

FINANCIAL FORECAST

Introduction

The Five-Year Financial Forecast provides a long-term view of General Fund revenue and expenditures to assist 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 limiting local governments' ability to raise revenues, adds 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.

Over the past year, the City has once again undertaken a review of the City's historical budget model, evaluated its methodology and assumptions, and explored the factors contributing to a favorable "bias" in the City's budget projections. In response to specific concerns over past forecasts, several assumptions have been updated for the forecast presented in this document.

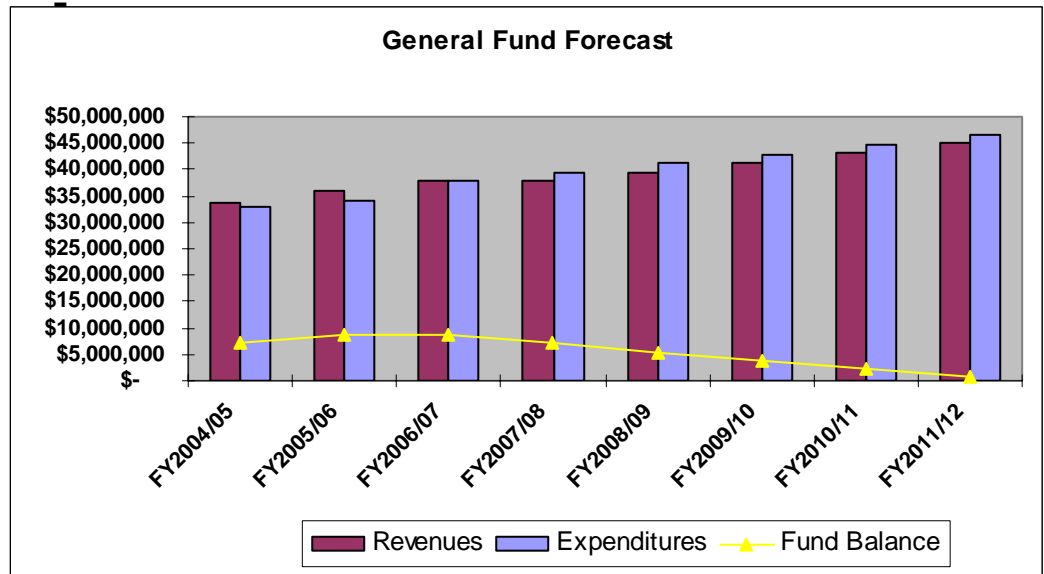
In addition, two major fund reclassifications were applied in the current year that will impact reporting of General Fund revenues and expenditures. First, the Traffic Safety Fund (Fund 114) is being reclassified into the General Fund. This fund, primarily funded through revenues from parking citations and moving violations, had previously been categorized as a Special Revenue Fund. Second, revenues and expenditures in support of the Building Division within the Community Development Department will now be recorded in a new Special Revenue Fund (Fund 195 – Building Fees/Permits). Funds collected by this division have historically been set-aside for the exclusive purpose of funding division expenditures. As this division is treated as a fully cost-covered division, with fees set annually to cover projected expenditures, a new special revenue fund has been created to facilitate budgeting, tracking and management of division resources and fund balances.

Summary of Five-Year Forecast

This section of the budget document presents an update of the General Fund Five-Year Forecast. Previous efforts to address the structural deficits projected in past forecasts have contributed to an increasingly improved forecast. With the balancing measures being recommended in the Adopted Budget, the General Fund deficit is projected to be reduced further to within \$200,000 - \$300,000.

