

June 28, 2005

Honorable Mayor and Members of the City Council:

Herein I present the Adopted Budget for fiscal year 2005/2006. This document presents a spending plan which provides for a balanced budget for the coming fiscal year, but defers significant steps to address the structural deficit currently projected in the City's Five-Year General Fund forecast.

The All Funds Adopted Budget for FY2005/06 totals \$112,428,410, representing an increase of \$2.6 million (2.4%) over the FY2004/05 Adopted Budget. The City's Adopted FY2005/06 operating budget – which excludes funding for the Capital Improvement Program – totals \$100,727,460, and represents an increase of \$6.3 million (6.7%) over the FY2004/05 Adopted Budget. The Adopted General Fund budget for FY2005/06 is \$36,251,498, reflecting an increase of \$2.25 million (6.6%) over the FY2004/05 Adopted Budget.

The Adopted Budget maintains the General Fund reserve at a projected level of \$5.02 million, or 15.0% of discretionary General Fund revenues, consistent with City Council policy.

Although I presented a budget which maintains current service and staffing levels across all program areas - and provides limited additional funding to address staffing needs in programs supported by our utility enterprise funds - this budget is balanced with a significant reliance on available one-time funding sources. This budget utilizes over \$2.2 million in available one-time General Fund reserves, as well as depleting over \$440,000 in Special Revenue reserves (Traffic Safety and Public Safety Funds) to fund ongoing operating costs. In the absence of new one-time sources, the City will be facing an operating deficit in excess of \$2.9 million next fiscal year. In addition, the City will need to address the loss of \$1.3 million in Parks Tax revenues upon the "sunset" of the current parcel tax in June 2006.

Given the magnitude of the City's operating deficit, it is with mixed feelings that I presented for your consideration a budget that effectively defers action to address our structural gap between budgeted revenues and expenditures. However, as a result of informative dialogue with the City Council during the course of two budget workshops

held earlier this year, I presented a budget that seeks to provide a more accurate projection of revenues and expenditures. I am hopeful that through this budget we will gain a better understanding of the City's true structural operating deficit and provide a more solid basis for the development of recurring balancing measures in next year's budget. To this end, some of the budget assumptions that have been updated in the development of this budget include:

- Consideration of historical "biases" in General Fund revenue and expenditure forecasts, resulting in less conservative budget estimates;
- Increasing the targeted "Salary Savings" by \$350,000 (to \$650,000) to more accurately reflect historical savings in personnel costs attributable to normal vacancies and attrition factors;
- Initial efforts to undertake a comprehensive review of the City's fee structure to establish appropriate policies and guidelines for cost-recovery and ensure compliance.

While the fiscal environment in which this budget has been developed continues to be characterized by some degree of uncertainty, the recent passage of Proposition 1A provides increased fiscal stability by protecting the City from significant threats from the State budget. However, the City will continue to feel budget pressures stemming from the general economic climate that challenges the City's ability to provide and maintain current service levels to the community across a wide range of programs.

The factors contributing to the City's budget problems are similar to those faced by many municipalities across the State. However, sound fiscal choices made by the City Council over the last several years have helped to mitigate some of the impacts experienced in other jurisdictions. Proactive steps taken by the City in response to early indications of the changing fiscal environment have included increasing the General Fund reserve, limiting new funding to largely one-time expenditures, and seeking voter-approval for Measure P, a one-half percent increase in our local Sales Tax.

Despite these efforts, the City still faces a projected structural deficit given that budgeted operating expenditures exceed annual revenues, and revenue growth is not expected to keep up with projected cost increases over the five-year financial forecast. Once one-time reserves and other resources are expended, the City will be required to implement recurring balancing measures to balance the budget over the next 2-5 years.

