June 6, 2016

Madame Mayor and City Council,

As part of our annual efforts, the Budget Advisory and Financial Planning Committee (the "Committee") has completed a review of the most recent 7 year projections as provided by the City Finance Director. The revenue methodology is consistent with prior years, which has proven to be appropriately conservative given the strength of the real estate market and local economy. Overall, we felt the assumptions used, and the results presented, to be reasonable and consistent with past practices. As in prior years, the projections show that the long term financial health of the City is dependent on the continuation of the Municipal Services Parcel Tax. However, due to revenue limitations and the need to approve a balanced budget, the City continues to underfund certain longer term capital and operating items, such as facilities maintenance and retiree healthcare. The ability for the City to begin to address some of these longer term underfunded issues depends on an increase in the Municipal Services Parcel Tax.

As you know, this Committee wrote a more complete report concerning the long term finances of the City as part of its four year review of the Municipal Services Parcel Tax. The budget and projections provided do not deviate significantly from last year's report and thus the same issues arise. Although the projections show a healthy General Fund balance over the planning period, there are several items that are being deferred and not funded on a current basis to the level they should be, including facilities maintenance and retiree healthcare. The annual shortfall is in excess of $1 million, some of which is made up for in the later years when the pension obligation bonds are repaid, and the rest would be made up by the increase to the parcel tax, assuming it passes.

The projections use a detailed 2016-2017 budget as a baseline and then make steady state growth assumptions for revenues and expenses. On the revenue side, the property tax growth rates are consistent with recent history, and the transfer tax is held level at $2.8 million (average for the last 10 years), consistent with the recommendation of the 2011 Municipal Tax Review Committee (MTRC). The transfer tax rate has been above this level in the last three years, and although it is currently running over 20% behind last year, it is projected to hit the $2.8 million mark by the end of the Fiscal Year. However, we are now many years into a strong real estate market and history has shown that this level of transfer tax is likely to fall with a softening economy.

The primary expenses, payroll costs, are shown growing at 3% per year which is below the long term history but more in keeping with the recent past. The actual growth rate will be dependent on negotiations with employees, but it is critical for the City to maintain the benefit sharing program with employees and continue to be vigilant on reducing uncontrollable benefit costs. Additionally, the Council should keep in mind that the assumption of a 3% benefit cost growth rate is likely understated as those numbers include monies paid for current retiree healthcare and that number is expected to grow at significantly higher rates as the number of retirees increases. To the credit of the Council and the City's employees, it is worth noting that modifications to CalPERS retirement plans and labor negotiations completed in 2013 have resulted in a savings of approximately $990,000 in the next Fiscal Year. Of this amount, $350,000 is attributable to lower retirement benefit formulas for new employees and $640,000 is attributable to a reapportionment of benefit costs from the City to employees. These savings are significant and contribute substantially to the financial health of the City.

Although the projections show a stable General Fund balance over the 7 year period, the Committee believes that additional information is necessary to more accurately project expenditures in future years for the following reasons:

1. The City projections are not providing enough funding for facilities maintenance, retiree healthcare, or equipment replacement (see below).
2. No monies are being reserved for large capital projects such as building improvements and certain park and recreation facilities.
3. The projections assume no economic downturn. The real estate cycle is now 9 years past the last peak, making this one of the longest expansions in post war history.

The Committee feels the objective of long term financial planning for the City is to take steps to ensure that current services are being paid for in the current year, to the extent possible, and funds for known future requirements (retirement commitments and facilities maintenance) are being set aside on a current basis. This is especially true during good economic times. The City has made significant strides in funding facilities maintenance and equipment replacement reserves over the past few years, and the projections continue that trend. However, the City still lacks a long term vision of facility maintenance which would better guide annual funding to make sure the City is on a long term sustainable path. Given the risk in the projections from the economy and the lack of a long term facilities plan, the Committee strongly recommends completing that long term plan before committing any new substantial monies out of the Facilities Maintenance Fund. It is impossible for the City to prioritize needs until all the needs are known.

In examining the projections of the equipment replacement funding versus equipment replacement planned expenditures, the Committee sees a looming shortfall, assuming funding is $3.1 million over 7 years, or $442K per year. However, the equipment replacement planned expenditures total $5.5 million over the next 7 years, or $785K per year, for a difference of $343K per year which over 7 years could reduce the General Fund balance by over $2 million or by 40%. Part of this difference can be made up by the current Equipment Replacement Fund balance of almost $3 million, which may be imprudent. Although the analysis of the Facilities Maintenance Fund expenditures has not been completed, we believe that there will be at least a similar difference. The Committee recommends that the City Council instruct Staff to analyze both the Equipment Replacement and Facilities Maintenance Fund balances to determine a recommended target balance each year given the volatility of transfer tax revenues.

The Committee appreciates the opportunity to present our findings and looks forward to continuing more in depth work on better understanding equipment replacement and facilities maintenance funding levels and fund balances once the long term facilities plan is in place. Please let us know if you have any questions or would like any additional analysis.

Thank you,

Bill Hosler
Chair of the Budget Advisory and Financial Planning Committee