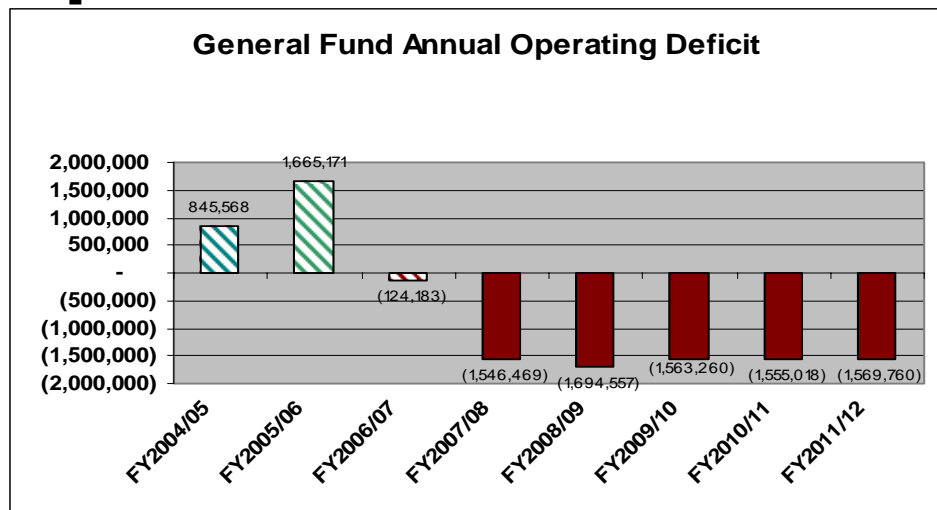
The Five-Year forecast continues to serve as an invaluable tool in assessing the City's progress in meeting its goal of fiscal stability, ensuring that current revenues are sufficient to meet expenditure requirements for maintaining existing service levels and that the City can sustain this level of service without reliance on growth or increases in current tax rates.

- General Fund revenues are projected to grow at an average annual rate of 4.4% per year, resulting in total revenue growth of \$7.1 million over five-year period FY 2007/08 through FY 2011/12.
- General Fund expenditures are projected to experience annual increases averaging 4.2% per year, resulting in total General Fund expenditures growth of \$7.1 million over five-year forecast period.
- Without corrective action, the General Fund reserve would decline from \$8.66 million (22.8% of revenues) at the end of the FY2006/07, falling below our 15% reserve policy level by FY2008/09, and be reduced to \$727,000 (1.6% of revenues) at the end of FY2011/12.



Baseline Operating Shortfalls / Structural Deficit

- In the absence of recommended adjustments to the FY2007/08 budget, the General Fund forecast continues to project annual operating deficits in the range of \$1.55 million to \$1.69 million.

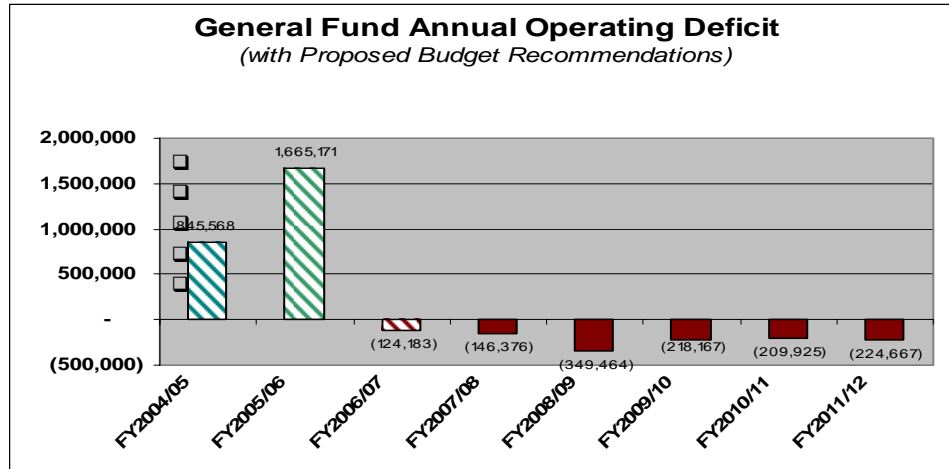


- The projected operating deficits shown over the five-year planning horizon remain relatively constant. This suggests that development of recurring budget-balancing measures in the range of \$1.5 million to \$1.6 million would successfully bring operating revenues and expenditures in balance.

