Agenda Item No. 2c

CITY OF WALNUT CREEK

Agenda Report

DATE: JUNE 16, 2015

TO: CITY COUNCIL

FROM: ADMINISTRATIVE SERVICES DEPARTMENT – FINANCE

SUBJECT: APPROVAL OF 2014-2024 LONG TERM FINANCIAL FORECAST

STATEMENT OF ISSUE:
A part of the Council's strategic focus on fiscal sustainability, the 2014-2024 Long Term Financial Forecast (LTFF) is being presented to the City Council for consideration and approval. Adoption of the forecast will allow the Council to evaluate the forecasted financial condition of the City and take actions if deemed appropriate to make financial course correction.

RECOMMENDED ACTION:
Staff recommends the City Council approve the 2014 -2024 Long Term Financial Forecast as presented in this staff report, including the associated attachments.

OVERVIEW AND BACKGROUND
The City Council has focused very directly on the long term financial health of the City. This included significant attention placed by the Council in the appointment of a Blue Ribbon Task Force on Financial Health in 2011 and the most recent adoption of a 2014-2016 Work Program that continues a key focus in this area.

The Finance Subcommittee met four separate times to work through all elements of the LTFF. The Subcommittee reviewed the underlying assumptions used for building the forecast and discussed various alternatives under consideration for evaluation of revenues and expenditures. This involved the review of expert guidance and exploration of processes used by other cities.

The City Council met on June 2, 2015 to discuss the LTFF and the assumptions used to develop the forecast. The Council approved the fundamentals and provided direction to staff to prepare the LTFF for approval at the June 16, 2015 Council Meeting.

Specifically, the Council was asked whether it was in agreement with the following general assumptions and forecast results:

1. Are the Revenues as presented in the LTFF acceptable to the Council? - *The Council affirmed that the revenues were acceptable*.

2. Does the Council agree that the following General Assumptions used to build the forecast are appropriate?
    a. Continuity of Services at current levels (allowing for reasonable growth to meet changing population and community needs)
    b. Maintenance of Roads and Facilities to provide for full use at current levels
    c. IT investments are adequate to allow timely maintenance of systems and applications to ensure security needs are met
    d. Reserves are maintained in accordance with current Council policy

    The Council affirmed that these assumptions are appropriate.

3. Are Expenses included in the forecast acceptable to the Council (Personnel and Non-Personnel)? - *The Council affirmed that the expenses as presented in the LTFF are acceptable.*

4. Are the Capital Budget costs used in the forecast acceptable to the Council? - *The Council affirmed that the costs used are acceptable.*

5. Are the IT unbudgeted costs used for the forecast acceptable? - *The Council affirmed that these costs are acceptable.*

The Council did not request any changes in the content of the LTFF. As a result, this forecast is the same as the one reviewed by the Council on June 2, 2015. The only modification is to the Capital Budget – Attachment 8. It now includes direct references to projects that may require facility replacements during the forecast period.

General Assumptions for the Forecast

The LTFF is prepared with the following basic operational assumptions as confirmed by the Finance Subcommittee :

- Service delivery is maintained at existing levels (no material service reductions or changes to services delivered by the City); staffing levels are indexed to grow and keep up with expected population trends
- Facilities, roads and infrastructure are maintained to ensure availability to the public and to maintain service delivery in a safe manner
- IT expenditures are adequate to maintain systems and applications at fully functional levels and to allow for updates to ensure the City can meet the service needs and information security requirements of the future
- Costs of services (personnel and non-personnel) are adjusted to keep pace with inflation
- Retirement, medical and contractual obligations are fully funded
- Financial reserves and required contributions are maintained in accordance with City policy
- Revenues reflect the impacts of new development (currently entitled)

- The 2014-2016 budgeted numbers are adjusted to eliminate one-time expenses and to depict unfunded capital and IT costs for comparison purposes

Summary Results of 2014 – 2024 Long Term Financial Forecast

The forecast identifies expenditure needs exceeding revenues by approximately $3 to $4 million per year for the forecast period, with a cumulative projected shortfall over the 10 years of approximately $32 million. While forecasted revenues are adequate to meet departmental (operating) expenditures, they are insufficient to cover both operating costs and address capital and IT needs.

