenues are projected to grow at an annual rate of 3.0%, which is consistent with the current growth rate, but reflects a decrease from the from the average growth rate of 4%-5% experienced in recent years. The projected growth rate reflects no real growth, when adjusted for inflation.
- *Business License Tax* – This revenue source is derived from a tax imposed on gross receipts of businesses licensed to operate in the City. The tax rate varies depending on the business enterprise. The revenue projections assume an annual growth rate of approximately 3%, consistent with the growth rate assumptions used for Sales Tax.
- *Motor Vehicle In-Lieu* – This revenue source represents the City’s allocated share of state-wide vehicle sales, apportioned throughout the County on a per capita basis. Historically, this revenue source has provided a stable funding source to the General Fund, in excess of \$3.5 million per year. Last year, this source of revenue was targeted by the State as a means to address the state’s budget dilemma. The end result was the loss of 3 months, or one-quarter, of the anticipated annual revenue. It is proposed that this loss of revenue be repaid by the State in FY 2006-07. However, among the current proposals included in the Governor’s May Revise is a plan to replace this state subvention with an equivalent amount of increased property tax dollars. Staff will be evaluating the details of the proposal in an effort to determine if the proposal indeed results in the intended revenue-neutrality.
- *Fee Revenues* – Several City programs are funded through fees charged to participants and users. These range from fees for recreation programs to fees for building permits. In general, fees should be reviewed and updated on a regular basis to reflect increasing costs. For this five-year projection, fee revenues are assumed to increase by 4.0% per year. In order to meet this target, the City will need to re-evaluate its fee-setting process so as to: a) provide that fees are reviewed and set in conjunction with the annual budget process, and b) ensure consistency in the approach and methodology used by the City in setting fees.

### **Five-Year Strategic Plan For Other Major Funds**

The Five-Year Strategic Plan for the General Fund provides a foundation for the long term fiscal health of the City. However, the General Fund only represents roughly 40% of the City’s total budget. Several other major funding sources are dedicated for specific purposes through Special Taxes, Assessments and Fees. Furthermore, many of the same pressures that continue to impact the relative health of the General Fund, are also impacting a number of other funds, resulting in deficits over the five-year fiscal planning horizon.

Limitations imposed by Proposition 218 effectively cap revenues for property-related fees and assessments, impacting the ability of these funds to meet programmatic funding requirements.

**Parks Tax (Measure D)**

The Parks Tax provides approximately \$1.3 million per year for maintenance of park facilities, the City's "urban forest" and street medians. This funding level represents less than 21% of the total cost for these services. One of the major issues facing the City Council is the scheduled "sunset" of this tax in FY 2006-07. In the absence of a re-authorization of this tax, the City would need to identify an alternative funding source to maintain current service levels, or consider a reduction in maintenance activities. The City Council has stated consideration of a replacement tax as a priority.

**Public Safety Tax**

This fund generates approximately \$2.0 million per year in support of the City's Police and Fire services. While an annual increase of 3% is built into the Five-Year Forecast, this funding source is unable to keep up with rising costs for the provision of public safety services. As such, this fund provides a decreasing proportionate share of public safety costs over time. A review of the structure of this tax is a key factor in establishing long-term fiscal stability and may also be prudent should the Council seek to significantly enhance public safety services through either increased police staffing and/or construction of a fourth fire station.