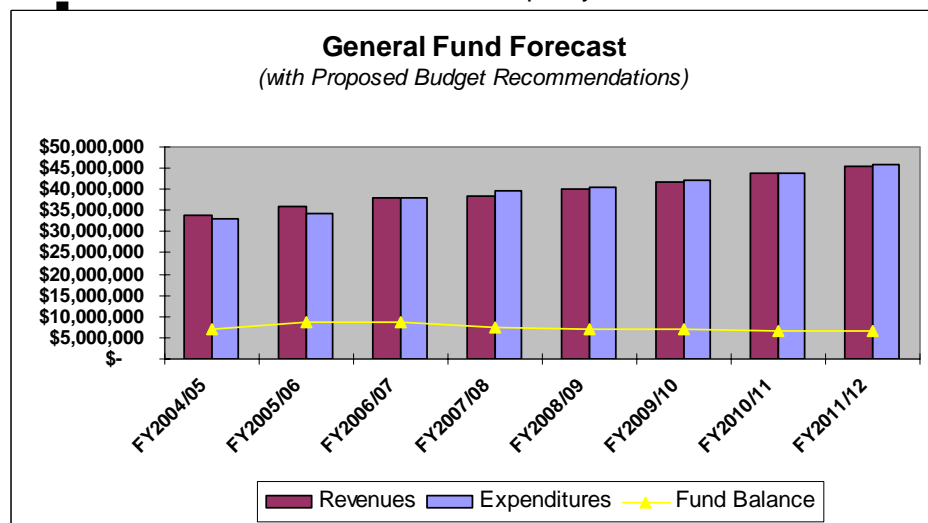
Multi-Year Budget Balancing Framework

- The FY2007/08 Adopted Budget has been developed consistent with the multi-year budget balancing framework. Key features of the multi-year framework include:
 - Gradual shift from reliance on reserves to fund annual operating expenditures
 - Ongoing refinement of the budget model to better reflect historical results
 - Development of recurring budget-balancing measures that “balance” use of new revenues against reductions in program expenditures and cost-savings.
 - Increasing and maintaining appropriate cost-recovery levels for fee-supported programs
 - Maintenance of a prudent 15% general fund reserve level with excess fund balances restricted for allocation to one-time uses.
- Elements of the budget-balancing framework included as part of the FY2007/08 Adopted Budget include:
 - Refinement of the budget forecast to more accurately project revenues and expenditures, resulting in a slight improvement in the forecast deficit.
 - Revenue forecasts have again been reviewed and adjusted to reflect less conservative growth assumptions
 - Expenditure baselines adjusted by further increasing the salary savings target from \$750,000 to \$1,000,000, representing 3.5% of General Fund personnel costs.
 - In addition, the adopted budget includes a baseline adjustment of \$750,000 to reflect historical savings levels within non-personnel expenditure categories.

- Propose charge to Redevelopment Agency (\$250,000) to reflect recovery of indirect costs in support of Agency activities
- A reduction in the reliance of one-time reserves to fund ongoing operating expenditures. The Adopted Budget utilizes approximately \$200,000 in one-time funding to balance the FY2007/08 operating budget. This is anticipated to be the final year where one-time resources are used for this purpose.



- The balancing plan addresses a significant portion of the projected General Fund deficits and maintains the 15% General Fund reserve level policy. However, additional balancing measures, in the range of \$200,000 - \$350,000, will be needed to maintain a balanced budget.
- The budget proposal would sustain General Fund reserves consistent with current policy.



- The forecast, as presented, focuses on the relationship between costs to support current service levels and the revenues expected to be generated by our existing tax base. The forecast excludes costs associated with significant unmet needs, nor does it reflect the potential loss of tax revenues subject to re-approval by the voters in 2010 (Measure P - Sales tax) or in 2012 (Measure G – parks tax). The forecast also excludes impact of new development projects yet to come on line. The latter could provide additional budget flexibility by FY2008/09.

State Budget Impacts

- ❑ Over the past decade, the City has lost approximately \$22 million to the State through a series of “raids” on local revenues. The ongoing annual loss of local property tax revenues from the “ERAF” shift now exceeds \$2.8 million per year.
- ❑ Additional State budget impacts, netting to \$2.1 million in lost revenue were incurred between FY 2003/04 through FY 2005/06. However, with the passage of Proposition 1A (2004) cities have gained significant protection against state takeaways. However, while this measure has so far succeeded in preventing future shifts of property tax and sales tax revenues to the State, cities continue to be “net-donors” to the State coffers.

| | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 |
|-------------------------------------|--------|------------------|-------------------|--------|--------|
| VLF | <1.60> | .95 | - | -- | -- |
| ERAF I & II ERAF III | <2.24> | <2.38> <0.66> | <2.590> <0.66> | <2.70> | <2.83> |
| Mandated Reimbursement | - | <0.18> | <0.18> | | |
| Totals | <3.84> | <2.27> | <3.43> | <2.70> | <2.83> |

- ❑ The passage of a second Proposition 1A (2006) provided additional guarantees related to future Proposition 42 funding for local streets and roads. Beginning in FY2008/09, the City is expected to see a significant increase in transportation funding through full-funding of our Prop 42 share.
- ❑ Cities continue to have some level of exposure to state impacts in the areas of State Mandate re-imbursments as well as Redevelopment Agency revenue shifts. Mandate reimbursements, while restored to some measure in recent years, are subject to the level of annual appropriations included in the state budget. Redevelopment Agency funds are not constitutionally protected, as is property tax revenue, however the State has considered these funds protected by the spirit of Prop 1A – for now. All of these assumptions are likely to be put to the test when the State Budget faces its next fiscal emergency.
- ❑ The City is expected to benefit from the passage of the State Infrastructure Bond package, approved by the voters this past November. Specifically, Proposition 1B will provide the City in excess of \$2.0 million over the next five years in support of local streets and roadways as well as other transportation related projects. The Legislature and the Administration will be making final determinations as to the disbursement of these funds.