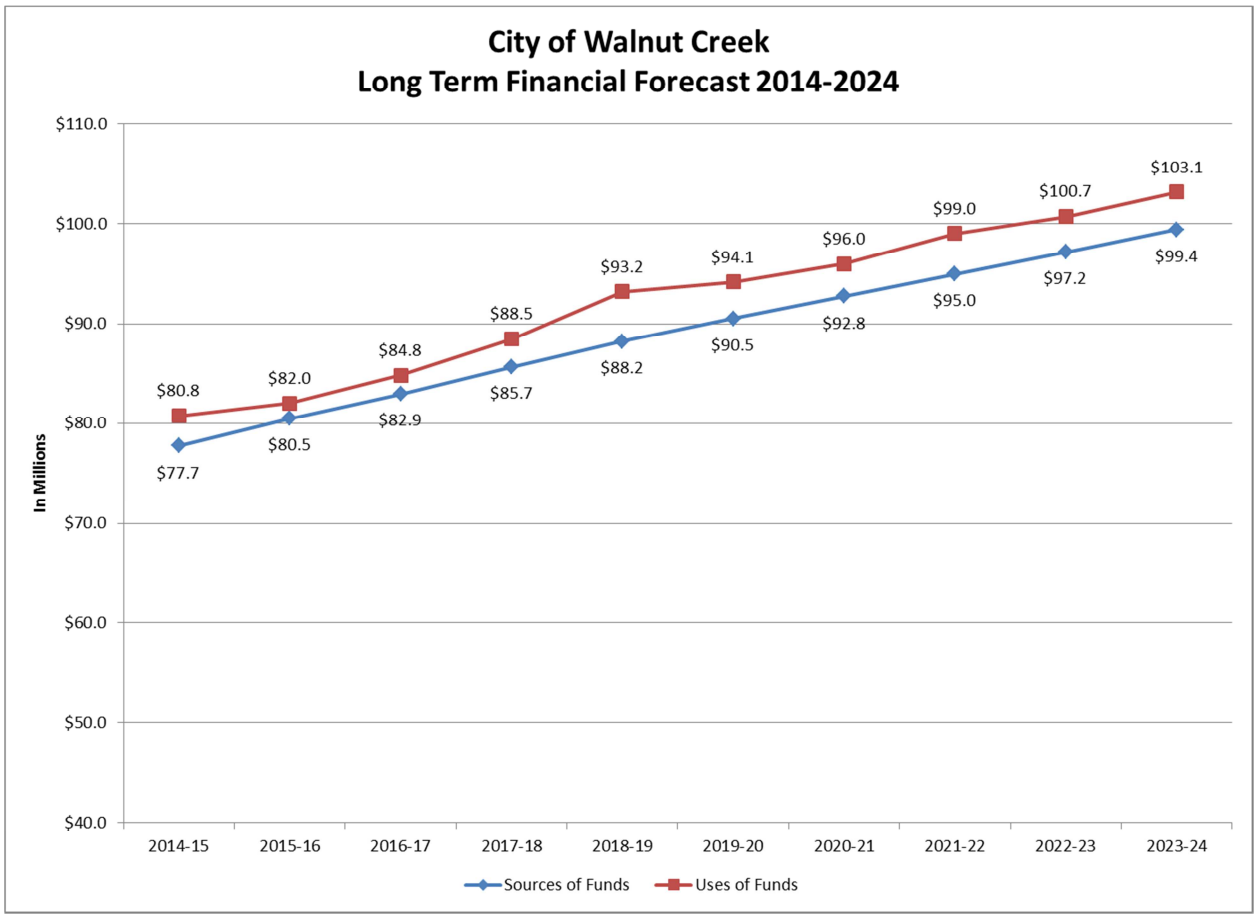
Summary for Forecasted Years (General Fund) $$ in millions

