



CITY COUNCIL STUDY SESSION REPORT

MEETING DATE: JULY 12, 2011

ITEM NUMBER:

**SUBJECT: INTRODUCTION OF THE CITY'S PRELIMINARY FIVE YEAR FINANCIAL FORECAST
AND CAPITAL REINVESTMENT STRATEGY**

DATE: JULY 6, 2011

FROM: FINANCE DEPARTMENT /FINANCIAL PLANNING DIVISION

PRESENTATION BY: BOBBY YOUNG, BUDGET AND RESEARCH OFFICER

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RECOMMENDED ACTION

It is recommended the City Council discuss the City's Preliminary Five Year Financial Forecast and Capital Reinvestment Strategy and provide comments/suggestions about future priorities.

BACKGROUND

During the recent decline in the economy, the City's financial position changed. Over the last few years, the City's revenues have declined forcing the City to take necessary actions to reduce expenditures. As part of reducing expenditures, among other things, it was determined to delay: purchasing or replacing equipment, repairs and maintenance to facilities, and funding reserves. Unfortunately, while reducing staffing costs, the City also used fund balance or reserves in the amount of approximately \$33 million.

Recently, City Council has expressed a desire to determine, financially, what the next five years (FY 12-13 thru FY 16-17) look like for the City's General Fund. The City has not had a comprehensive five year financial forecast to provide such information, therefore staff has developed one. Staff created this five year financial forecast using most of the City's own tools for developing the annual budget, both revenues and expenditures.

At this time, this forecast is based on preliminary assumptions and is intended to be a tool to help: 1.) project what future year's budget might be; 2.) demonstrate how decisions in the current year may impact the financial future of the City; and 3.) allow City Council to discuss and determine future priorities based upon available resources. City Council has expressed a desire to contribute more General Fund monies to capital improvements and therefore the 5-year forecast may allow for even more clarification of priorities under the capital improvements topic (Streets, Alleys, Sidewalks, etc).

ANALYSIS

For revenues, staff compiled about 10 years of historical data at the individual account level. This historical information is very important when determining future forecasting. Having such data helps determine if a revenue account is relatively flat (Business License Tax),

increasing at consistent rate (some fee and charges), or fluctuating with current market conditions from year to year (Sales Tax and Property Tax). Using this data, staff was able to then summarize into two line items – Total Revenue and Total Other Financing Sources (Transfers In). These two items can be seen in historical CAFR's and therefore allows for easy year to year comparison/verification.

For expenditures, staff also compiled about 10 years of historical data at the department/division individual account level. Using this detail, staff was able to summarize the information into the major categories of Salaries and Benefits (S&B), Maintenance & Operations (M&O), Fixed Assets and Transfers Out, as well as have year over year data at the individual account level. Establishing a database at this level allows for maximum analysis and the ability to forecast certain line item data at the department/division level, similar to the annual budget.

Since salaries and benefits are a large part of the overall expenditure forecast, staff created the necessary database to forecast these future costs at the position level. Currently, staff uses a similar database for the annual budget, which includes current salary information, applicable step/merit increases, other compensation rates/amounts, PERS rates (for a given year), medical/flex bucket amounts and Medicare contributions. While having this data for one year, staff extrapolated the same database for each of the five years to forecast. Having such a database, has allowed staff to more accurately forecast salary and benefit costs, especially with variables like PERS rates and salary increases.

This salary and benefit information feeds into the department/division line item database to be combined with any M&O account analysis. Maintenance and operations account analysis is very similar to that of revenues. Having historical data helps when determining if individual accounts remain flat (office supplies and debt service), increase at a consistent rate (utility costs – water, gas, electric), or fluctuate with current conditions or needs (building modifications and fixed asset purchases). Staff reviewed current funding levels for each department/division line item and forecasted each according to the type of account.

Assumptions:

As with any forecast, making assumptions about future conditions is very important. For the City, assumptions need to be made for both revenues and expenditures.

Revenues: At this time, staff determined there were 4 main revenue sources that would require an assumption be made, Sales Tax, Property Tax, Transient Occupancy Tax (TOT) and Building/Electrical/Plumbing Permits. In the future, it may be necessary to incorporate additional accounts in the forecast to provide more detailed analysis. With most of the assumptions, trying to eliminate year to year fluctuations while forecasting, staff determined it was prudent to assume an average rate.

