

STAFF REPORT

DATE: December 17, 2024

TO: City Council

FROM: Mike Webb, City Manager
Kelly Stachowicz, Assistant City Manager
Elena Adair, Finance Director

SUBJECT: Initial Budget Priorities for FY26 and FY27

Recommendation

1. Provide feedback to staff regarding key budget priorities for the upcoming two-year budget cycle (fiscal years 2026 and 2027), particularly for the General Fund.
2. Appoint a Pavement Management Subcommittee to work with staff to refine the City's pavement management funding strategy

Executive Summary

The City has a multi-faceted budget with many demands placed on the General Fund. Staff and City Council have worked diligently over many years to put in place structures to allocate funding for future replacement costs, to pay for various "in the background" operating costs such as risk insurance, to maintain a qualified workforce, to proactively fund infrastructure, and to provide programs and services desired by the community. The increase in General Fund revenue from Measure Q, beginning in Fiscal Year 2026, will allow the City to make headway on its obligations and interests. However, the City will have to prioritize spending, in some cases waiting to fund important interests and/or spreading the costs over multiple fiscal years. Input from the City Council to staff at this juncture, especially on key elements of General Fund Reserve and OPEB at this time, will provide helpful guidance as staff begins work on the upcoming two-year budget preparation.

Fiscal Impact

This report does not have a fiscal impact directly, but the feedback provided will inform the budget process and ultimately the 2-year budget brought forward for City Council approval in the spring of 2025.

Council Goal(s)

The budget provides the City's spending plan for a two-year period and touches on all the Council Goals.

Commission Input

This initial discussion is coming directly to the City Council for input. The City's Fiscal Commission will play a role in reviewing the budget, as per direction from the City Council.

Background and Analysis

The City has a two-year budget, with each fiscal year running from July 1 to June 30, and work for the upcoming two-year cycle has begun. With deferrals and cuts in previous budget years, the passage of Measure Q, and a change in the Council composition, staff is taking the opportunity to provide background information to the City Council to request input on priorities and interests for the upcoming budget cycle, particularly as relates to the General Fund. Staff will use this feedback as a guide to provide direction to departments in preparing the proposed budget to deliver to the Council in the spring. This is not intended to be a full budget discussion, and the Council will have multiple other opportunities to provide direction to staff over the winter and spring prior to any budget adoption.

In order to deliver a balanced budget for the current fiscal year, the City had to make several adjustments in the mid-cycle update of the current two-year budget. These included cuts, deferrals of projects and payments, and a draw down on the General Fund reserve, which is anticipated to end the year at 7.5%, or half the Council's targeted amount of 15%. This report outlines several current budget needs.

In the November 2024 election, the Davis voters approved Measure Q, with 64.2% of the votes supporting the measure. Measure Q is a transaction and use (sales) tax, adding 1% to the cost of applicable purchases. The tax will go into effect for vendors in April of 2025, although the first revenues will not reach the city until June of 2025, with a full year's worth of revenue realized by July 2026. Although this tax will fluctuate based on consumer purchases made, the City estimates the tax to generate roughly \$11 million for the City's General Fund in the upcoming fiscal year. This revenue, as a general tax, is not earmarked for specific purposes; however, understanding the Council's priorities will assist staff in preparing the proposed budget.

Budget Needs

The following is a list (in no particular order) of items to be considered for the upcoming budget.

- **General Fund Reserve Restoration**. The General Fund reserve is the unallocated money set aside in case the City has unexpected emergencies or needs that arise over the course of a fiscal year. The City's General Fund reserve policy (Attachment 1) is between 10% to 15% of expenditures, with the amount over 10% available at the mid-year check-in for possible allocation to capital projects or other one-time expenditures. The industry standard is to keep a reserve amount equal to at least 15% of a year's General Fund expenditures, or about two months of operating expenses. In addition, if funding is removed from the reserve, the goal should be to replenish it as soon as practical. For the current fiscal year, the 15% reserve target

is approximately \$12.6 million. Assuming next year's expenditures increase, the targeted reserve amount should increase accordingly.

In order to reach a balanced budget for the current fiscal year, the City has drawn on its reserve, and is currently expected to end the fiscal year at half the targeted amount (7.5% or \$6.3 million). In anticipation of increased revenue generated by Measure Q, the additional expenditures are estimated to necessitate additional amounts required in the reserve. Over the course of the next few budget cycles, the reserve amount should be restored to the City's policy of 10%-15%, which is a cost ranging from \$2.1 to \$6.75 million. Given the large dollar amount, Council may wish to re-build the reserve over more than one budget year, which means the reserve won't reach 15% immediately. The chart below illustrates some options.