Fiscal Year	*2016-2017*	*2017-2018*	*2018-2019*	*2019-2020*	*2020-2021*	*2021-2022*	*2022-2023*	*2023-2024*
Total Revenues	$82.9	$85.7	$88.2	$90.5	$92.8	$95.0	$97.2	$99.4
Departmental (Operating) Costs	($80.6)	($83.7)	($86.6)	($87.6)	($90.1)	($93.0)	($95.8)	($98.5)
Net Operating Surplus	$ 2.3	$ 2.0	$ 1.6	$ 2.9	$ 2.7	$ 2.0	$ 1.4	$ .9
Capital Budget Costs	($ 3.2)	($ 3.2)	($ 5.3)	($ 5.3)	($ 4.7)	($ 4.7)	($ 3.2)	($ 3.2)
IT Costs (unbudgeted)	($ .6)	($ 1.1)	($ .8)	($ 1.1)	($ .8)	($ 1.0)	($ 1.3)	($ 1.1)
Transfer to Reserves	($ .4)	($ .5)	($ .5)	($ .1)	($ .4)	($ .4)	($ .4)	($ .4)
Net Deficit	($ 1.9)	($ 2.8)	($ 5.0)	($ 3.6)	($ 3.2)	($ 4.1)	($ 3.5)	($ 3.8)

Revenues are projected to grow at an average rate of 3.1% annually, while Departmental expenditures are expected to grow by an average of 3.3% annually. This small disparity in revenue growth versus operating cost growth slowly diminishes the operating surplus over the forecast period. The operating surplus begins at $2.3 million in FY 2016-2017 and reduces to $900,000 by 2023-2024.

The General Fund portion of Capital Projects varies by year but averages approximately $3.9 million annually. IT unbudgeted costs also vary annually and average approximately $860,000 annually.

In total, the average budget deficit for the forecast period averages $3.2 million each year. The following chart demonstrates the total forecasted revenues and expenditures and the resulting projected shortfall. **Attachment 1** provides a more detailed summary of the results of the LTFF and provides a chart demonstrating the cumulative financial impact of deferring capital maintenance and not fully funding IT needs.



Revenue and Expenditure Details

Staff reviewed major revenues and consulted with our tax revenue consultant to establish forecasts for the LTFF. Similarly, expenditures were grouped into personnel and non-personnel costs for review and projections of cost estimates. Capital budget costs are broken out separately as are information technology costs that do not currently appear in the Departmental operating budgets. Transfers to reserves are also included and demonstrated in accordance with existing Council policy.

A summary of assumptions used in the completion of this forecast is included as **Attachment 2.**

Revenues

For the purposes of the LTFF, staff focused its efforts on sales tax, property tax, and department revenues. Collectively, these revenue streams make up 90% of the total sources of funding.

