

FINANCIAL FORECAST

Introduction

The Five-Year Financial Forecast provides a long-term view of City revenues 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 few years, the City has undertaken a review of the City's historical budget model, evaluated its methodology and assumptions, and explored the factors contributing to the favorable "bias" that has characterized past budget projections. In response to specific findings, several assumptions have been updated for the forecast presented in this document.

Over the course of the most recent City Council budget workshops, there has been increased focus on the sensitivity of the budget forecast to the major underlying revenue and expenditure assumptions. The uncertainty that characterizes the current economic climate not only argues for prudent long-term financial planning, but also suggests that the City being prepared for a range of outcomes is perhaps more appropriate than focusing on any single predicted outcome. As such, the five-year budget model truly serves as a planning tool rather than a forecasting tool.

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 in past forecasts have relied on decreasing levels of one-time resources and contributed to an increasingly improved forecast. However, the current economic recession, triggered by the bursting of the housing market “bubble” has greatly eroded the two most significant local revenue sources.

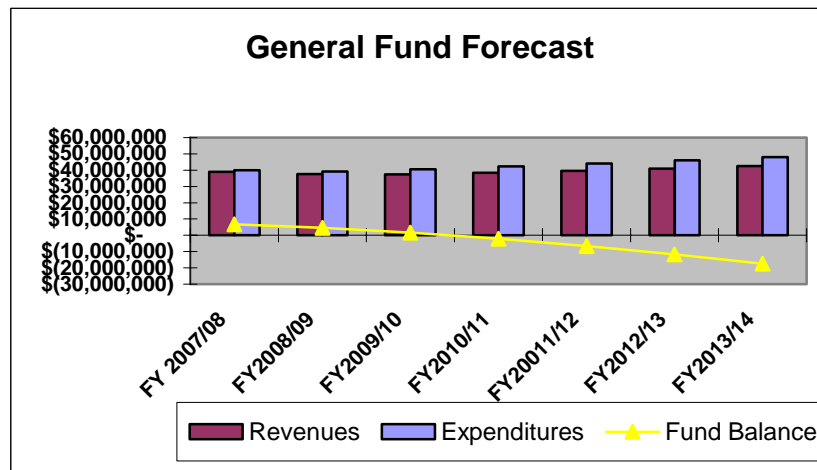
Balancing measures are proposed as part of this FY2009/10 budget to close a projected General Fund deficit of \$3.15 million, while endeavoring to maintain a 15% General Fund reserve through the five-year forecast.

Past Five-Year forecasts have served as valuable tools 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.

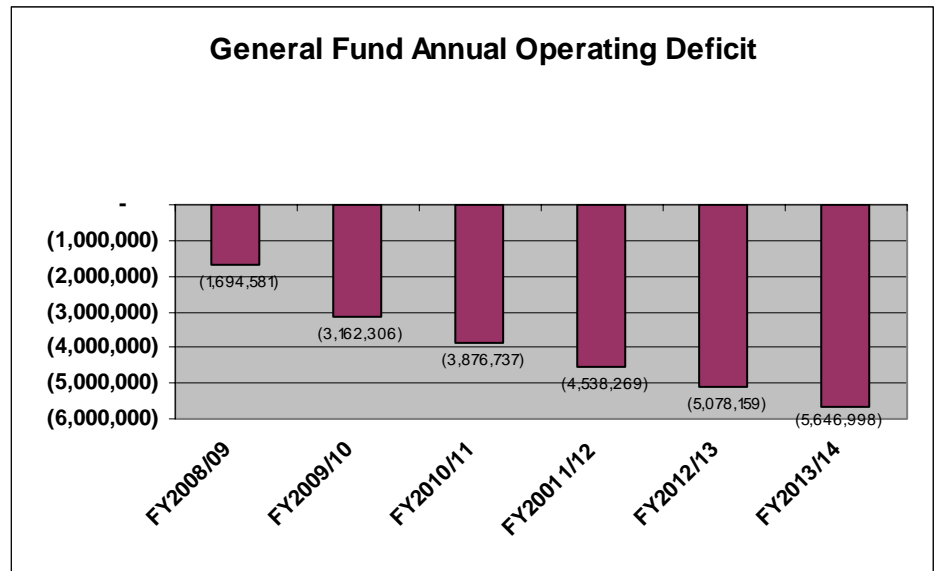
This year, the five-year budget forecast serves to highlight the variability of the City’s budget outlook in the face of declining revenues and increasing uncertainty. Through modeling alternative revenue and expenditure assumptions, the forecast provides not only a sense of the short-term measures that are required to maintain a balanced budget, but also informs the level of contingency plans that also need to be in place, should alternative scenarios play out.