Next Steps

- Additional refinement of the multi-year budget framework will be needed in several respects:
 - During the course of the upcoming fiscal year, revenue and expenditure projections will be updated periodically with the goal of addressing the remainder of the structural budget shortfall in the FY2008/09 budget. The multi-year framework will be used as a guide to this process, ensuring an appropriate balance of new revenues and expenditure reduction measures.
 - Staff will seek to evaluate the appropriateness of the City's recently adopted General Fund reserve policy level, as well as the advisability of establishing formal reserve policy in selected other funds. The current 15% General Fund reserve policy requires that the City retain a reserve fund of \$5.7 million, which increases by \$150,000 for every additional \$1.0 million in revenue growth. The goal of the reserve policy is to buffer against revenue fluctuations (economic uncertainties) as well as provide for needs arising in emergencies. As such, the amount of the reserve should be periodically assessed against the risk factors it is designed to guard against.
 - Given the inter-dependency of the General Fund to less discretionary funding sources, the City will seek to establish complimentary multi-year forecasts for selected Special Tax and Enterprise Funds, including: Parks Tax, Public Safety Tax, Building Permit, Sewer, as well as Transportation and Internal Service Funds.
 - Staff will continue to evaluate and refine recommendations related to the multi-year budget balancing framework, including identification of funding requirements to meet priority unfunded needs as well as a range of proposals to establish appropriate funding mechanisms for identified needs.

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 economic cycles, and unforeseen emergencies. These assumptions impact revenue and expenditure projections and variations can cause wide swings in budget balancing strategies.

Inflation

Inflation is an important factor in any economic forecast, given its influence on both 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 influenced by annual cost-of-living increases.

The City of Davis uses as its inflation index, the All Urban Consumer Price Index for the Bay Area. This index has increased an average of 2.7% 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

| YEAR | |
|----------------|------|
| 2001 | 5.8% |
| 2002 | 2.1 |
| 2003 | 2.2 |
| 2004 | 0.5 |
| 2005 | 2.1 |
| 2006 | 3.5 |
| 6-Year Average | 2.7% |

Population

Based on data from the State Department of Finance, population is projected to be 64,585 for FY2007-08 and remain relatively flat. Population impacts some state revenues (allocated on a per capita basis) as well as drives demands for a variety of city services. The population figure reported for the City of Davis excludes persons housed on the University of California at Davis campus as it lies outside of City limits.

State Impacts

Over the past several years, the City's financial forecast has been subject to significant impacts from the State budget. Specifically, property tax shifts under ERAF (first implemented in 1992/93, and most recently in 2004/05 and 2005/06), loss of Vehicle License Fee backfill revenues, and the exchange of Sales Tax for Property Tax under the "Triple-Flip" enacted in this budget year have greatly impacted overall city revenues as well as cash flow positions. With the Passage of Proposition 1A, cities have now been afforded significant protection against future State take-aways. The current

Five-Year Forecast reflects the lingering impacts of past and current State actions, but reflects restoration of ERAF II funds and VLF backfill monies per current statutory and constitutional provisions.

Expenditure Baseline

The expenditure baseline for the Five-Year Forecast is the Adjusted FY2006-07, and the Adopted FY 2007/08 budgets. The forecast projects expenditures as a result of anticipated changes in factors and assumptions highlighted in this section.

Current service/staffing levels - The Five-Year forecast assume current (FY 2006-07) staffing levels, adjusted only for any new positions recommended in the adopted budget for FY2007/08. In the past, this assumption has been referred to as a “flat budget”; however, it should be noted that any budget that maintains “flat” staffing/service levels needs to account for increased costs resulting from personnel costs as well as inflation and contractual obligations impacting non-personnel expenditures.

Personnel Costs

Salary and benefit costs make up 71% of the discretionary General Fund budget. Every 1% increase in total compensation costs approximately \$516,000, on an all funds basis, and approximately \$285,000 to the General Fund.