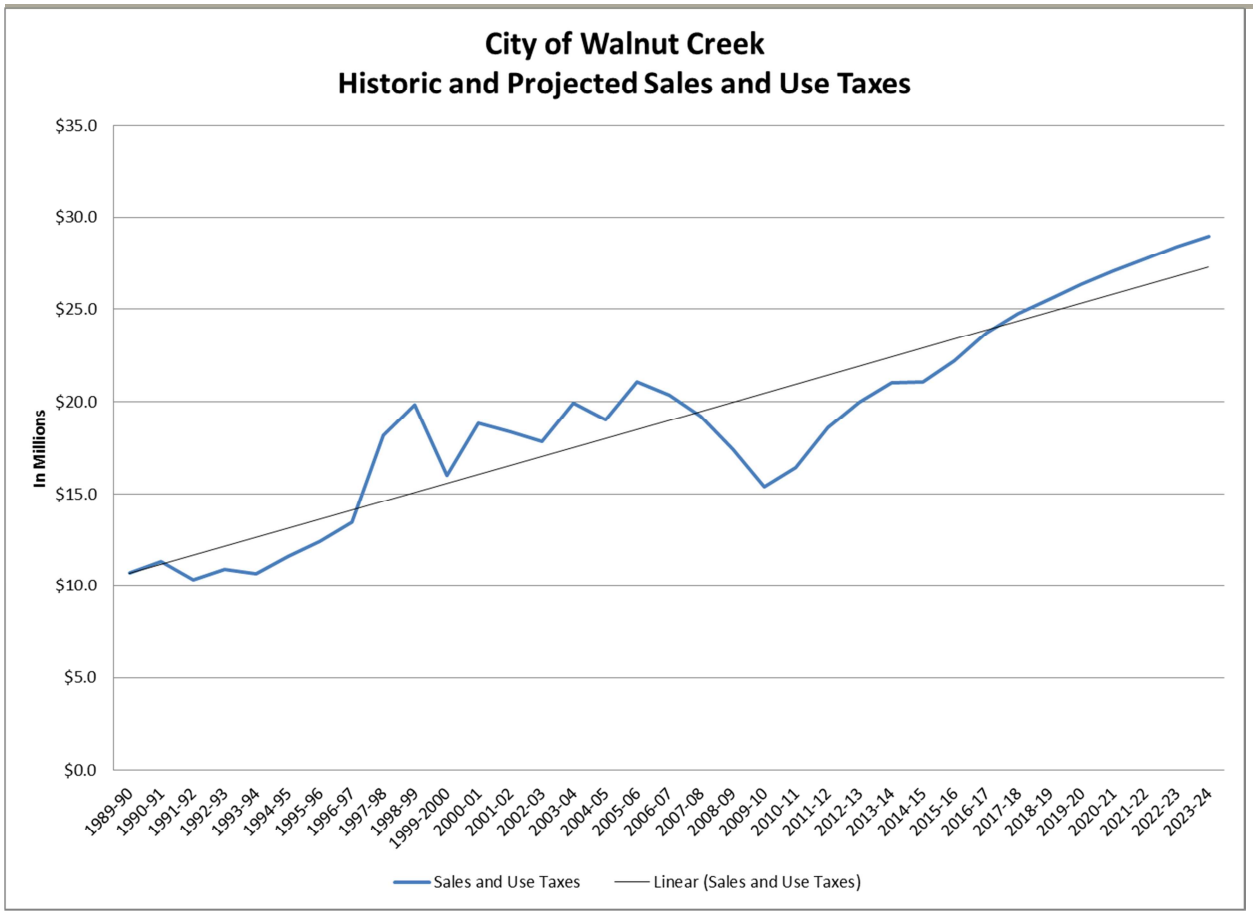
Sales Tax

Sales tax represents approximately 24% of total sources of funding for the City. Staff consulted with MuniServices to develop a forecast from 2014 – 2024. MuniServices employs economists that specialize in evaluation and forecasting of sales tax for municipal governments in California. The forecast adopted a reasonably conservative approach to future revenue growth. Sales tax is projected to grow at an average of 4.2%. This average assumes higher growth in FY 2016-2017 and FY 2017-2018 due to the scheduled completion of Broadway Plaza. For the remainder of the years, growth is estimated from 2.1% to 3.3% annually.

Staff did review a forecast model that included a recession. This model was considered due to the fact that the nation has experienced a recession on the average of every seven (7) years dating back to the 1920's. Since we are more than five (5) years into a recovery, there is a reasonable probability that a recession or economic slowdown will occur during the upcoming forecast period.

The recession model significantly underperformed the conservative forecast presented by staff and adopted for recommendation by the Finance Subcommittee. In addition to consideration of the recession model, staff considered the growing trend toward internet purchases and the City's reliance on a relatively narrow sales tax base (limited business-to-business or construction) in our recommendation to use a conservative sales tax forecast.

Staff also took the opportunity to evaluate sales tax trends dating back to 1990. Since 1990, the average year-over-year growth in sales tax has been 3.4 %. Sales tax has experienced volatility over the years and the City experienced a significant drop in the most recent recession.



