City of Woodland

REPORT TO MAYOR AND CITY COUNCIL

AGENDA ITEM

TO: THE HONORABLE MAYOR
AND CITY COUNCIL

DATE: October 28, 2008

SUBJECT: Development of the FY 2009-10 Budget and 10-Year Financial Plan

Report in Brief

The City Council has provided staff with guidance in the development of the City's annual budget for the past ten years. This guidance is especially critical during these uncertain economic times as Woodland addresses extremely challenging fiscal conditions that will require staff and the City Council to review programs and service levels in order to address a structural imbalance within the General Fund and various other issues within the other major funds. Staff has identified several issues in association with the 10-Year Financial Plan assumptions that were presented during the Council's consideration of the FY 2008-09 budget. These assumptions have been reviewed and modified to begin the process of developing the FY 2009-10 budget and FY 2009-10 – FY 2018-19 10-Year Financial Plan for each major fund. The purpose of this report is to summarize the major issues and reaffirm the guiding principles for the City Council's review and consideration.

Staff recommends that the City Council reaffirm the guiding principles for the FY 2009-10 Budget and 10-year Financial Plan and approve the general direction associated with each specific fund as described herein.

Background

As are all local governments, Woodland is currently facing very challenging fiscal conditions due to the decline of the regional and national economy fueled primarily by the collapse of the housing market. More recently, the economic decline was exacerbated by the crisis in the US and international financial markets that some analysts believe are the most severe since the 1930's. In response to these challenges, the Woodland City Council approved two critical actions to address the situation while at the same time maintain the balance of services necessary to meet community needs. These actions included:

- Approved Mid-Year FY2008 Operating Budget reductions of $2.2 million and Capital Budget reductions of $12 million to address the revenue shortfalls projected by staff on December 4, 2007

- Approved the FY2009 Budget with an additional $6.3 million adjustment in the Operating Budget that was achieved through a combination of expenditure reductions ($3.1 million), recurring revenue enhancements ($1.4 million) and one-time revenues ($1.8 million)

Unfortunately, the significant actions approved by the City Council were not enough to address the impact of the declining economy. While revenue figures for FY 2008 are still being finalized, ***it appears that the income collected for the General Fund will be under the Mid-Year projections by approximately $700,000.*** The most disturbing trend associated with these reductions is the loss of property and sales tax revenue which were a combined $1.1 million under the Mid-Year projections. The availability of one-time and new revenues in other areas and expenditure reductions generated by staff's careful spending helped to offset the loss of revenue. As a result, the City's General Fund reserves will be reduced by approximately $700,000 to $5.7 million. Despite this undesirable outcome, the City's General Fund reserves remain relatively healthy at approximately 14% of the annual operating budget. However, the dip into the General Fund reserves and the use of one time revenue to balance the current FY2008 budget means that the City needs to correct the structural imbalance within the General Fund that has existed for the last three years.

In addition to the General Fund, the City is experiencing a decline in development impact fee revenue that is impacting the capital program. Income from development impact fees that had been estimated in 2006 and 2007 based on approximately 400 annual building permits has reduced to approximately 150 permits based on actual permits issued. In addition, the City Manager and City Council have been asked by the development community to consider reductions to development impact fees because of the declining sales prices for new homes and the general lagging economy that is affecting the commercial/retail sector. In response, staff is reviewing the fees assessed for the Spring Lake Specific Plan infrastructure and the Citywide Major Projects Financing Plan. This review includes downsizing the scope of projects based on community needs and removing discretionary projects from the fee program altogether. Staff is preparing information for consideration by the Spring Lake Financial Subcommittee and plans to bring proposed changes to the development impact fees to the City Council for consideration within the next two months. In any case, the loss of development impact fee revenue due to the combined impact of reduced development activity and potential fee reductions will require the City to slow down capital projects.