The Five-Year Plan reflects total compensation (salaries and benefits) increases of 5.6% for FY2007/08, and averaging 5.2% per year over the five-year forecast. This represents an increase of approximately \$8.2 million over the Five-Year Plan.

Increases in the specific components that make up total personnel costs are summarized as follows:

| | Annual % Change | |
|------------------------------|-----------------|----------------------------|
| | FY2007/08 | Five-Year Forecast |
| Salaries* | 3.5% | 4.0% - 3.0% (range) |
| Insurance | 10.0% | 12.0% |
| Retirement | 21.0% | 4.0% - 3.0% (range) |
| Total Personnel Costs | 8.8% | 4.8% - 5.5% (range) |

Increases for employee salaries are estimated based on negotiated labor contracts, inflationary cost-of-living adjustments, as well current labor markets:

| | FY05-06 | FY06-07 | FY07/08* | FY08/09 | 5-Yr |
|-----------|----------------|----------------|-----------------|----------------|-------------|
| Civilian: | 3.0%-5.0% | 3.0%-5.0% | 0.6%-4.4% | 3%-4% | Inflation |
| Fire: | 10.0% | 8.0% | 8.0% | 6% | Market |
| Police: | 3.0% | 5.0% | 6.0% | 6% | Market |

* Note: Civilian salary increases for FY2007/08 reflect an adjustment of up to 4.4% to cover the cost of a enhancement to the CalPERS retirement formula (2.5@55) consistent with provisions of applicable labor contracts.

Insurance Premiums

Costs related to Health, Dental, Retiree Medical, Disability, Workers' Compensation, Life Insurance and Unemployment insurance. are assumed to grow at an annual rate of 10.0% for FY 2007-08 and the forecast assumes

annual increases of 10.0% thereafter. The City is projected to pay out \$12.5 million in FY 2007-08, with \$7.0 million charged to the General Fund.

Other Post-employment Benefits (OPEB)

GASB Pronouncement 45 requires public agencies to evaluate and report in its annual financial statements the fully-funding cost of any post-employment benefits (i.e. retiree healthcare). While GASB 45 does not require full-funding of post-employment benefits, its effectively sheds light in the gaps between the true cost of these benefits and the funds typically allocated on an annual basis for pay-as-you-go funding plans.

The City of Davis, which is required to comply with this new reporting requirement by December 2009, is currently undertaking an actuarial valuation of the city’s retiree health benefit plan. Upon completion of the study, the City will need to evaluate strategies to gradually shift to a full-funding of its benefit plan.

It is anticipated that the City will be reporting a significant unfunded liability that could require significant increases in annual funding. City staff, the Council and representatives from the employee bargaining units will need to discuss the viability of funding and/or policy alternatives in this area.

State Retirement System

Retirement rates are set annually by the California Public Employees’ Retirement System (CalPERS). The rates established for FY 2007-08 reflect a slight increase from current rates. Retirement contribution rates are primarily driven by investment earnings for the CalPERS’ investment portfolio, as well as variations in other actuarial assumptions. While investment returns continue to exceed plan assumptions, there is typically a two-year lag time for these results to be reflected in employer contribution rates.

The following table summarizes the employer contribution rates used in the Adopted FY2006/07 Budget and Five-Year Forecast:

| | | FY 03-04 | FY04-05 | FY05-06 | FY06-07 | FY07-08 |
|----------|----------|----------|---------|---------|---------|---------|
| Police | (Sworn) | 6.40% | 22.62% | 23.98% | 21.11% | 22.50% |
| Fire | (Sworn) | 15.30% | 20.68% | 23.98% | 21.11% | 22.50% |
| Civilian | (Misc.)* | 7.00% | 10.04% | 16.30% | 16.25% | 20.32% |

Note - (FY03-04 – FY06/07) -Civilian Plan contribution rates include 7.0% employee contributions paid by the City (FY07/08) Civilian plan rates reflect a 3.3% increase related to the enhancement of the retirement benefit plan. This cost is fully-offset by a corresponding reduction (plus an additional percent) in the salary adjustment per applicable labor contracts.

On an all-funds basis, the City’s cost for retirement benefits in FY2007/08 is \$6.8 million, an increase of \$1.3 million over FY 2006-07. The General Fund represents approximately 58% of citywide personnel costs which implies that the General Fund cost for retirement contributions would grow by approximately \$660,000 for FY2007/08.