Sales Tax – the current sales tax assumption is an increase of 3% per year. Staff recognizes that current market conditions are more favorable than previous years and that those conditions may not continue. Using a 3% average could allow for a 6% increase in one year and a 0% increase the following. The average for those two would be 3%.

Property Tax – the current property tax assumption is an increase of 3% per year. A portion of the property tax base has been restricted by Prop 13, which establishes a maximum annual assessment increase to 2% (CPI Adjustment Factor). Therefore, even though market values are down, these properties may still increase annually by the CPI adjustment factor until they are assessed at the market value.

Another aspect of property taxes is, with the recent decline of property values, the County Assessor reduced the assessed value of many properties. In the future, when the market value increases, these properties can be assessed in excess of the CPI adjustment factor (2% maximum) until they return to the Prop 13 assessed maximum value. Should this occur, property tax revenue will increase in excess of normal inflationary factors.

Transient Occupancy Tax (TOT) – the current TOT assumption is an increase of 2% in 2012-13, 2.5% in 2013-14, and 3% the remaining years. The rate increase from 2010-11 is fully implemented and staff is including a slight increase as the economy begins to stabilize. Also the business sector may begin to increase from where it currently is and Costa Mesa will benefit by being in Central Orange County and its proximity to the airport.

Building/Electrical/Plumbing Permits – the current permit assumption is an increase of 2.5% in 2012-13, 3.0% in 2013-14, and 2% the remaining years. It is anticipated by many economists that the building industry will be increasing in the next couple of years for both housing and business development. While Costa Mesa is fairly built out for new development, the City is starting to see more redevelopment of current properties. Staff reducing this increase in future years is a conservative reduction.

For all other revenue line items staff used historical trends to help determine changes (increases or no change) from year to year.

Expenditures: At this time, staff determined there were 2 main expenditure attributes that would require assumptions: salary increases and PERS rates. Since greater than 70% of the City's budget is salary and benefits, staff felt it important to focus on those aspects at this time. Staff recognizes both attributes could change as part of the negotiation/contract process, so both are viewed more conservatively as to not influence that process.

For both assumptions there are 3 categories – Miscellaneous, Police and Fire. Miscellaneous should be considered all non-sworn full time personnel. Police and Fire are the sworn personnel in each of those departments.

Salary Increases – City staff have not received salary increases since the 2008-09 fiscal year.

The current salary increase assumption for the Miscellaneous personnel is 0% until 2014-15, then 2% the remaining two years. The current employment contract is effective until 2013. Given current employment market conditions and the length of the current employment contract, staff is not forecasting a salary adjustment for three years. Staff has included a 2% salary increase in the final two years of the forecast as it may be more probable some adjustment would take place in the future.

The current salary increase assumption for sworn Police personnel is 0% until 2014-15, then 2% the remaining 2 years. This is based on the current employment contract that states if the City's top 3 revenues have increased to previous all time highs (FY 07-08) then a minimum 2% increase would be required. At this time, the current forecast does not meet this requirement; therefore staff is not including a salary increase until 2015-16.

The current salary increase assumption for sworn Fire personnel is 0% in 2012-13 the 2% the remaining 4 years. This is based on the current employment contract that states the requirement by the City not to adjust salaries until September 2013. Therefore starting in FY 2013-14 staff has forecasted a 2% increase and assumed the same each year after.

PERS Rate Increases – Staff based the forecast using the most recent PERS rate increases received from PERS in March 2011. They are displayed as the total PERS rate (including both the Employee and Employer rates).

For calculating the forecasted cost, staff has separated the two as it normally does for the annual budget, and only taken into account the City's net cost (excluding the amounts paid by employees).

The forecasted rates for Miscellaneous are as follows:

FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17
18.53%	19.38%	27.18%	27.58%	27.88%	28.18%

There are 2 reasons for the increase in FY 13-14. One is because CalPERS has projected a rate increase of 2.8%. They are currently projecting rate increases to level off after that year. The other reason is because that is the time when the current employment contract will conclude and the 5% the Miscellaneous personnel currently contribute would revert back to the City. In FY 13-14, staff estimates that amount to be \$740,067.