Finally, other major City funds, including the water and sewer enterprise funds and combined transportation funds will have major impacts that need to be addressed. These impacts include new obligations such as debt service payments, setting aside expenses for capital projects to replace aging infrastructure and accounting for declining income. Each of these issues will be addressed in the Discussion section of this report under the individual fund title.

When considering the challenges that the City Council and staff must face, it is important to reaffirm the Guiding Principles that were first introduced to the budget process in December 2007. Staff believes these principles must be applied at all times, especially during challenging fiscal periods such as the City of Woodland is currently facing. These Guiding Principles include:

- **<u>Develop operating and capital budgets that have the minimum impact on public services:</u>** The City's first priority is providing responsive, efficient and effective public services. Therefore, the proposed FY 2009-10 budget needs to have the minimum impact on public services. Without question, the preparation of a balanced budget will require some level of service reductions. In recognition of this fact, staff must work toward mitigating the reductions through collaboration or other forms of alternative service delivery, develop alternative revenue sources to offset costs and present a prioritized list of service level reductions that will enable the City Council to review options.

- **<u>Develop operating and capital budgets that have the minimum impact to employees:</u>** Woodland employees are the City's Number One asset. Without City employees, public infrastructure will not be maintained, critical buildings and programs are not adequately staffed and public safety needs unmet. Employees provide their skills, commitment and passion for public service to the City organization. In return, the City should provide a positive and productive work environment, fair compensation, 100% commitment to the current MOUs and open, direct and honest communication. The current status of the City's fiscal condition is a source of concern to City employees. Preparation of the City's budget during uncertain times needs to include assurances to employees that management will take every reasonable step to minimize the impact on the City's workforce. Since significant program and service reductions will likely include staffing reductions, City employees need to know that management will review options such as implementing a planned attrition program that seeks to reduce the workforce over time through retirements and voluntary separation. In turn, employees need to be flexible and consider accepting new work assignments in order to minimize the impact to public services. The development of the FY 2009-10 budget and 10-Year Plan needs to include opportunities for employees, employee associations and work units to receive updates and status reports.

- **<u>Develop the FY 2009-10 budget based on the actual FY 2007-08 Revenues/Expenditures:</u>** The FY 2009-10 budget and updated 10-Year Plan must use the actual revenues and expenditures from FY 2007-08 as the baseline. The new baseline may be adjusted based on the actual revenues and expenditures for the current FY 2008-09. However, trends such as the $1.1 million combined reduction for sales and property taxes compared to the projections within the FY2007-08 Mid-Year Adjustment mandates that further expenditure reductions will be necessary. Unlike last year, more scrutiny will be necessary when reviewing the proposed reductions because the adjustments will need to be ***structural.*** The term ***structural*** means that programs, work units and departments will need to reorganize and change to become more efficient or adjust service levels based on Council and community priorities. Specific actions may include:

  - *Review existing vacancies to determine if the loss of the positions can be absorbed permanently with minimal service level impact;*

- *Modify and/or discontinue programs and services based on identified Council and community priorities;*
- *Review reductions in supplies, services, contracts, training and equipment to determine if those reductions can be absorbed with minimal impact;*
- *Provide a prioritized list of activities with associated costs that will be discussed with the City Manager and City Council in order to consider alternatives for an additional General Fund expenditure reductions for FY 2009-10;*
- *Consider other operating alternatives such as contractual services or community collaborations that would generate significant savings;*
- *Consider utilizing other revenue sources to fund existing programs and services in order to reduce the impact on the General Fund;*
- *Consider implementing new or expanded program fees for appropriate programs in order to mitigate reductions;*
- *Consider reorganization and use of attrition to facilitate staffing reductions in a manner that reduces the impact to employees;*
- *Meet all budget submission deadlines and review potential cost saving or revenue generating scenarios with Finance staff prior to inclusion within the department's budget submittal.*

- **Present a capital and operating budget that is balanced over 10-years:** The City Manager and Senior Staff will work together in order to present a 10-year Capital Improvement Plan that is balanced over the entire planning period. This principle recognizes the potential for annual fluctuations and implements strategies to insure that an operating contingency and appropriate balance in all funds is maintained each year of the 10-year planning period. In addition, this principle recognizes the need to expedite "fund integrity" between the various categorical funds and cease or at least significantly limit the practice of internal borrowing between fund categories. Finally, this principle recognizes the need to reevaluate how long term debt for capital projects is paid; approximately $4 million in annual debt service payments is currently being funded by development impact fees and the decline of this revenue source requires the identification of alternative fund sources.

