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 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 will be made, beginning this fiscal 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.

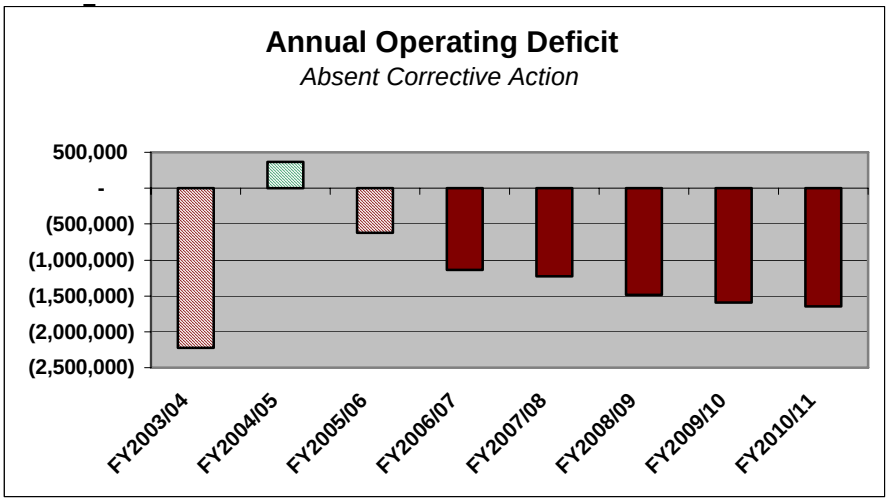
Summary of Five-Year Forecast

- General Fund revenues are projected to grow at an average annual rate of 4.35% per year, resulting in total revenue growth of $8.8 million over five-year period FY 2006/07 through FY 20011/12.

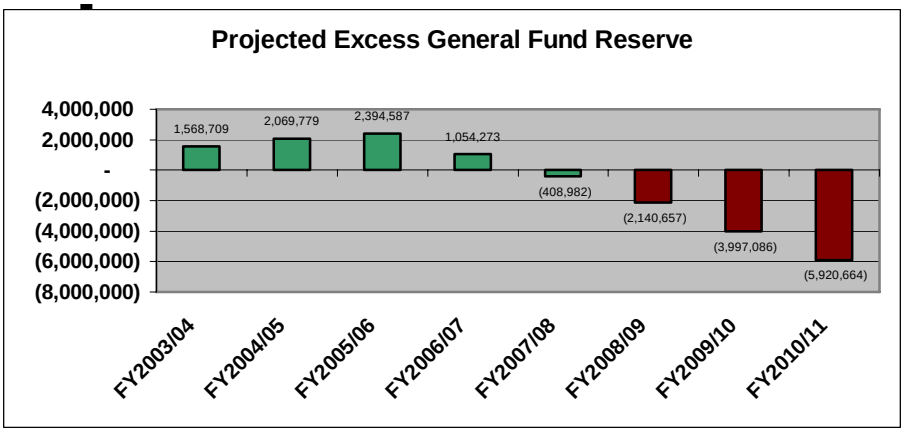
- General Fund expenditures are projected to experience annual increases averaging 4.6% per year, resulting in total General Fund expenditures growth of $9.4 million over five-year forecast period.

Operating Shortfalls / Structural Deficit

- While the General Fund forecast continues to project an annual operating deficit, the deficit has been reduced to $1.14 million for FY 2006/07, increasing incrementally to $1.64 million by FY 2010/11.



- General Fund reserves are projected to decrease from $7.62 million (21.9%) in FY 2005/06 to $6.48 million (17.9%) in FY 2006/07. This points to the need to develop $1.15 million in General Fund balancing measures over the next year in prevent the reserve from annual draw-downs, and eventually falling below the 15% reserve target.



Multi-Year Budget Balancing Framework

- The FY2006/07 Final Budget has been developed consistent with the multi-year budget balancing framework discussed with the City Council over a series of budget workshops. Key features of the multi-year framework include:
  - Gradual shift from reliance on reserves to fund annual operating expenditures
  - Development of recurring budget-balancing measures that "balance" use of new revenues against reductions in program expenditures and cost-savings.
  - Renewal in June 2006 of the $1.3 million Parks Maintenance Tax, and
  - Development of potential ballot measures for 2008 and beyond to help address both:
    - Recurring annual structural deficit, and
    - New funding needs, such as public safety staffing and a fourth fire station.

- Elements of the budget-balancing framework included as part of the FY2006/07 Final 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 been reviewed and adjusted to reflect less conservative growth assumptions
    - Expenditure baselines have been reviewed to identify potential flexibility in the budget as well as increasing the estimates used for "salary savings" due to vacant positions.
  - Addressing the baseline $1.15 million operating deficit through a combination of new revenues and expenditure reductions.
    - Propose increasing charge to Redevelopment Agency to reflect direct and indirect costs
    - Increase Parking Citation Fines from $30 to $35, consistent with neighboring jurisdictions
    - Explore imposition of a 9-1-1 Fee to recover costs associated with emergency dispatch services.
  - A reduction in the reliance of one-time reserves to fund ongoing operating expenditures.
    - Utilize a total of $2.25 million in one-time reserves, over the next two years to balance operating deficits as well as fund priority one-time needs.

- The Proposed Balancing Plan successfully addressed projected General Fund deficits over the next two budget cycles, and maintains the 15% General Fund reserve level. However, additional balancing measures, including possible new revenues requiring voter-approval will be necessary as early as 2008 to fully cover cost for current service levels as well as address a variety of identified needs currently not provided for in the annual budget.