The forecasted rates for Police are as follows:

FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17
38.06%	38.80%	42.20%	42.50%	47.80%	48.10%

The reason for the increase in FY 13-14 is because CalPERS has projected a rate increase of 3.4%. They are currently projecting rate increases to level off after that year. The reason for the increase in FY 15-16 is because that is the time when the current employment contract will conclude and the 5% the Police personnel currently contribute would revert back to the City. In 15-16, staff estimates that amount to be \$894,908.

The forecasted rates for Fire are as follows:

FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17
40.04%	47.70%	51.90%	52.50%	53.00%	53.50%

The reason for the increase in FY 12-13 is because that is the time when the current employment contract will conclude and the 6% the Fire personnel currently contribute would revert back to the City. In 12-13, staff estimates that amount to be \$637,598. The reason for the increase in FY 13-14 is because CalPERS has projected a rate increase of 4.2%. They are currently projecting rate increases to level off after that year.

For all other expenditure items, staff also used historical costs to help determine changes (increases or no change) from year to year. Certain items that are based on current rates (utilities and insurance), staff included annual increase amounts and will continue to determine if included amounts are reasonable. For other more controllable line items (office supplies, furniture, equipment), staff forecasted flat using current proposed budgeted amounts.

Preliminary Forecast Results:

Given these assumptions, staff was able to forecast the fiscal years 2012-13 thru 2016-17 (five fiscal years) and determine if the City would have a positive or negative change in fund balance (difference between revenues and expenditures) from year to year. It appears that if the City is able to control expenditures while the revenues increase, each forecasted year shows a positive change (excess) in fund balance or more revenues than expenditures (as shown on Attachment 1). Staff then began drafting a list of current and future year initiatives (as shown on Attachment 2) to use as an example of how or where excess fund balance can be prioritized.

The first items in the initiatives (#1 - #5) relate to the current year budget proposed by the CEO. They include savings created by the Police Department Reorganization and Continued Organizational Efficiencies (reduction in personnel/vacant positions). Both items, because they are structural in nature, will continue to generate savings each fiscal year since those costs are included in the forecasted expenditures on Attachment 1. When staff updates the forecast in the future, it will take into account any decisions made by City Council while adopting the budget as part of the analysis on Attachment 1. Other priorities include the replenishment of fund balance for both the General Fund and the Equipment Replacement Fund.

Also, based on City Council's desire to begin reinvestment in Capital Infrastructure with General Fund monies, staff created line items (#6 - #11, #15) including: Building Modification/Park Maintenance, Streets, Alleys, Sidewalks, IT (Information Technology/Computer) Upgrades and Website Design. Items #12 - 14 and #16 - 20 are other initiatives staff wanted to include to track and determine City Council's desire to fund them in the future. The last item #21 is for Budget Contingencies and at this point is a balancing amount to account for all available funds. A description of the items has been included as Attachment 3 to help provide City Council and the public with some general information of each.

Staff has included funding amounts on Attachment 2 as an example and should be viewed as a starting point for City Council to establish funding priorities for future initiatives. Staff also recognizes more information may be necessary to properly set funding levels and will do so when provided that direction.

ALTERNATIVES CONSIDERED

Staff has not considered any alternatives at this time.

FISCAL REVIEW

There is no fiscal impact to the Five Year Financial Forecast.

LEGAL REVIEW

There is no legal review necessary at this time.

CONCLUSION

Recently, City Council has expressed a desire to determine, financially, what the next five years (FY 12-13 thru FY 16-17) look like for the City's General Fund. The City has not had a comprehensive five year financial forecast to provide such information, therefore staff has developed one. Staff created this five year financial forecast using most of the City's own tools for developing the annual budget, both revenues and expenditures.

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Attachment(s): 1 – [Total Revenues, Expenditures and Net Fund Balance](#)
2 – [Current and Future Year Initiatives](#)
3 – [Current and Future Year Initiatives Descriptions](#)
4 – [Current Assumptions](#)