- **Utilize the 10-year Plan as the basis for making long-term financial planning decisions:** All financial decisions, including the commitment to implement new programs and services, submission of grant applications with fixed-term funding commitments and employee compensation, will have long range impacts on the City's fiscal condition. These decisions need to be evaluated based on ***short-term and long-term*** impacts and factored into the 10-year Financial Plan.

- **Include resources required to maintain and operate all capital improvements commencing in the year the project is completed and continuing through the balance of the 10-year Plan:** All projects that require operating and maintenance funds need to have those funds factored into the 10-year Financial Plan ***before*** a commitment is made to fund the design and construction of the facility or improvement. These resources may include staff, equipment and annual contributions to reserve funds. If the resources are not available when the project is expected to be completed, consideration must be given to delay or cancel the project or reallocate future funds from another program for maintenance and operation.

- **Maintain essential services and existing facilities:** The City's investment in high priority services and established facilities needs to be factored into the 10-year Plan. Services evaluated by Senior Staff and the City Council as no longer essential should not be funded and resources reallocated to other higher priorities. Facilities that no longer meet community needs should be sold, transferred or appropriately disposed.

- **Continue the commitment to the future implementation of the Performance Based Budget:** Implementation of a Performance Based Budget will facilitate the City organization's commitment to outcomes and performance measures which will help guide program evaluation. The City's commitment to implementing a Performance Based Budget will be one of the primary factors in establishing a data driven, results oriented, customer focused and responsive local government organization.

- **Foster thriving and diverse residential and business communities:** The City's budget priorities need to provide adequate resources to community development activities. These activities have a tremendous impact on the quality of life for all people who live, work, visit and conduct business in Woodland. The City's success in this area also helps to generate the resources that fund City services.

Staff believes the guiding principles described above will lay the foundation for developing the FY 2009-10 budget and 10-year Financial Plan for operating and capital programs in a responsible manner. Completing the budget will be challenging; however, it is a challenge that must be embraced as an opportunity to collaborate across departments and with the community in order to deliver the highest priority services.

Discussion

This section will discuss each of the major City funds including the impacts and issues that need to be addressed. The context of this discussion will be a review of each 10-year Financial Plan. Since the 10-year Plan is the basis for long term financial decisions, it is appropriate to review the assumptions associated with each fund, identify changed conditions and determine actions that will need to be considered as staff prepares the FY 2009-10 and 10-year update for the City Council's consideration in 2009.

General Fund

The depth of the current economic downturn fueled primarily by the decline of the regional housing market and the worst crisis to impact US and international financial markets since the 1930s has generated a structural imbalance to the City's General Fund. Staff believes that this imbalance actually began with the addition of City services approximately three years ago that were initially funded by unsustainable revenue sources. As the Council may recall, FY 2007-08 started with a $700,000 structural imbalance that was resolved through salary savings generated from FY 2006-07. This balance was further exacerbated by the failed Storm Drain ballot measure which immediately placed an approximate $200,000 burden on the General Fund. Further erosion of revenues identified by Finance staff in October 2007 generated the Mid-Year Adjustments approved by Council on December 4 that reduced General Fund expenditures by $2.2 million. The use of one time revenue to close the additional $6.3 million gap identified as staff prepared the FY09 budget continued the imbalance.