- Assuming adoption of recurring measures, General Fund reserves would be maintained at the current 15% policy reserve level.

State Budget Impacts

- Over the past decade, the City has lost approximately $19 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 $2.7 million per year.

- Additional State budget impacts, netting to $2.1 million in lost revenue from FY 2003/04 through FY 2005/06, are expected to subside in FY 2006/07 and the out-years of the forecast due primarily to the passage of Proposition 1A. 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. In addition, other local revenues continue to be considered "at-risk", including transportation and redevelopment agency funds.

	03/04	04/05	05/06	06/07
VLF	<1.600>	.950	-	
ERAF I & II	<2.240>	<2.380>	<2.590>	<2.700>
ERAF III		< .660>	< .660>	
Mandated Reimbursement	-	< .180>	< .180>	< .180>
Totals	<3.840>	<2.270>	<3.430>	<2.880>

Next Steps

- Staff will seek Council adoption of a formal General Fund reserve policy to re-affirm appropriate reserve levels as well as establish appropriate uses of General Fund reserve to address economic uncertainties, emergencies and smooth-out impacts of potential balancing measures.

- Given the inter-dependency of the General Fund to less discretionary funding sources, the City will seek to establish complimentary five-year forecasts for selected Special Tax and Enterprise Funds, including: Parks Tax, Public Safety Tax, Gas Tax, Sewer, Storm Sewer, Sanitation and Internal Service Funds.

- Staff will continue to refine recommendations related to the multi-year budget balancing framework, including identification of funding requirements to meet critical 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 2.8% 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	
2000	3.8%
2001	5.8
2002	2.1
2003	0.8
2004	1.6
2005	2.6
6-Year Average	2.8%

Population

Based on data from the State Department of Finance, population is projected to be 64, for FY2006-07 and remain relatively flat. Some revenues, such as Motor Vehicle In-Lieu Fees (VLF), have historically been based on population, distributed by the State on a per capita basis.

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 funds and VLF backfill monies per current statutory and constitutional provisions.

Expenditure Baseline

The expenditure baseline for the Five-Year Forecast is the Adjusted FY2005-06, and the Proposed FY 2006/07 budgets. The forecast projects expenditures as a result of anticipated changes in factors and assumptions highlighted below in this section.

Current service/staffing levels - The FY2006/07 Proposed Budget and Five-Year forecast assume current (FY 2005-06) 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 nearly 70% of the discretionary General Fund budget. Every 1% increase in total compensation costs approximately $470,000, on an all funds basis, and approximately $265,000 to the General Fund.

The Five-Year Plan reflects total compensation (salaries and benefits) increases of 8.8% for FY2006/07, normalizing to a range of between 5.5% and 6.0% per year over the five-year forecast. This represents an increase of approximately $9.5 million over the Five-Year Plan.

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

	Annual % Change	
	FY2005/06	Five-Year Forecast
Salaries	5.6%	6.0% - 3.0% (range)
Insurance	12.5%	12.5%
Retirement	6.0%	5.5% - 7.5% (range)
Other Benefits	11.0%	11.0%
Total Personnel Costs	8.8%	5.5% - 6.5% (range)

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

	FY04-05	**FY05-06**	**FY06-07**	**5-Yr**
Civilian:	3.0-4.0%	3.0%-5.0%	3.0%-5.0%	Inflation
Fire:	8.8%	10.0%	8.0%	Inflation
Police:	3.0%	3.0%	5.0%	Inflation

Insurance Premiums

Costs are projected to grow 12.5% for FY 2006-07 and the forecast assumes annual increases of 12.5% thereafter. The City is projected to pay out $6.8 million in FY 2006-07 and $7.7 million in FY 2007-08 for insurance premiums. These include costs for Health, Dental, Retiree Medical, Disability, Workers' Compensation, Life Insurance and Unemployment insurance.

An additional $4.3 million is projected to be paid out to employees eligible to cash-out unused health insurance premiums under the City's Cafeteria Health Benefit Plan.

State Retirement System

Retirement rates are set annually by the California Public Employees' Retirement System (CalPERS). The rates established for FY 2006-07 reflect a slight reduction 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 improve, 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:

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

** Note: Miscellaneous Plan contribution rates include 7.0% employee contributions paid by the City.*

On an all-funds basis, the increased PERS rates result in a total cost of $5.4 million for FY 2006-07, an increase of $1.4 million over FY 2005-06. The General Fund represents approximately 58% of citywide personnel costs which implies that the General Fund cost for retirement contributions would grow by approximately $600,000 for FY2006/07.

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 rats 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 Legislature continues to consider proposals aimed at reforming public employee retirement plans on a statewide basis. While the City will continue to monitor developments in this area, most of the major reforms being discussed 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 review of the proposed budget, staff will seek Council adoption of 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 6 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, 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 turn-over 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 3%, consistent with the growth rate assumptions used for Sales Tax.

- *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 this year, roughly 90% of cities' VLF revenues will be exchanged for an equal amount of Property Tax revenues from the state. In subsequent years, the amount of the property tax "in-lieu" payments will increase in proportion to growth in each jurisdiction's assessed value. As a result, cities where appreciation of assessed values is expected to grow faster than population, increased revenues would be generated.

- *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 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 40% 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 (Measure D)

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. One of the major issues facing the City is the "sun-setting" of this tax in June, 2006.

The City Council has placed a measure seeking renewal of this tax on the June 2006 ballot. Should the measure not be approved by the voters, staff has prepared a contingency plan to address the loss of $1.3 million in annual revenues. If the renewal measure is successful, then the current tax rate and revenues would 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.