FINANCIAL FORECAST

Introduction

The Five-Year Financial Forecast provides a long-term view of City revenues 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.

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 course of the most recent City Council budget workshops, there has been increased focus on the sensitivity of the budget forecast to the major underlying revenue and expenditure assumptions. The uncertainty that characterizes the current economic climate not only argues for prudent long-term financial planning, but also suggests that being prepared for a range of outcomes is perhaps more appropriate than focusing on any single predicted outcome. As such, the five-year budget model truly serves more as a planning tool rather than a forecasting tool.

Summary of Five-Year Forecast

This section of the budget document presents an update of the General Fund Five-Year Forecast. Previous efforts to address the structural deficits in past forecasts have relied on decreasing levels of one-time resources and contributed to an increasingly improved forecast. However, the current prolonged economic recession has necessitated budget reductions in each of the past three budgets.

Additional balancing measures were proposed as part of this budget to close a projected FY2011/12 General Fund operating deficit, as well as restore General Fund reserves to the 15% policy level. This balancing plan does not rely on one-time sources of revenues for ongoing operating costs.

Past Five-Year forecasts have served as valuable tools in assessing the City's progress in meeting its goal of fiscal stability, ensuring that current revenues are sufficient to meet expenditure requirements for maintaining existing service levels and that the City can sustain this level of service without reliance on growth or increases in current tax rates.

This year, the five-year budget forecast again serves to highlight the variability of the City's budget outlook in the face of stagnant revenues and continued uncertainty. Through modeling alternative revenue and expenditure assumptions, the forecast provides not only a sense of the short-term measures that are required to maintain a balanced budget, but also informs the level of contingency plans that also need to be in place, should alternative scenarios play out.

Multi-Year Budget Balancing Framework

- The FY2011/12 Adopted Budget has been developed consistent with the City's multi-year budget balancing framework. Key features of the multi-year framework include:
  - Development of annual budgets that fully-address the recurring structural deficits, through measures that generate ongoing savings, and do not rely on new revenues or one-time sources.
  - Need to either renew or replace revenues subject to re-authorization by voters, including the Parks Maintenance Tax (2012).
  - Evaluate funding sources to address the highest priority needs that are not currently funded within existing resources
  - Maintenance of a prudent 15% general fund reserve level with excess fund balances restricted for allocation to one-time uses.

  - The balancing plan addresses a projected deficit of $799,000, resulting in a 15.4% General Fund reserve – consistent with current City. Further measures will need to be taken to maintain this reserve level in the coming years.

With the balancing plan adopted for FY2011/12, the forecast yields a FY2011/12 budget surplus of $152,000, followed by deficit years for FY2012/13 to FY2015/16 before returning to a surplus by FY2016/17. This result reflects a marked increase in expenditures in FY 2012/13 that is greater than the forecasted increase in revenues.

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 April-to-April All Urban Consumer Price Index for the San Francisco Bay Area. This index has increased an average of 2.1% over the last five years. For the purposes of this forecast, a 2.0% annual inflation rate is used throughout the five-year planning timeframe.

CONSUMER PRICE INDEX
Change from previous year

YEAR	
2005	2.1
2006	3.2
2007	3.3
2008	2.1
2009	0.8
2010	1.4
2011 (Aug)	2.9
Average	2.1%

Population

Based on data from the State Department of Finance, population is projected to be 65,915 for FY2011-12 and remain relatively flat. Population impacts some state revenues (allocated on a per capita basis) as well as drives demands for a variety of city services. The population figure reported for the City of Davis excludes persons housed on the University of California at Davis campus as it lies outside of City limits.

State Impacts

Over the past several years, the City's budget 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 the previous budget year have greatly impacted overall city revenues as well as cash flow positions.

With the Passage of two separate Proposition 1A's (2004 and 2006), cities have now been afforded significant protection against future State takeaways. However, despite these protections, this year the State triggered the "borrowing" provision of the 2004 Proposition 1A whereby 8% of local property tax revenues were loaned to the State. In addition, the State has moved to eliminate Redevelopment Agencies or require payment in order to continue them.

In the meantime, the current Five-Year Forecast reflects the lingering impacts of past and current State actions, but reflects restoration of ERAF II funds and VLF backfill monies per current statutory and constitutional provisions.

Expenditure Baseline

The expenditure baseline for the Five-Year Forecast is the Adjusted FY2010-11, and the Proposed FY 2011/12 budgets. The forecast projects expenditures as a result of anticipated changes in factors and assumptions highlighted in this section.