Beginning in FY2004/05, the City's Police and Fire retirement plans were combined into a single Public Safety plan so as to avoid being mandated to participate in a statewide safety plan (required for all agencies with fewer than 100 members). The City was able to avoid potentially higher costs for public safety retirement given that the rates for Police and Fire have typically been well-below state averages for similar plans.

Employer contribution rates are projected to stabilize somewhat over the next five-years, as the impact of investment losses from past years are fully-factored into CalPERS' rates. In addition, CalPERS has recently implemented a rate-smoothing methodology to moderate potential year-to-year fluctuations in employer contribution rates.

Finally, the Governor continues to consider proposals aimed at reforming public employee retirement (and retiree health benefit) plans on a statewide basis. While the City will continue to monitor developments in this area, most of the reform measures that may emerge are unlikely to impact the City's fiscal situation in the short-term.

General Fund Reserve

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.

The Five-Year Plan reflects a continuation of the Council's current policy of maintaining 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).

In conjunction with the City Council's adoption of the FY2006/07 budget, it adopted a formal General Fund Reserve Policy. The goal of the policy is to establish the level of reserves as well as establish clear guidelines on the appropriate use of reserve funds.

General Fund Revenues

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 the only fully discretionary revenue available to the Council and citizens to directly support changing local priorities. 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.

While there are numerous sources contributing to overall General Fund revenues, there are 7 primary 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, transient occupancy (hotel) tax, municipal service tax and fee revenues. In FY 2006-07, these indicator revenues comprised 87% of the total General Fund revenue.

General Fund Major Revenue Sources

The City's ability to maintain General Fund revenue 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 between 5%-6%. This growth is mostly influenced by the recent trends in home appreciation rates and the turnover rate for home sales 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 however, 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 now generally receives 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.

The City continues to assess the impact of the voter-approved ½ cent sales tax on new auto sales. Since this tax is technically a “use” tax, it is only assessed on vehicles purchased for “use” (ie. registered) in the City. The tax is not assessed on vehicles purchased within the City by residents of other communities. As such, the additional 50% sales tax is not generated by a significant portion of local auto sales. Offsetting this, to some degree, is the fact that the ½ cent sales tax is applied to sales to local residents by out-of-town dealers. In FY2005/06, the City began a regular audit of sales tax receipts to ensure that the City receives its appropriate share of sales tax revenues.

- *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 2%.
- *Motor Vehicle In-Lieu* – This revenue source represents the City’s allocated share of state-wide vehicle registrations, 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. In FY2003/04, this source of revenue was targeted by the State as a means to address the state’s budget dilemma. This resulted in the loss of 3 months, or one-quarter, of the anticipated annual revenue.

The FY2004/05 State Budget changed how VLF revenues are distributed, and lessened the reliance of this revenue source on the part of cities. Beginning last year, roughly 90% of cities’ VLF revenues were exchanged for an equal amount of Property Tax revenues from the state. In subsequent years, the amount of the property tax “in-lieu” payments increased in proportion to growth in each jurisdiction’s assessed value. As a result, in cities where appreciation of assessed values is expected to grow faster than population, increased revenues would be generated.

- *Municipal Service Tax* – This revenue source was adopted by local voters in 1986. The tax is paid by residential property owners based primarily on a per dwelling unit basis, and to commercial property owners primarily on a per square foot of building basis. The tax is expected to generate \$2.1 million in FY2007/08. An annual increase of 3% is built into the Five-Year Forecast.
- *Fee Revenues* – Several City programs are funded through fees charged to participants and users of city services. These range from fees for recreation programs to fees for building permits. In general, fees are

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, consistent with the projected growth in expenditures.

Beginning in FY2005/06, City departments – Parks (Recreation) in particular – began to evaluate individual fees and have adopted a series of fee increases to enhance cost-recovery for fee-supported programs. The City continues to work towards a formal fee and cost-recovery policy to provide comprehensive and consistent guidelines in the establishment of appropriate fees.

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 27% 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

The Parks Tax provides approximately \$1.3 million per year for maintenance of parks and park facilities. This funding level represents less than 25% of the total cost for these services.

The City Council placed a measure seeking renewal of this tax on the June 2006 ballot. The renewal measure was successful, and the current tax rate and revenues will continue for an additional 6 years, pending renewal at an election in 2012, or identification of an alternative revenue measure that could result in the repeal of the current park tax.

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 this tax, and possible means to supplement its revenues are a key factor in establishing long-term fiscal stability and enhancing public safety services through either increased police staffing and/or construction of a fourth fire station.