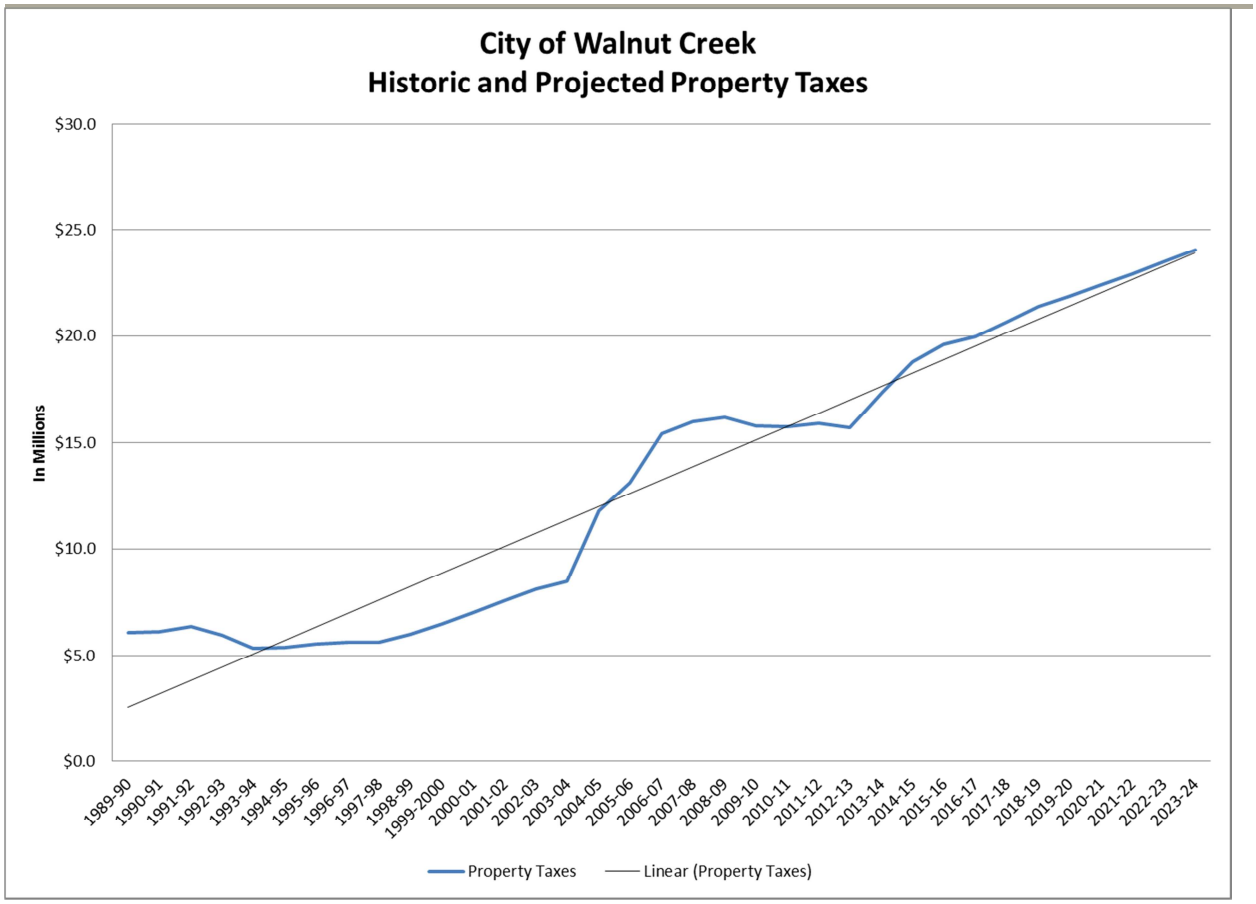
Details regarding sales tax projections are included in **Attachment 3**

Property Tax

Property tax represents approximately 27% of total revenues. Staff coordinated with MuniServices to develop the property tax forecast. The forecast provides for an average growth of 3.1%. Growth is higher in 2017-2018 and 2018-2019 at 3.4% in consideration of the impact of currently entitled projects which will increase assessed valuations when completed. The forecast then drops off to

2.4% year-over-year growth for the remaining years. This growth estimate considers baseline growth of existing properties (subject to the 2% Proposition 13 limit). It also provides for turnover in properties and the resulting increase in assessed value. Finally, there is a small increase each year to account for new properties in the City.

