FINANCIAL FORECAST

Introduction

The Five-Year Financial Forecast provides a long-term macro-view of City general fund revenues and expenditures to assist in evaluating the impact of policy choices on the long-term fiscal health of the City. The Five-Year Forecast is useful in identifying trends and potential issues that may arise in the future that require fiscal planning affecting the current budget. Multi-year fiscal planning is critical to ensuring long-term stability for the organization. The fact that there are restrictions imposed by the State that limit local governments in their discretion to raise revenues adds weight to the importance of longer term financial forecasting.

This forecast is a snapshot in time starting with the assumption that there is no significant change in the 'base budget" of the agency over the forecast period. The base budget is roughly the existing level of service and its resources projected through each future year with some adjustments about likely changes, such as inflation and known mandates, in the cost and revenue for that base budget over the forecast period. By understanding the factors impacting the forecast policy makers can change the long-term outcome by taking certain budgetary actions in the present. As such, the five-year budget model serves as an important fiscal strategic planning tool.

The City of Davis has experienced and to a large extent addressed a persistent situation where general fund expenses have exceeded revenues. In spite of its efforts to reduce expenses though human resource reductions, cost reductions and the resulting service level reductions, the gap of less revenues than expenses remains. Peering into the future from the point of the conclusion of FY 13/14, it is apparent from the forecast that there remains a gap, also known as a "structural budget deficit," projected into next fiscal year and the following years of the forecast period. Further reductions to the base budget and/or material increases in the revenue base of the general fund will need to be made.

Five-Year General Fund Forecast

The City has been addressing its financial challenges for several years. Over the past seven years 110 positions funded in whole or in part by the general fund have been cut. Furthermore, employees are paying more of their benefit costs and the City uses more contract services in areas where costs savings can be realized. Expensive projects have been deferred, such as the General Plan update as well as a number of capital projects which require General Fund resources. Even with all that has been done to address expenses, these efforts have not been sufficient to eliminate the general fund's structural imbalance.

The proposed budget forecast was based upon the last financial report to the Council which was produced in April 2014. It predicted that there would be a $4.2 million budget deficit in FY14/15 without material reductions in the base budget expenses if no new revenues are available. The Council had placed a ½ cent sales tax ordinance on the ballot prior to that time, with estimated revenue of $3.6 million annually, in current dollars. At that time, the Council also directed that $1.2 million in specific cuts recommended by staff would be included in the FY14/15 Budget. This was the starting point for the 5 Year Forecast.

The bottom line is that the 5 Year Forecast projected that without corrective measures the City would run out of General Fund reserves early in FY15/16 and, by the end of the five year forecast period, the deficit would be in the range of $17 million. This is a scenario that was highly unlikely to play out but it did indicate the present severity of the problem and the hard work that remains to address the general fund's structural imbalance.

Since the original forecast a ½ cent sales tax increase on the June 2014 ballot was approved by a majority of Davis voters. This additional tax is estimated to provide $3.6 million annually and the Five Year Financial Forecast includes the impact of that additional revenue.

The conclusion drawn from this is that the City needs to continue on the path of examining ways to reduce costs; ensure that its revenue collections for user fees and efforts to obtain grant funding are robust; consider other revenue sources, including taxes or fees, that may preserve and or improve service levels; seek partnerships with government and private agencies that will reduce costs; and, through targeted economic development efforts in line with community values, increase and broaden the tax base of the general fund.

The following chart depicts the long-term financial projections with Measure O revenue.

FY 14-15 Proposed Budget
(including $1.164 Million in reductions and Measure "O" revenue)

CM FY 14-15 Proposed Bud with Measure "O" Revenues & $1.164 M in Reductions	Proposed w/Msr "O" Budget 2014/15	Forecast for Fiscal Year 2015/16	2016/17	2017/18	2018/19
Begin Fund Balance	$ 5.23	$ 3.78	$ 3.30	$ 2.57	$ 1.56
Revenues	$ 46.68	$ 48.77	$ 50.08	$ 51.44	$ 52.83
Expenditures	$ (48.13)	$ (49.25)	$ (50.81)	$ (52.45)	$ (53.70)
Ending Fund Balance	$ 3.78	$ 3.30	$ 2.57	$ 1.56	$ 0.69
Structural Imbalance	$ (1.45)	$ (0.48)	$ (0.73)	$ (1.01)	$ (0.87)

Additional Information and Assumptions Related to the Forecast

The following summarizes the results of the City's General Fund forecast for FY 2014-15.

o General Fund revenues are projected to grow at an average annual rate of 2.7% per year, resulting in total revenue growth of $6.15 million for the period FY 2014/15 through FY 2018/19. This includes additional sales tax revenue from Measure O.

o General Fund expenditures are projected to experience annual increases from FY 2014/15 through FY 2018/19 averaging 2.9% per year, resulting in total General Fund expenditures growth of $5.57 million over five-year forecast period.

o The operating projections shown over the five-year planning horizon remain sensitive to assumptions related to major city revenues and expenditure categories. Among the main areas of concern are property and sales tax revenues. While the City has seen a fairly robust improvement to these revenues for FY 2014/15 it is not certain that it will continue.