General Fund Reserve Restoration			
	FY26	FY27	FY28
In One Year to 10-15%	\$2.1 - \$6.75m	--	--
In Two Years to 10-15%	\$1 - \$3.4m	\$1 - \$3.4m	--
In Three Years to 10-15%	\$0.67 - \$2.25m	\$0.67 - \$2.25m	\$0.67 - \$2.25m

If the reserve was backfilled over two years, then the end-of-year reserve percentages would range from 8.75% - 11.25% at the end of the first year before reaching 10-15% at the end of the second year. If spread over three years, the reserve percentage at the end of the first year would range from 8.3% - 10% and at the end of the second year from 9.1% – 12.5% before reaching 10% - 15% by the end of the third year. The range depends on where between 10% and 15% the City is targeting.

- **OPEB (Other Post Employment Benefits).** The City has obligations through CalPERS to pay “OPEB” costs, sometimes known as retiree medical costs. These costs are in two parts: a required annual amount known as “pay go” that covers current employee costs, which the City pays in full each year and an “unfunded liability” portion.

The timing of the “unfunded liability” payments is flexible (and optional in any given year). Previous Councils had a goal to ramp up payments so that the budget eventually included 100% of the annual unfunded liability portion, as well as the required pay-go. Unfortunately, due to COVID and other factors, the City has not been able to make extra payments toward the unfunded liability portion of OPEB costs. Restoring the full OPEB contributions at a 100% level would be approximately \$1,750,000 in ongoing annual costs. Staff estimates that the unfunded liability would be close to fully funded in 25-30 years, if the City paid down the annual payments at 100%. The chart below shows rough payment amounts at different payment levels:

Unfunded OPEB Liability			
	FY26	FY27	FY28
50%-75%-100%	\$0.9 million	\$1.31 million	\$1.75 million
	FY26	FY27	FY28
100%	\$1.75 million	\$1.75 million	\$1.75 million

- Pavement Management (CIP 8250)**. A decade ago, recognizing the importance of funding for our streets, sidewalks and bike paths, the City adopted a funding strategy to allocate local funds to support pavement maintenance, which has evolved into the City’s [Pavement Management Plan](#). This strategy includes the City’s “maintenance of effort” requirement of \$3 million for pavement management. The City Council has also authorized additional funding from multiple fund sources above the \$3 million to double down on efforts to improve pavement across the city, resulting in significant city investment in the transportation infrastructure. For FY25, the City deferred \$1.5 million due to a temporary buildup of projects in progress and a lack of capacity to implement more due to staff and contractor constraints. However, increasing funding for pavement maintenance remains a critical need.

In addition to the General Fund noted above, other fund sources are also used toward pavement management and include: construction tax dollars, SB1 gas tax, non-transit TDA dollars, and roadway impact fees. The City allocated over \$5.8 million each year in FY22 and FY23, \$7.7 million in FY24 and \$6.5 million in the current fiscal year.

With the continued evolution of pavement condition and construction costs, staff recommends reinstating a city council subcommittee to work with staff on refining the City’s pavement management funding strategy.

- Miscellaneous Capital Improvement Projects**

 - Veterans Memorial Theater Facility Funds**. As part of budget balancing for FY25, \$345,000 in funding to assist with renovations/rehabilitation of the Veterans’ Memorial Theater was deferred.
 - Arlington Roundabout**. The City deferred \$175,000 in funding from the FY25 budget from this project.
 - Traffic Safety Measures**. For the FY25 budget, the City deferred \$100,000 in funding for general traffic safety measures.
- Employee Contracts**. Seven of the city’s eight contracts with employee groups expire on December 31 and the City is currently in talks with those groups to bargain new contracts. While the most recent contracts brought employees to the market median for total compensation in July of 2023, no cost of living adjustments (COLAs) have been provided since. The increased cost associated with salaries and wages will

need to be budgeted. For reference, the General Fund cost of a 1% increase across all employee bargaining units is approximately \$520,000 (so a 2% increase is \$1,040,000 and so on).