Similar to sales tax, staff did evaluate a recession model for property tax. This model did not demonstrate decreases in property taxes but did include a flattening of growth for a two to three year period. Instead of using the recession forecast, the Finance Subcommittee is recommending use of a conservative property tax forecast that includes conservative but steady growth. Property tax also includes new projects set to come open during FY 2017-2018 and FY 2018-2019 – see **Attachment 4**.



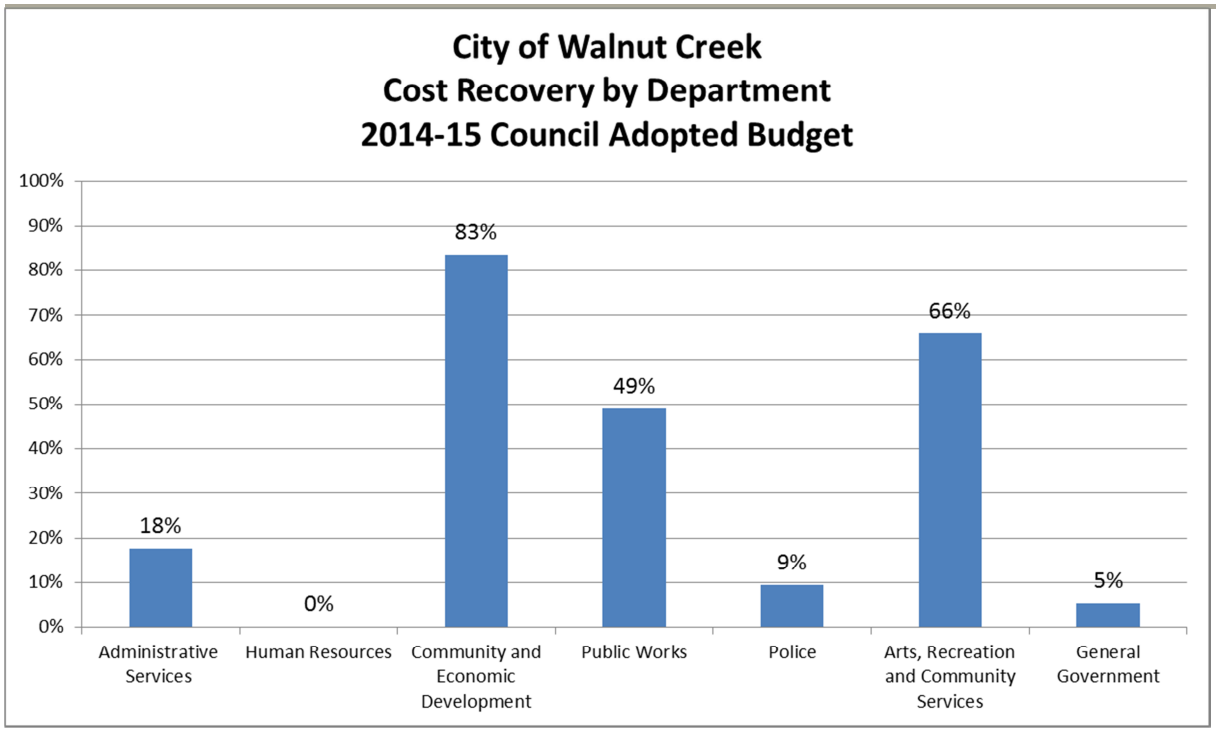
Details regarding the property tax forecast are included in **Attachment 4**

Department Revenues

This includes a long list of fees for services and charges assessed by the City as detailed in the City's master fee schedule. Department revenues account for approximately 38% of total revenues. Departmental revenues are forecasted to increase by an average of 2.5% annually.

This has been an area of significant focus over the past several years and Department revenues have risen as an overall percentage of the City's revenues. This resulted from a cost study completed in 2010 that concluded the City was charging far less than the cost of services. By state law, cities can recover the cost of services. As a result of the study, the City increased the fees and charges significantly from 2011 through 2014.