**FY2005/06 Adopted Budget Highlights**

- The FY2005/06 Adopted Budget provides funding required to maintain current service levels across all City program areas;
- Additional funding is included in the budget in support of selected priority needs, funded entirely through non-discretionary enterprise funds:
  - Three new positions within the Water Utility program are proposed for enhanced maintenance of water valves, meter repair and maintenance
  - A new Senior Engineering Assistant in the Capital Projects Division is proposed to assist with workload generated by construction-related activity.
- The budget maintains a projected General Fund Reserve of \$5.02 million, or 15.0% of projected revenues; however the adopted spending plan results in a draw-down of undesignated reserves totaling \$1.18 million as well as \$1.035 million in reserves specifically set-aside to buffer impact on increased retirement plan costs;
- The budget also relies on a draw-down \$446,000 in reserves within the Public Safety and Traffic Safety funds to support annual operating costs, which compound the General Fund deficit projected for FY2006/07;
- The Adopted Budget addresses a small portion of the structural deficit by increasing the target “salary discount” from \$350,000 to \$650,000 based on normal vacancy rates resulting from turn-over and attrition of staff positions.

**Two-Year Balancing Framework**

The five-year forecast continues to project a significant General Fund structural budget deficit - which is exacerbated in FY2006/07 by the sun setting of the City’s current Parks parcel tax. Staff has begun formulating a two-year framework to develop up to \$5.5 million in balancing measures needed to address the structural budget deficit and achieve the Council’s articulated goal of “fiscal stability.”

**The Problem**

	FY2005/06	FY2006/07
<i>General Fund Operating Deficits</i>		
<i>General Fund Forecast</i>	2.16	3.07
 <i>Other Funds</i>		
Gas Tax	0.08	0.10
TDA / Transportation	0.36	0.40
Self-Insurance Fund		0.60
	0.44	1.10
Parks Tax (Expires June '06)		1.30
Totals	2.60	5.47

\* Need Approximately \$3 Million (GF) Balancing Measures for FY2006/07

\*\* Additional shortfalls in Other Funds add \$1 Million to structural deficit

\*\* Over two-years, need to address potential loss of \$1.3 million in Parks Tax revenues

A pair of budget workshops was held earlier (December and March) to explore the elements of the City's budget model and discuss parameters for addressing structural budget imbalance. Council feedback – instrumental in shaping the FY2005/06 budget– suggested the following strategy:

- 1) Improve the budget forecast so as to address the conservative bias inherent in previous forecasts,
- 2) To the extent possible maximize use of available reserves and other one-time resources to balance the FY2005/06 budget, while maintaining the current 15% reserve level,
- 3) Establish a formal policy to re-affirm reserve levels as well as the appropriate use of reserve funds,
- 4) Pursue economic development opportunities that have the potential to expand the City's economic base, consistent with community values and interests,
- 5) Continue to evaluate potential cost savings and service-level impacts resulting from initial program reduction proposals developed by City departments, and
- 6) Develop a workplan and timetable for consideration of potential revenue enhancement proposals for possible placement on the June 2006 ballot.

Deferring implementation of recurring balancing measures to FY2006/07 requires that \$2.66 million in one-time reserves be utilized to balance the FY2005/06 budget and a total of nearly \$5.5 million in recurring measures will need to be developed over the next 6-12 months for implementation with the next budget.

**The Plan**

Budget Balancing Framework	FY2005/06	FY2006/07	Two-Year Totals
<i>One-Time Sources (Reserves/Set-Aside)</i>			
Undesignated General Fund Reserve	1.18	-	
PERS Set-Aside	1.04	-	
Other Funds Reserves	0.44		
<b>Sub-Total One-Time Sources</b>	<b>2.66</b>		<b>2.66</b>
<i>Revenue Enhancements</i>			
Fees/Fines/Other		0.25	<b>0.25</b>
Tax Measure (Replace Parks Tax - TBD)		1.30	<b>1.30</b>
<i>Expenditure Reductions</i>			
		3.92	<b>3.92</b>
<i>Other Cost-Saving Measures</i>			
		TBD	
<b>Total Recurring Balancing Measures</b>	<b>0.00</b>	<b>5.47</b>	<b>5.47</b>
<b>Total All Balancing Measures</b>	<b>2.66</b>	<b>5.47</b>	<b>8.13</b>