The following summarizes the results of the City’s baseline General Fund forecast:

- General Fund revenues are projected to grow at an average annual rate of 2.5% per year, resulting in total revenue growth of \$5.0 million over five-year period FY 2009/10 through FY 2013/14.
- General Fund expenditures are projected to experience annual increases averaging 4.2% per year, resulting in total General Fund expenditures growth of \$7.5 million over five-year forecast period.
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- Without corrective action, the General Fund reserve would decline from an estimated \$5.3 million (15% of revenues) at the end of the FY2008/09, falling below our 15% reserve policy level, to \$1.7 million (or 4.9%) by FY2009/10, and be fully-exhausted by FY2010/11.
- In the absence of adjustments to the FY2009/10 budget, the General Fund structural deficit would increase from an estimated \$3.1 million in FY2009/10 to over \$5.6 million by FY2013/14. This result not only suggests that aggressive balancing measures are required for the coming year, but that ongoing annual reductions – in the range of \$550,000 to \$700,000 may be needed in each outlying years.

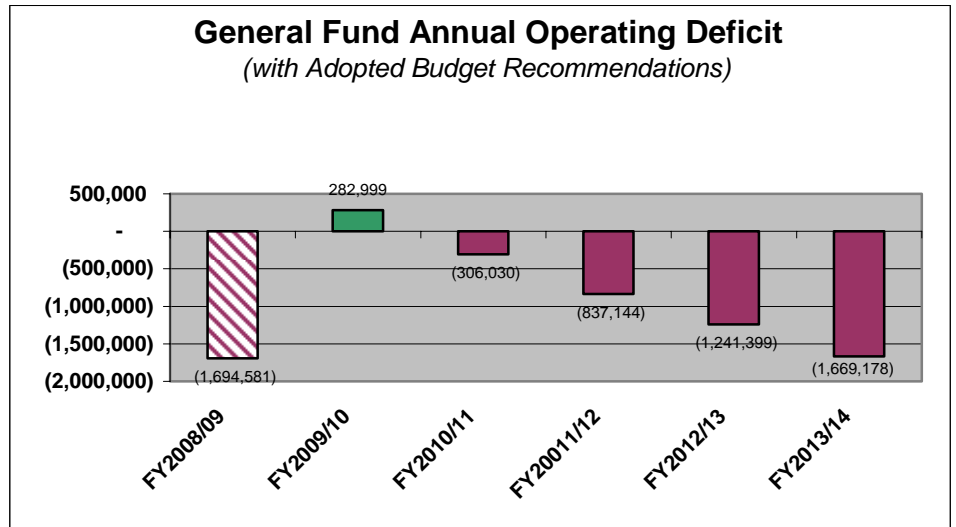


- The projected operating deficits shown over the five-year planning horizon remain highly sensitive to assumptions related to major city revenues and expenditure categories. Among the main areas of concern are, property and sales tax revenues, overall personnel costs (and specifically costs for health and retirement benefits), and the renewed threat of adverse actions by the State that could further erode revenues at the local level.

Multi-Year Budget Balancing Framework

- The FY2009/10 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.

- The balancing plan addresses a projected deficit of \$3.15 million, maintains the General Fund reserve at 15% of operating revenues – consistent with current policy – but falls short of ensuring long-term structural budget balance.



- With the proposed balancing plan for FY2009/10, the forecast yields a budget shortfall of \$300,000 for FY2010/11, growing to \$837,000 by FY2011/12, and \$1.6 million by FY2013/14, This result reflects the fact that general fund revenue growth is not expected to keep pace with expenditure growth, using model assumptions.
- The forecast excludes costs associated with significant unmet needs and unfunded liabilities, 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 as early as FY2009/10.

State Budget Impacts

- ❑ Over the past decade, the City has lost in excess of \$30 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 is now over \$3 million per year.
- ❑ 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. Moreover, the deteriorating situation relative to the State budget has resulted in the prospect of a Prop 1A “borrowing” being back on the table in Sacramento.

| (\$ Millions) | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 08/09 | 09/10 |
|-------------------------------------|--------|-------------------|--------------------|--------|--------|--------|--------|
| VLF | <1.60> | .95 | - | -- | -- | -- | -- |
| ERAF I & II ERAF III | <2.24> | <2.38> <0 .66> | <2.590> < 0.66> | <2.70> | <2.83> | <2.96> | <3.20> |
| Mandated Reimbursement | - | < 0.18> | < 0.18> | | | | |
| Totals | <3.84> | <2.27> | <3.43> | <2.70> | <2.83> | <2.96> | <3.20> |

- ❑ 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-imburements 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 are property tax revenues, however the State has considered these funds protected by the spirit of Prop 1A – for now. While recent court rulings have supported the argument that Redevelopment Funds are protected from State takeaways, all of these assumptions are likely to be put to the test as the State grapples with its growing and unprecedented fiscal emergency.