The final revenue from FY08 shows that the Mid-Year Adjustments were not enough. While the results are still in process as tax payments and other receipts are finalized, it appears that FY08 will show a deficit of approximately $700,000. This deficit reduces the General Fund reserves to $5.7 million. While this amount is a moderately healthy reserve, prudent financial policy requires that the City takes the steps to correct the structural imbalance and seek to grow instead of diminish the reserve.

It is important to review the assumptions associated with the current General Fund 10-Year Financial Plan. These assumptions include:

- 3% annual increase in sales tax and property tax based on modest growth beginning in FY 2008-09 through FY 2010-11, 4% for FY 2011-12, 5% for FY 2012-13 and 6% for the balance of the plan
- Fee increases proportionate to projected slower growth in development through 2010-11 and 3% for the balance of the plan
- 5.6% annual increase for overhead and other revenues
- 5.6% annual increase for salaries and overtime (MOU and Merit increases)
- Annual benefits increase of 8% primarily based on medical costs
- Discretionary operating expenditures held flat beginning in FY 2009-10
- Non-discretionary expenditures held flat through 2009-10 and escalated at 3% thereafter
- Vehicle replacement deferred for first two years and resumed for the balance of the plan
- Assumes storm drain increase is approved and becomes effective in FY 2010-11
- City share of Gateway development fees is deferred until FY 2012-13
- Assumes annual reduction of 5.5 staff (FTE) and/or sharing of benefit costs
- Assumes that Other Post Employment Benefit (OPEB) costs will be met through alternative strategies, such as the sale of surplus City property

Staff believes it is appropriate to add the following assumption to the items listed above:

- Revise revenue estimates based on the actual FY 2007-08 revenues

The inclusion of the above assumption into the 10-Year Plan will further exacerbate the structural imbalance and drive the General Fund into deficit spending unless expenditures are significantly reduced. **In recognition of this fact, staff believes that annual adjustments primarily focused on expenditure reductions of an approximate minimum amount of $2.5 million are necessary beginning with FY 2009-10.**

These adjustments need to be structural. Currently, the City is utilizing reserve funds and frozen positions to reduce expenditures and manage through the current economic malaise in anticipation that the economy will turn. However, most economic analysts believe that the boom times that began in 2004 through 2006 will not return. While a gradual rise in economic activity is certain, significant upswings such as the $2.5 million increase in sales tax that occurred in Woodland between 2005 and 2006 are extremely unlikely. Therefore, the assumptions on the previous page are conservative in order to reflect the gradual rise scenario.

Staff wrestled with the need to develop structural reductions during preparation of the FY 2008-09 budget. The May 13, 2008 staff report presented to the City Council summarizing the proposed current year budget included the following summary of potential reductions should economic conditions worsen:

- Close Hiddleson Pool
- Close Brooks Swim Center
- Reduce Library Service by One Day per Week
- Eliminate Code Enforcement Program
- Non-Safety Employee Furloughs
- Defer COLA's for all Employees
- Defer Step Increases for all Employees
- Reduce City Hall Hours through Modified Work Schedule
- Defer Medical-in-Lieu and Opt Out Payments

Staff believes all of the above options plus others that were not thoroughly discussed during the budget process need to be reconsidered. Programs that were added back to the proposed budget as directed by Council need to be reconsidered as well. In effect, all programs and services that receive General Fund resources need to be reviewed, including public safety.

Staff believes that the discussion of this challenge needs to be open, transparent, direct and honest. Employees at all levels of the organization need to be involved. The community, including residents, business owners, property owners, community organizations, members of City boards and commissions, other local governments and other stakeholders need to be informed. Staff believes that the City needs to utilize new methods for outreach to the community and employees in order to gain a solid understanding of service and program priorities and potential ideas for reductions. The entire organization and community need to be open to new ideas and new ways of conducting the public's business.

There are already ideas in various stages of development within the organization. Two departments, Police and Community Development, have outlined reorganization plans that have the potential for saving significant resources while having minimum impact on the public. The Fire Department has reviewed a process for seeking recovery of a portion of their emergency response costs for incidents that may be directly paid by insurance companies. In each of these scenarios, the sponsors have had the courage to question long held beliefs and principles associated with the delivery of their service. Whether or not these and similar ideas will come forward for the City Council's consideration as policy issues remains to be seen. However, the fact that staff are searching for alternatives is very appropriate.