Based on current forecasts, even under a scenario where the Council – and electorate – were to approve a ballot measure to continue (or replace) the \$1.3 million Parks Tax (\$49 per parcel), it is estimated that nearly \$4.0 million in program reductions would be required to balance the FY2006/07 budget. This represents the equivalent of over 10% across-the-board reductions for all discretionary-funded programs. Recognizing that it is

unlikely that public safety programs would be required to contribute this level of reductions, the impacts on other city programs will be significant and severe.

As we work together to address our budget situation, it is critical that the larger community be informed and involved – particularly with regards to evaluation of potential service reductions and/or revenue enhancement proposals.

### **Update on Budget Reform Initiatives**

Last year our newly appointed Finance Director identified several areas within the budget development process for possible reform. While significant progress has been made on several fronts, more work will be required over the coming year to fully assess current practices and implement potential process improvements. The following provides a brief summary of efforts undertaken over the past year that are reflected in the current FY2005/06 Adopted Budget:

- *Reserve Policy* – The current budget maintains the City Council's current 15% General Fund Reserve policy. Staff is preparing a draft General Fund Reserve Policy document that would formally establish the desired reserve level, as well as provide guidelines for uses of reserve funds and priorities for allocation of funds in excess of established reserves. This draft policy, developed and presented in conjunction with this budget, will be reviewed by the Finance and Budget Commission, and then brought back to the Council for consideration and adoption.
- *Internal Services* – Staff has begun a comprehensive review of internal services to ensure that overall funding is sufficient to maintain and replace the City's capital assets and adequately support potential liabilities within our self-insurance fund. The focus of this year's efforts has been to update citywide fleet maintenance and replacement charges, which have been held "flat" for several budget cycles. The FY2005/06 budget reflects up-to-date estimates of maintenance replacement costs for the City's vehicle fleet.

Facilities maintenance was also reviewed and it was concluded that while building maintenance is adequately funded, some refinements on the basis for allocating citywide costs back to specific programs might be warranted. In the upcoming year, staff attention will focus on costs and charges for the City's Information Services as well as a comprehensive review of self-insurance liabilities, costs and rates.

- *General Fund Support for Programs* – The FY2005/06 Adopted Budget attempts to minimize the level of automatic General Fund back-fill to programs with declining sources of dedicated revenues, relying instead on other one-time sources to sustain program level. However, as we focus on resolving the current structural deficit, and the Council is forced to evaluate potentially significant reductions in

General Fund programs, consideration will need to be given as to appropriate level of General Fund subsidy to programs with heavy reliance on outside funding sources.

- Two areas where more work will be needed in the coming year include expanding the City's Capital Improvement Program and a review of the process used to amend the budget throughout the year. Our long-term goal is the development of a comprehensive, citywide 5- or 10-Year Capital Improvement Program with identified funding needs and sources. We are also striving to review how budget adjustments are implemented with the goal of limiting the number of mid-year budget adjustments as well as provide a process whereby non-urgency items are reviewed at the same time and considered in the context of overall funding priorities.

### **Ongoing Dialogue / Public Participation**

As we work together to address our budget situation, it is imperative that the larger community be informed and involved – particularly with regards to evaluation of potential service reductions and/or revenue enhancement proposals.

An ongoing priority for the coming year will be the presentation of regular budget updates and periodic City Council worksessions to discuss budget pressures and possible corrective actions. Looking to the challenges that lie ahead, solutions are likely to emerge from a collaborative process, informed by participation on the part of the City Council, City Commissions and the public.

I look forward to working in concert with the City Council, Commissions, City departments and the larger community to ensure that the City of Davis can continue to provide quality programs and services and address priority needs, despite the fiscal challenges that we must address.

Respectfully,

James W. Antonen  
City Manager