Current service/staffing levels - The baseline Five-Year forecast assumed current (FY 2010-11) 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 80% of the discretionary General Fund budget. Every 1% increase in total compensation costs approximately $510,000, on an all funds basis, and approximately $302,000 to the General Fund.

The Five-Year Plan reflects total compensation (salaries and benefits) decreases of 0.3% for FY2011/12, and averaging 2.7% per year increases over the five-year forecast. This represents an increase of approximately $2.7 million over the Five-Year Plan.

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

	Annual % Change	
	FY2011/12	Five-Year Forecast
Salaries*	-4.8%	0.1% - 0.6% (range)
Insurance	17.7%	6.0% - 8.0% (range)
Retirement	10.4%	up to 19% (civilian) up to 38% (sworn safety)

Insurance Premiums

Costs related to Health, Dental, Retiree Medical, Disability, Workers' Compensation, Life Insurance and Unemployment insurance are assumed to grow at an annual rate of 8% for FY 2011-12.

Other Post-employment Benefits (OPEB)

GASB Pronouncement 45 requires public agencies to evaluate and report in its annual financial statements the fully-funding cost of any post-employment benefits (i.e. retiree healthcare). While GASB 45 does not require full-funding of post-employment benefits, its effectively sheds light in the gaps between the true cost of these benefits and the funds typically allocated on an annual basis for pay-as-you-go funding plans.

The City of Davis met its obligation to report the funding statute of its OPEB liability with the 2008/09 fiscal year. For the past four years, the city budget has included incremental funding – over and above the historical pay-as-you- go levels - with the goal of meeting our actuarial funding requirements over a 5-7 year period. For FY2011/12, the OPEB contribution rate is approximately 12% of salaries, and includes an estimated $1.5 million in supplemental funding, to be applied to the amortization of the unfunded liability.

State Retirement System

Retirement rates are set annually by the California Public Employees' Retirement System (CalPERS). The rates established for FY 2011-12 reflect a slight increase 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. There is growing concern that rates will need to be substantially increased over time in order to properly fund the retirement system.

The following table summarizes the employer contribution rates used in the Proposed FY2011/12 Budget and Five-Year Forecast:

	FY10/11	FY11/12	FY12/13	FY13/14	FY14/15	FY15/16	FY16/17
Police (Sworn)	22.846%	25.907%	26.800%	30.300%	24.800%	24.800%	24.800%
Fire (Sworn)	22.846%	25.907%	26.800%	30.300%	24.800%	24.800%	24.800%
Civilian (Misc.)	13.495%	18.180%	18.800%	21.200%	21.200%	21.200%	21.200%

On an all-funds basis, the City's cost for retirement benefits in FY2011/12 is $7.2 million, an increase of $787,000 over FY 2010/11. The General Fund represents approximately 61% of citywide personnel costs which implies that the General Fund cost for retirement contributions would grow to just under $480,000 for FY2011/12. The City's exposure to increased retirement costs is largely mitigated through agreements reached with a majority of the City's employee bargaining groups whereby employees would cover the first 3% of any increases in employer retirement contribution rates, the City the next 3% and anything greater shared equally.

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 rates for Police and Fire have typically been well-below state averages for similar plans.

CalPERS employer contribution rates are projected to increase significantly beginning in FY2013/14 as a result of retirement fund investments loses incurred this past year. The rate impacts are effectively "delayed" as a result of a "rate-smoothing" methodology adopted by CalPERS.

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 adoption of the FY2006/07 budget, it adopted 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 7 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, Municipal Service Tax and fee revenues. In FY 2011-12, these indicator revenues are expected to comprise an estimated 75% 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 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 increase 1.5% for FY2011/12, and grow at a modest 2.2 – 2.7% throughout the forecast.

- *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 have declined from the peak of 2007-08 levels, but have shown some modest growth recently with 2% growth built into the 11-12 budget.

- *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 no growth in 10/11 and 2% per year thereafter.

- *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. In that year, roughly 90% of cities' VLF revenues were exchanged for an equal amount of Property Tax revenues from the state. In subsequent years, the amount of the property tax "in-lieu" payments increased in proportion to growth in each jurisdiction's assessed value.

- *Municipal Service Tax* – This revenue source was adopted by local voters in 1986. The tax is paid by residential property owners based primarily on a per dwelling unit basis, and to commercial property owners primarily on a per square foot of building basis. The tax is expected to generate $2.48 million in FY2011/12. An annual increase of 3% is built into the Five-Year Forecast.

  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 3.0% per year.

Beginning in FY2005/06, City departments – Community Services (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.