- Health Benefit Cost Increases. Health insurance costs continue to increase at a rate faster than inflation, with the 2025 average CalPERS health premium increases at 11%. The City is currently contractually obligated to pay these costs. The difference from what the City originally budgeted for FY25 and the actual cost now that the new numbers are available is approximately \$167,000 for this year.
- Increased Insurance Payments (YCPARMIA). The City is part of YCPARMIA, our risk management agency. This JPA pools payments from member agencies to handle insurance claims made against its members. The organization has secondary or tertiary insurance carriers (excess premium coverage) and the costs to maintain those policies is increasing across the industry. Staff is still awaiting precise numbers from YCPARMIA and the excess carriers, but the City currently estimates cost increases of approximately \$1,200,000 for next fiscal year to maintain the same coverage. Because this is a citywide number, the entire cost burden would not be on the General Fund.
- Fleet Replacement Fund (621). The City maintains several “replacement” funds to collect money over multiple fiscal years to replace large ticket items, like fleet vehicles. This ensures that when a vehicle reaches the end of its useful life, the City has funding available to replace it. As a budget balancing decision in the current 2-year budget, the City deferred \$3.2 million to the fleet replacement fund. These dollars need to be replenished. In addition, staff overseeing fleet purchases believes that higher annual contributions from departments will be necessary going forward given that vehicle costs have increased in excess of the rate of inflation.
- Enterprise Resource Planning (ERP). The City is currently using an ERP system that stems from the early 1990s and which is overdue for replacement. The City has collected the funds to replace the actual system but does not have the funds currently budgeted to provide for a project manager or for the backfill of staffing that will be critical to the successful implementation of the ERP, which is likely to span a three-year period at least. Currently, the City has \$3.3 million saved and set aside for purchase and implementation of a new system. Over the course of this time, staff estimates up to \$1 million additional funds are needed (spread over the course of three years starting in FY 2026) for actual implementation costs associated with the project.
- General Plan Update. The City has collected funding for the General Plan Update to allow for the update to be initiated. An additional approximately \$750,000 in one-time funds will be needed to complete the plan. Staff does not expect needing this funding until FY27.

- CAAP Implementation/GHG Reduction. The City adopted the Climate Action and Adaptation Plan (CAAP) in 2023. Staff is prioritizing implementation options and seeking grants, and the City Council has previously allocated \$500,000 in one-time funding made possible from American Rescue Plan dollars. Additionally, the city has adopted a CAAP implementation grant strategic plan to leverage grant funding. Otherwise, additional funding to implement the full plan has not been identified.
- Downtown Streets Team. The Downtown Streets Team pilot, which works with unsheltered individuals providing them with life skills and helps to clean the downtown, was funded for a two- year period, which will conclude this fiscal year. Half of the original funding was provided from Yolo County American Rescue Plan funds (one-time) and the City funded the other half through cannabis benefit funds, which had been collected over more than one year. In order to continue the program, the City will need to identify approximately \$400,000 in annual ongoing funding.
- Homeless Services. In addition to the Downtown Streets Team, the Council has directed staff to return with costs for several possible additional programs that address homelessness, including possible expanded services for the respite center, sanctioned camping/parking, a navigators program, etc. The costs for these programs is to be determined. Discussion on this item will return to the City Council in February.
- Affordable Housing. The Council has a goal to shore up the housing continuum, and has long been seeking resources to backfill the loss of redevelopment agency revenue. Current sources of funding include the annual federal HOME grants, the City's percent of proceeds from sales of ownership units in the affordable program, occasional housing in-lieu fees, and grants. The Council has expressed interest in programs related to affordable housing, from permanent supportive services for extremely low-income households to down payment assistance for ownership opportunities.
- Facility Capital Maintenance and Replacement. Although the City has a fund for facility maintenance, the annual maintenance needs are greater than the funding and with the age of city facilities, needs are likely to continue to increase. The City should consider increasing the annual amount into the fund by at least \$300,000 per year.
- Urban Forestry. The City has made conscious efforts to enhance the urban forestry program over the past several years, adding staff and funding. Additional funding is needed to ensure that the tree canopy remains vibrant and safe and that the City's trees are appropriately inspected and maintained. The annual ongoing funding recommended is at least \$250,000.

- Park Equipment. The Parks Division has \$100,000 in equipment that was intended to be included in the FY24 mid-year budget update last spring, but was not. The recommendation is to include this in the budget for FY26.

Conclusion

The City has a multi-faceted budget with many demands placed on the General Fund. Staff and City Council have worked diligently over many years to put in place structures to allocate funding for future replacement costs, to pay for various “in the background” operating costs such as risk insurance, to maintain a qualified workforce, to proactively fund infrastructure, and to provide programs and services desired by the community. The increase in General Fund revenue from Measure Q, beginning in Fiscal Year 2026, will allow the City to make headway on its obligations and interests. However, the City will have to prioritize spending, in some cases waiting to fund important interests and/or spreading the costs over multiple fiscal years. Input from the City Council to staff at this juncture, especially on key elements of General Fund Reserve and OPEB at this time, will provide helpful guidance as staff begins work on the upcoming two-year budget preparation.