Water Enterprise Fund

The Water Enterprise Fund 10-year plan presented as part of the Council's budget approval assumed the implementation of the meter program under a phased approach and the capital projects such as replacement of the elevated water tank and meter implementation. This forecast showed a balanced 10-year plan with the Ending Working Capital at no less than 21% of the operating expenditures. The 10-year Plan did not assume implementation of the Surface Water program.

The updated 10-year Plan for the Water Enterprise Fund needs to show the impact of the debt service for the capital projects funded by the bond issuance currently in progress. As stated on October 21, the actual bond issuance action will be considered by the City Council on November 18 and the award of a bid for the elevated water tank will be considered by Council at a future date.

In addition, the updated 10-year Plan will need to incorporate the projected financial impact of the Surface Water project. As stated during the September 29 Study Session, the City's anticipated Waste Water Discharge Permit will allow the City to meet interim water quality limits based on the eventual use of surface water from the Sacramento River as a source of domestic water. Based on this condition, the City needs to proceed with the assumption that the Surface Water project will be implemented. A rate study is currently in progress to determine the impact of this project on future rates. All information associated with the Surface Water project, including costs, projected debt service and rate impacts, need to be incorporated into the updated 10-year Plan.

Sewer Enterprise Fund

The Sewer Enterprise Fund 10-year plan presented as part of the Council's budget approval assumed marginal rate increases and stable operating expenses. The financial plan also assumed capital expenses ranging from $774,000 to over $5.7 million that will replace main trunk lines, lateral lines and elements of the Wastewater Treatment Plant at various times. The Ending Working Capital is maintained at a prudent level throughout the entire 10-year plan.

A major change that needs to be considered as part of the updated 10-year Plan is the impact of the Surface Water Project on the sewer rates. This idea may seem confusing since surface water is associated with its use as a source for residential and business purposes. However, as stated above, the anticipated approval of the City's Waste Water discharge permit is based on the future of improved "source" water. The inclusion of the Sewer Enterprise Fund in the Surface Water project may provide options for spreading the projected rate increases. In any case, the updated plan could include a portion of the debt service payment for the Surface Water project.

Combined Transportation Funds

Last year staff presented a 10-year plan that summarized the combined revenues and expenditures for all programs that support the maintenance of Woodland's local streets and roads. Staff developed this projection in order to address the diminishing level of Transportation Development Act (TDA) funds that are allocated from the Yolo County Transportation District to the cities and the County. The first priority for the use of TDA funds is transit activities. As Yolo County's population continues to grow, a larger share of these funds will be used for transit purposes, such as expanding bus routes. Based on projections reviewed with YCTD staff, Woodland's share of TDA funds is expected to diminish from the 2009 projected amount of $564,715 to zero by 2018. In order to maintain the present level of road maintenance funding, the City would need to backfill with another source. The 10-year Plan showed the source of the backfill as Measure E funds. As the Council is aware, approval for spending a maximum of $750,000 annually was secured in October 2007. Staff projects that the $750,000 allocation will be fully utilized in FY 2010-11. However, additional backfill funds will be needed beginning in FY 2011-12 and for the remainder of the 10-Year Plan. If Measure E funds are unavailable, staff will need to find an alternative funding source in order to maintain local streets and roads at the current level.

The update for this 10-year Plan will need to revisit the above assumptions. It is likely that TDA funds could diminish at a faster pace than projected last year. However, discussions at the federal and state level continue to suggest that an economic stimulus package that would feature transportation projects may be on the horizon. There is a note of caution to these discussions; the projects may favor mass transit options typically focused on large urban areas. In any case, staff will need to watch these developments closely and factor them into updated projections.