Five-Year Forecast 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 emergencies. These assumptions impact revenue and expenditure projections and variations can cause wide swings in the budget.

Inflation

Inflation is an important factor in any economic forecast because of its influence on both city revenues and expenditures. Inflation-sensitive revenue, such as sales and business license taxes, make up 27.4 percent of the General Fund budget. Salary and benefit costs are also influenced by annual cost-of-living increases.

The City of Davis uses the April-to-April All Urban Consumer Price Index for the San Francisco Bay Area as its inflation index. This index has increased an average of 2.4% over the last five years. Forward-looking indicators of overall economic strength or weakness are important to consider. Other factors can also be used in areas where specific increases are known, i.e. water rates and insurances.

CONSUMER PRICE INDEX
Change from previous year

YEAR	
2010	1.7
2011	2.8
2012	2.1
2013	2.4
2014	2.8
Average	2.4%

Population

Based on data from the State Department of Finance, population is projected to be 66,656 for FY 2014/15 which is a 0.8% increase over the prior year. 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 impacts from the State legislation. In 2012 state legislative action dissolved redevelopment agencies shifting property tax revenues from RDA's and relieving the state of obligations to schools and other local entities.

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.

Recently there has been legislation (AB 2372) which, if adopted, will raise an estimated $73 million statewide. It proposes to close a loophole in Proposition 13 which some corporations have used to avoid a reassessment when property changes hands by making sure that no one has a majority interest.

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 such as business licenses). The General Fund provides the only discretionary revenue available to the Council and citizens to directly support local priorities. The General Fund provides most of the funding if not all for services such as police and fire protection, parks, recreation, community development, as well as most of the administrative and support functions of City government.

There are seven 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 14/15, these indicator revenues are expected to comprise an estimated 85% 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 by 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 see a 2% increase for FY 14/15, and grow at 3.5% throughout the forecast.

Property tax assessments grew at a rate of 5.6% this past year, an improvement over the previous year that only saw an increase of 2 percent.

- *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 was renewed by voters in June of 2010 and was set to expire in June 2016. The City placed Measure "O" on the June 2014 ballot, which passed voter approval, adding an additional 0.5% to the local tax rate and extending the current rate through December 31, 2020. This will take the current local sales tax rate from 8% to 8.50%. Of the current 8%, the City now generally receives approximately 1.5 cents from the sales tax generated in the City, incrementing to 2.0 cents with the voter approved Sales Tax increase. Sales Tax revenues are projected to be increase at 2.5% throughout the forecast.

- *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 2% growth in throughout the forecast.

- *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 $5 million in FY 13/14.

The FY 2004/05 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 $2.7 million in FY 14/15. 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 between 1% and 3% per year.

Expenditure Baseline

The expenditure baseline for the Five-Year Forecast is the Adjusted FY 13/14, and the Proposed FY 14/15 budgets. The forecast projects expenditures as a result of anticipated changes highlighted in this section.

Current service/staffing levels - The baseline Five-Year forecast assumed current staffing levels and updated employee service and operational costs. Since the FY 14/15 baseline budget was constructed continued citywide reorganizations and restructuring have reduced the full-time equivalent staff by seven (7) positions from the FY 13/14 level.

Budget Reductions

The forecast has incorporated $1.2 million in General Fund budget reductions that were based on reduction lists that were generated in response to the City's current structural deficit. The lists were across all departments and presented to the City Council in April 2014.

Personnel Costs

The City recently negotiated contracts with a majority of its employee bargaining units and imposed its last-best-final offer. The contracts included provisions for cost sharing with employees which resulted in wage and benefit savings over time. For example, the City is no longer paying the employee share of CalPERS benefits for all bargaining units except for the Davis Professional Firefighter's Association which opted to take a pay cut in lieu of covering that share. The City also negotiated cost sharing of medical insurance increases; reduced the available cash in-lieu payments; and, restructured the retiree medical benefit. All of these measures reduce the City's long-term costs.