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 April-to-April All Urban Consumer Price Index for the San Francisco Bay Area. This index has increased an average of 2.0% over the last seven 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 | |
|---------|------|
| 2002 | 2.1 |
| 2003 | 2.2 |
| 2004 | 0.5 |
| 2005 | 2.1 |
| 2006 | 3.2 |
| 2007 | 3.3 |
| 2008 | 2.1 |
| 2009 | 0.8 |
| Average | 2.0% |

Population

Based on data from the State Department of Finance, population is projected to be 65,400 for FY2008-09 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 FY2008-09, and the Proposed FY 2009/10 budgets. The forecast projects expenditures as a result of anticipated changes in factors and assumptions highlighted in this section.

Current service/staffing levels - The baseline Five-Year forecast assume current (FY 2008-09) staffing levels. 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 \$510,000, on an all funds basis, and approximately \$306,000 to the General Fund.

The Five-Year Plan reflects total compensation (salaries and benefits) increases of 2.6% for FY2009/10, and averaging 5.2% per year over the five-year forecast. This represents an increase of approximately \$8.7 million (All Funds) over the Five-Year Plan.

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

| | Annual % Change | |
|------------------------------|-----------------|----------------------------|
| | FY2009/10 | Five-Year Forecast |
| Salaries* | 3.2% | 2.5% - 3.0% (range) |
| Insurance | 10.0% | 12.0% |
| Retirement | 3.2% | 4.0% - 3.5% (range) |
| Total Personnel Costs | 8.8% | 4.5% - 5.3% (range) |

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

| | FY06-07 | FY07/08* | FY08/09 | FY09/10 | 5-Yr |
|-----------|-----------|-----------|---------|---------|-----------|
| Civilian: | 3.0%-5.0% | 0.6%-4.4% | 3%-4% | 0.0% | Inflation |
| Fire: | 8.0% | 8.0% | 6% | 0.0% | Inflation |
| Police: | 5.0% | 6.0% | 6% | 5.0% | Inflation |

* 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 2009-10 and the forecast assumes annual increases of 10.0% thereafter. The City is projected to pay out \$14.0 million in FY 2009-10, with \$8.4 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, has completed its actuarial valuation of the city's retiree health benefit plan, which resulted in an estimated \$42 million unfunded liability, and an annual required contribution rate of approximately \$4.2 million, or 16.5% of salaries. For the past two years, the city budget has included incremental funding – over and above the historical pay-as-you go levels - with the goal of meeting our actuarial funding requirements over the next 5-7 years.

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 Proposed FY2006/07 Budget and Five-Year Forecast:

| | <u>FY04-05</u> | <u>FY05-06</u> | <u>FY06-07</u> | <u>FY07-08</u> | <u>FY08/09</u> | <u>FY09/10</u> |
|-------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Police (Sworn) | 22.62% | 23.98% | 21.11% | 22.50% | 22.10% | 22.755% |
| Fire (Sworn) | 20.68% | 23.98% | 21.11% | 22.50% | 22.10% | 22.755% |
| Civilian (Misc.)* | 10.04% | 16.30% | 16.25% | 20.32% | 20.20% | 20.542% |

Note --Civilian Plan contribution rates include 7.0% employee contributions paid by the City of 7% through FY2006/07and 8% thereafter. Civilian plan rates reflect a 3.3% increase related to the enhancement of the retirement benefit plan, beginning in FY2007/08. 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 \$7.2 million, an increase of \$300,000 over FY 2008-09. The General Fund represents approximately 56% of citywide personnel costs which implies that the General Fund cost for retirement contributions would grow to just over \$4.0 million for FY2009/10.

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.

CalPERS employer contribution rates are projected to increase significantly beginning in FY2011/12 as a result of retirement fund investments losing significant value over the past year (in comparison to the assumption that the fund would earn 7.75% interest annually). CalPERS has provisionally advised contracting employers to plan for increases in the range of 2% to 5%, depending on the year-end investment return performance as of June 30, 2009.

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 2008-09, these indicator revenues are expected to comprise an estimated 75% 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 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 trends in home appreciation and the turn-over rate for property sales in the City. The growth rate used in the budget and Five-Year Forecast assumes a reduced growth rate as compared to recent years, reflecting the recent softening of the real estate market in terms of both market values and resale activity.

Property tax revenues in 08-09 grew at 1.6%, a sharp decline in the rate of growth experienced in recent years.

- *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 decline 10% from 07-08 levels, with 0% growth expected in 09-10.

The City continues to assess the impact of the voter-approved ½ cent sales tax (Measure P – 2004). Since this tax is technically a “use” tax, it is only assessed on goods purchased for “use” (ex. vehicles 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 auto 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 0%.
- *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. In that 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 \$2.3 million in FY2009/10. 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 3.0% 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 proposed 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 28% 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 23% 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 4 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 deployment of a fourth fire engine company.