The Finance Subcommittee evaluated the current state of fees and charges and has determined that it is appropriate to forecast using the current collection levels as a percentage of overall costs. Therefore, department revenues are increased in proportion to the departmental expenses to maintain current collection percentage levels for each department. This varies considerably by department as follows:



Other Taxes

Other taxes include smaller revenue areas such as business license, transient occupancy tax (hotel tax) and franchise tax. These revenues collectively represent approximately 9.7% of the total revenues for the City. Staff has projected these revenues to increase at the Bay Area Consumer Price Index (CPI) rate of 2.4% annually.

Details regarding other taxes are included in **Attachment 5.**

Expenses

Expenses are broken into four major elements (1) departmental costs, (2) capital budget costs, (3) information technology unbudgeted costs and, (4) transfers to financial reserve funds.

Departmental Costs

Departmental costs are further broken down into two major subsections – personnel and non-personnel. **Attachment 6** provides details regarding the departmental expenses, including a breakdown by individual department. Per the Finance Subcommittee recommendation, we have included full funding for both libraries at 56 hours per week.

Personnel Costs

Personnel costs represent approximately 58% of total departmental costs and are expected to grow as a percentage of overall costs during the forecast period. Personnel costs are projected to grow by an average of 3.8% annually. This increase is driven by the following assumptions:

- Salaries increase by existing MOU agreements and then the 10 year Bay Area CPI of 2.4% annually
- PERS increases are factored in for all employees

- Non Public safety – increase contribution from 22% to 25.5% of total salaries

- Public Safety (non PEPRA) – increase contribution from 40% to 51% of total salaries (this large increase in contributions is part of the retirement system's plan to reduce the unfunded liability)

PERS contribution increases are computed by the retirement board and distributed to the City each year. The computations used for this forecast provide for a 5-year ramp-up in costs beginning in 2015-2016 and then a flattening of costs for the remainder of the forecast period.

- Medical – increase of 5.2% annually

- Limited duration positions are eliminated at the end of their term and the City has projected a restoration of two (2) frozen maintenance positions and the addition of two (2) FTE annually to maintain service levels to the community as the population grows and new businesses open in the City. **Attachment 7** provides a historical and projected comparison of City staffing levels to population. This chart demonstrates that the level of employees consistent with the population over the forecast period. Further, the staffing remains well below levels experience prior to the recession. While the LTFF demonstrates a changing staffing to align with a changing community, any specific position additions would be considered by the City Council as budgets are developed and amended in future years.

Non-Personnel Costs

Non-personnel costs include all other expenditures such as goods and services that are acquired and used by the City to provide services. This includes contract labor and professional services. This accounts for the remaining 42% of departmental costs. These costs are increased by the CPI factor of 2.4% annually.

Capital Budget Costs

For the purposes of the LTFF, staff used the existing Council-approved Capital Improvement Plan (CIP) and eliminated discretionary and non-general fund projects. The remaining costs are those considered essential to maintain roadways and City facilities.

The average annual expenditure for capital projects is approximately $3.9 million annually. This expenditure varies each biennium based upon the projects scheduled. Details regarding the capital budget, including detailed assumptions, are included as **Attachment 8**. Staff would note that these costs include construction inflation costs for most projects. However, the cost of replacing facilities is not included even where replacement is a recommended option. Rather, the CIP focuses on maintenance of existing buildings. Of note, none of the discretionary projects approved in the 2014-2024 CIP are included in the LTFF capital costs.

Over the past several years, the City has not fully funded capital projects. This has led to a backlog of projects that are needed to ensure continued availability and quality of roads and to ensure city buildings continue to meet the needs of employees and the community. A failure to adequately fund capital projects can also result in roads or buildings deteriorating to the point where maintenance becomes far more costly. Delays could also result in a need to replace rather than repair these roads and facilities. There are several projects in the CIP that will increase

significantly in cost if they are not completed in a timely manner. For example, the cost to maintain our roadway network in its current condition has increased from $3.8 million annually based on a pavement condition survey completed in 2012 to $4.5 million annually based on a pavement condition survey completed in early 2015.

While delaying capital projects has been used by the Council in the past to address budget shortfalls, staff believes it is critical that the Council understand the short-term savings will lead to either higher future costs or the loss of functionality in the future.