Attachments

1. General Fund Reserve Policy

RESOLUTION NO. 16-060, SERIES 2016

**RESOLUTION UPDATING THE GENERAL FUND RESERVE POLICY
AND REPLACING RESOLUTION NO. 06-112**

WHEREAS, the City Council of the City of Davis wishes to update its formal General Fund reserve policy to establish appropriate levels of reserves as well as guidelines for uses of funds in excess of said reserve levels; and

WHEREAS, a General Fund Reserve Policy was adopted by the City Council in June 2006 via Resolution No. 06-112; and

WHEREAS, it is the City Council's desire to update the General Fund Reserve Policy; and

WHEREAS, the Finance and Budget Commission reviewed the draft policy in April 2016 and provided recommendations to the City Council; and

WHEREAS, the General Fund Reserve Policy was presented to the City Council on May 17, 2016, in conjunction with the presentation of the FY2016/17 Proposed Budget.

NOW, THEREFORE, BE IT RESOLVED that the City Council of the City of Davis does hereby adopt the General Fund Reserve Policy attached hereto.

PASSED AND ADOPTED by the City Council of the City of Davis this 17th day of May, 2016, by the following vote:

AYES: Davis, Frerichs, Lee, Swanson, Wolk

NOES: None



Daniel M. Wolk
Mayor

ATTEST:



Zoe S. Mirabile, CMC
City Clerk

General Fund Reserve Policy

Purpose

The City of Davis establishes its General Fund Reserve policy as additional insurance against disasters, emergencies and unforeseen expenditures.

Reserve Level

The City Council hereby establishes the following minimum General Fund reserve targets:

- The City shall strive to maintain a General Fund reserve equal to 15% of General Fund expenditures, with up to 5% allocated to special capital projects for roads/paths, facilities and parks. The unallocated reserve funds are set-aside to address potential needs in the following areas:
 - A Reserve for Economic Uncertainty - funds designated to mitigate periodic revenue shortfalls due to downturn in economic cycles, thereby avoiding the need for service-level reductions within the fiscal year.
 - An Emergency Reserve - funds designated to mitigate costs of unforeseeable emergencies and natural disasters.
- The appropriate level of General Fund reserves shall be reviewed annually.

Use of Reserve Funds

Reserve for Economic Uncertainty – General Fund reserve intended to offset quantifiable revenue uncertainty in the multi-year forecast. The long-term funding level for this reserve is determined by measuring the level of financial risk associated with the following areas of uncertainty:

- Revenue risks: Revenues falling short of budget projections may cause shortfalls. Transitional funding is also necessary to respond to reductions in major revenues due to local, regional and national economic downturns, as well as reductions in revenues caused by actions by State/Federal governments.
- Uncontrollable costs: There may be cost increases that are beyond the City's control (e.g. various fuel and utility charges). In addition, the City requires a source of supplemental funding for further increases in CalPERS retirement rates that result from CalPERS investment performance that falls short of actuarial assumptions.

Any reserve funds expended within this category that result in year-end reserves below the established policy level shall be restored in no more than three budget cycles. However, if the reserve level falls to below 5%, the Council may restore funds over a multi-year period.

Emergency Reserve - Funds reserved under this category shall be used to mitigate costs associated with unforeseen emergencies, including natural disasters. Should unforeseen and unavoidable events occur that require expenditure of City resources beyond those provided for in the annual budget, the City Manager shall have the authority to approve appropriation of Emergency Reserve Funds. The City Manager shall then present to the City Council – no later than its first regularly scheduled meeting - a resolution confirming the nature of the emergency and formally authorizing the appropriation of reserve funds.

Excess Fund Balance

At the end of each fiscal year, the Finance Department will report on the audited year-end budgetary fiscal results. Should actual General Fund revenues exceed expenditures and encumbrances, a year-end operating surplus shall be reported. Any year-end operating surplus which results in the General Fund balance exceeding the level required by the reserve policy shall be deemed available for allocation for the following, subject to Council approval:

- Transfer to other funds, as appropriate, to offset year-end deficits within those funds,
- Transfer to the Capital Program Fund (Fund TBD) for appropriation within the Capital Improvement Program Budget and/or Deferred Maintenance for non-recurring needs,
- Re-appropriation within the subsequent year's operating budget to provide for one-time, non-recurring needs.

It is the intent of the City Council to limit use of fund balances in the General Fund to address unanticipated one-time needs. Fund Balances shall not be applied to recurring annual operating expenditures.

Other Funds

In conjunction with approving the General Fund Reserve Policy, the City Council expresses its intent to evaluate other Special Revenue, Enterprise and Internal Service funds to establish appropriateness of developing formal fund-specific reserve policies.