Redevelopment Agency

The Redevelopment Agency (RDA) 10-year Plan presented as part of the budget approval to the City Council included a summary of projected Tax Increment that will add to the current base amount. This projected Tax Increment is based on various projects that staff expects will be completed over the next ten years. There are no expenses projected for capital projects since staff and Council have not identified a project or projects at this time. However, RDA funds will likely be used for the Court Modernization and Expansion Project and could be considered for other projects. The RDA operating funds would be used as part of a funding package that would include bond proceeds of over $6 million to facilitate a strategic downtown project. Staff anticipates working with the City Council to review options for using all or part of the bond proceeds in association with a project during FY 2008/2009.

Based on this review, the updated 10-year Plan could include assumptions for capital expenditures for the Court Modernization and Expansion project. A second project that could be included for possible capital expenditure is the Bust Street Plaza. Inclusion of this project may depend on the progress made with the study that was recently initiated.

One potential negative development that will need to be included in the updated 10-year Plan is the impact of the State's outright seizure of $142,000 in RDA funds for FY 2008-09 and possible seizure in FY 2009-10 and FY 2010-11. Staff is closely following the efforts of the California Redevelopment Association and League of California Cities who are working to thwart any future seizures of these important local funds by the State.

Capital Improvements

As the Council is aware, the City's Capital Improvement Budget is developed as a separate document and presents the funding plans for City construction and repair projects and purchases of land, buildings and equipment. As part of the FY 2008-09 budget, staff developed the Capital Improvement Plan (CIP) as a balanced ten-year spending plan that represented a collaboration among all City departments and was designed to be consistent with respective Master/Specific Plans, the Major Projects Financing Plan (MPFP), Measure E spending plan and other Council adopted plans. The proposed Capital Budget is the first three years of the CIP and identifies the projects for which three-year capital appropriations are requested.

The FY 2009-10 of the 10-year CIP needs to revisit the revenue assumptions and other issues in order to reflect the realities of declining economic activity and the potential reduction of development impact fees. These assumptions may include:

- Reduced revenues generated by development impact fees based on lower than projected development activity and reduction of the actual fees necessary to keep some level of development active

- Reduced Measure E revenue based on the reduction in sales tax projections discussed as part of the General Fund 10-year Plan herein

- Impacts associated with debt service payments for various projects funded by development impact fees that are declining and the need to identify alternative sources of funding

- Impacts to Council adopted master plans and similar policy documents

- Impacts to operating budgets based on the availability of resources to operate and maintain new facilities and amenities

- Expediting "fund integrity" by further limiting if not able to completely cease the practice of internal borrowing between development fund categories

The development of the 10-year CIP and three year capital budget will be very challenging. There is one issue that is absolutely certain: capital projects will be significantly slowed down and additional projects will either be delayed, land in the "unfunded" category or dropped from further consideration at this time. This action is simply a matter of available resources.

Summary

The information presented herein has attempted to provide a realistic summary of the City's fiscal challenges headed into the development of the FY 2009-10 budget. For the most part, the information presents serious and difficult challenges that can only be met by effective leadership, collaboration with the community and City employees and a belief that the challenges will be met.

It is also important for the City Council to note that staff is working on Mid-Year Adjustments that will be proposed for the current year budget based on the revised revenues. These adjustments will include both operating and capital budgets and should be provided to the City Council in December. At this point, very few positions will be approved for hiring and considerations such as revenue impacts will be weighted very significantly. Departments that offer reorganization alternatives which are expected to save significant resources such as described herein will also receive favorable consideration.

Fiscal Impact

There is no direct fiscal impact associated with the City Council's review and consideration of the information contained within this report.

Public Contact

Posting of the City Council agenda. Copies of this report were provided to the leadership of all employee associations.

Recommendation for Action

Staff recommends that the City Council reaffirm the guiding principles for the FY 2009-10 Budget and 10-year Financial Plan and approve the general direction associated with each specific fund as described herein.

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Mark G. Deven
City Manager