Employee wages are projected to increase 1% throughout the Five-Year Forecast. In total the forecast reflects total General Fund compensation (salaries and benefits) increases of 3.3% for FY 2014/15, and averaging increases of 2.5% per year over the remainder of the five-year forecast. This percentage takes into account the cost increases for CalPERS retirement benefit and the full funding of the City's current OPEB requirement. The City's OPEB liability is currently being updated by the City's actuary and new figures will not be available until July.

125 Plan Benefits

Costs related to Health, Dental, and Life insurance are assumed to grow at an annual rate of 4% throughout the forecast. With the implementation of the most recent MOU's, the City shares the cost of increases in Medical insurance with the employee and the amount of cash that employee can take in lieu of benefits is decreasing over the next two years to a maximum of $500 per pay period.

Other Post-employment Benefits (OPEB)

GASB 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, it effectively highlights the difference between the actual cost of these benefits and the funds typically allocated on an annual basis for pay-as-you-go funding plans. These include retiree Medical, Disability, Workers' Compensation and Unemployment.

The last actuarial valuation estimated the City's unfunded liability at $57 million which equates to $6.2 million annual contribution in FY 14/15 for full funding. The actuarial calculation assumes this will grow 3.25% annually in order to maintain the full funding requirements of the OPEB obligation and this value has been used in the five-year forecast. The newest actuarial evaluation will be available in July.

State Retirement System

Retirement rates are set annually by the California Public Employees' Retirement System (CalPERS). The rates established for FY 14/15 reflect an increase from current rates. CalPERS has changed some of its actuarial assumptions which will result in rate increases. The City hired an outside consultant to do its own evaluation of future costs to the City for CalPERS and these are slightly higher. The City uses the values received from CalPERS for FY 14/15 and the actuarial values in the out years.

The following table summarizes the employer contribution rates used in the Proposed FY 14/15 Budget and Five-Year Forecast:

	FY13/14	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19
Police (Sworn)	27.823%	28.81%	33.70%	35.60%	37.50%	39.40%
Fire (Sworn)	27.823%	28.81%	33.70%	35.60%	37.50%	39.40%
Civilian (Misc.)	20.797%	24.80%	27.30%	29.10%	30.80%	32.40%

Note: The PERS rates used are based on actuarial forecasts prepared by Bartel Associates Inc. These actuarial calculations include assumptions for newly adopted PERS Market value smoothing method change using 25 year (fixed) amortization period paid over 30 years, as well as anticipated changes to mortality assumptions and anticipated investment returns from 7.5 to 7.25%.

On an all-funds basis, the City's cost for retirement benefits in FY 2014-15 is $7.1 million, which is an increase of $665,000 over FY 13-14. This increase reflects the 3.6% increase in regular employee's rates and the 0.98% increase in Public Safety rates. The General Fund represents approximately 59% of citywide personnel costs which implies that the General Fund cost for retirement contributions would increase by just over $392,000 for FY 14/15.

Beginning in FY 2004/05, 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 because the rates for Police and Fire have typically been well-below state averages for similar plans. At June 30, 2014, the City's pool of participating safety employees fell below the required 100 members and has been placed into the statewide safety plan. This change will not affect our FY 14-15 PERS rates, but will be a factor to monitor in future safety PERS rates beginning FY 15-16. The analysis of this change is currently under review by our PERS actuarial consultant and will be taken into consideration when preparing future actuarial reports.

Other Major Forecast Expenditure Assumptions

City service costs for water and sewer have been included in the forecast model with anticipated increases to rates over the next four years consistent with Council approved rate structures. These costs are projected to increase $1.5 million over this time. This cost partially offset by $581,937 in annual lease revenue. The City is also setting aside money to improve and upgrade the current irrigation infrastructure in an effort to conserve water use in the City parks. The FY 14-15 Budget includes $500,000 towards this effort with an additional carryover of $160,000 from the prior year. These amounts are reflecting year end projections and may change on the bases of FY 13-14 final year end actual results.

City roads and bike paths are in need of rehabilitation. The City is dedicating $3.4 million all funds ($2.5 M in General Fund) in FY 14/15 for roadway rehabilitation. An additional $1.3 in carryover ($1.2 General Fund) is earmarked for the annual street and bike path paving program, which is aimed at improving the pavement throughout the City in an effort to ensure that the City's transportation infrastructure is maintained to an acceptable level. This effort frontloads the infrastructure maintenance project until a long-term funding source can be identified.