IT Strategic Projects Unbudgeted Costs

The City has developed an IT Strategic Operating Plan (ITSOP). The ITSOP provides a list of projects needed to ensure continuity of services and to ensure the City has adequate infrastructure and security to meet technology needs into the future. The ITSOP developed in 2012 detailed software application and equipment replacement projects the City needs to complete. Further, new projects and changing business needs have been identified that require resources. While there is a direct departmental budget to meet many of the ongoing IT needs, a long list of unfunded projects remains.

Staff has estimated these projects will cost an average of $860,000 per year, if fully funded. While the City has made strides in improving our technology capabilities, much work remains if Walnut Creek wants to be a City that embraces technology as a cost effective means of delivering services to the public. There are several old and inefficient programs that need replacement or upgrading in order to deliver services that the public will expect in the future.

A list of projects on the ITSOP yet to be completed, and those that have been identified since its adoption, are included are **Attachment 9**.

Transfers to Reserve Funds

In accordance with Council policy, the LTFF provides for contributions to reserve balances. This contribution varies depending upon changes in revenues and expenditures but averages approximately $400,000 per year for fiscal and catastrophic Emergency funds. Detail regarding reserve policy is included at **Attachment 10.**

Conclusion for Council Consideration

The updated LTFF provides for an improved outlook when compared to the prior forecast completed in November 2013. This is due to increases in revenues the City has experienced over the past 24 months and continued increases in both property and sales tax that are expected in the next three years.

Despite the improvement in the financial picture, the forecast continues to demonstrate there are not enough resources to meet operational needs and to fund:

- Capital budget needs
- Unbudgeted Information technology needs

Continuing to underfund the capital maintenance projects will likely lead to much higher future costs as assets will either require more significant maintenance or replacement of assets may become unavoidable. Further, it is possible that assets will become unavailable for future use.

It is also evident that there are insufficient funds to meet information technology needs. While basic maintenance funds are included in the budget, funding needed to update and fully replace our applications and infrastructure is not available under the forecast.

Options for the Council to Consider

The financial condition faced by the City is not a new dilemma. Since the great recession of several years ago, Walnut Creek has been faced with a new financial reality. Quite simply, forecasted revenues are inadequate to continue current operations and to address infrastructure needs.

The Council can either seek to increase revenues or it can seek to reduce expenditures. It can also seek to remedy the financial situation through a combination of both.

In response to the last recession, the Council took a very balanced approach to addressing the budget issues. The Council directed a significant reduction in expenses through increased employee cost sharing and the elimination of over 40 positions. It also increased fees and department revenues by capturing a higher percentage of the costs of providing services. The Council does not have the ability to further increase fees and departmental revenues in any significant manner as our fees already approximate the cost of services in most areas.

The Council should also consider that there are many expenditure pressures that we have little control over. For example, PERS contributions, which are increasing significantly, cannot be adjusted by the City. Similarly, medical cost for employees cannot be entirely controlled.

Approval of this forecast sets the foundation for critical future decisions of the City Council. Adoption of this model, as has been done in the past, serves as the platform for developing the City's next two year budget (2016-2018) which will begin in earnest early next calendar year.

ALTERNATIVE ACTION:

The Council could direct Staff to make changes in the forecast for future consideration or choose not to adopt a Long Term Financial Forecast.

DOCUMENTS:

Attachment 1: Long Term Financial Forecast/ Cumulative Deficit Chart
Attachment 2: Terms and Assumptions
Attachment 3: Sales Taxes
Attachment 4: Property Taxes
Attachment 5: Other Taxes and Revenues
Attachment 6: Departmental Revenues and Expenditures
Attachment 7: Staffing Level Comparison
Attachment 8: Capital Budget
Attachment 9: ITSOP Funding
Attachment 10: Emergency Reserves
Attachment 11: Budget to LTFF Adjustments

RECOMMENDED COUNCIL ACTION

Move to approve the 2014 -2024 Long Term Financial Forecast.

STAFF CONTACT: Jeff Mohlenkamp, Administrative Services Director
(925) 943-5810
Mohlenkamp@walnut-creek.org