Council Agenda Report

From: Ryan Cornell, Finance Manager

Subject: FY 2018-19 and 2019-20 General Fund Budget Update

Date: May 7, 2018

Facts

1. The Fiscal Year (FY) 2016-17 and 2017-18 Operating and Capital Budget (Budget) for all funds was approved by City Council on June 21, 2016. The FY 2017-18 Budget was updated and approved by City Council on June 20, 2017.
2. The City is required to adopt an Operating and Capital Budget for the FY 2018-19 no later than June 30, 2018.
3. On February 17, 2018, the City Council held a Visioning and Goal-Setting Workshop that provided Councilmembers, the public, and staff a variety of opportunities to provide input and to fully participate in the development of the vision and goals for the City.
4. On March 6, 2018, City Council held a follow-up discussion of the workshop outcomes, in order to obtain additional public input and finalize City goals and strategic initiatives.
5. This budget update report focuses solely on the General Fund. It includes the forecasts for both revenues and expenditures, the traditional first step in the City's budget process. It allows City Council the opportunity to ask for additional information and provide direction.
6. On May 15, 2018, the Enterprise Funds, Capital Improvement Program, and a variety of additional options for Council consideration, will be presented for City Council consideration.
7. The final FY 2018-19 and 2019-20 Budget document, based on Council direction at each of the prior meetings, will be scheduled for Council consideration, approval, and adoption at the June 19, 2018 Council meeting. It will contain all projected revenues, appropriations, and transfers, and shall be implemented by the City Manager per Council policies and direction.

Analysis and Conclusions

The City's Biennial Budget provides funding for all City services, infrastructure investments, and activities performed during the year. The first step in this process is to examine existing accounting, budgetary, and financial reporting and analyze the efficiency and effectiveness of existing programs and reporting. As such, staff is recommending a few changes in the financial reporting of the City such as: establishing a Capital Improvement Program Fund, establishing adequate funding for vehicle and equipment replacement, and revising the process in which we handle Interdepartmental Charges. Each of these items is discussed in more detail below:

1. <u>Capital Improvement Program (CIP) Fund</u> – This standalone fund will account for all major capital improvements including, but not limited to, construction projects or projects that are anticipated to be completed over the course of more than one fiscal year. The current accounting practice makes it difficult to determine whether or not deficit spending is a result of capital projects being carried forward into the new fiscal year or if there is truly an instance where spending is greater than the revenues received.

   For example, if the City appropriates $5 million each year, for budgetary purposes, it is easily displayed in Table 1:

Table 1: Typical Capital Project Budgeting

	Year 1	Year 2	Year 3
Project A	$3,000,000	-	-
Project B	$1,000,000	-	-
Project C	$1,000,000	-	-
Project D	-	$2,500,000	-
Project E	-	$500,000	-
Project F	-	$2,000,000	-
Project G	-	-	$5,000,000
Total	$5,000,000	$5,000,000	$5,000,000

In a perfect world, all appropriations would be spent in the same fiscal year appropriated. However, that is rarely the case, since a construction project, for example, can take several years to complete. Table 2 is an example on how expenditures might typically be incurred for Projects A-G as listed above:

Table 2: Typical Expenditures over Time for Capital Projects

	Year 1	Year 2	Year 3
Project A	$1,000,000	$750,000	$1,250,000
Project B	$100,000	$900,000	-
Project C	-	$1,000,000	-
Project D	-	$1,200,000	$1,300,000
Project E	-	$400,000	$100,000
Project F	-	$1,000,000	$1,000,000
Project G	-	-	$5,000,000
Total	$1,100,000	$5,250,000	$8,650,000

In this scenario, there was a surplus of $3.9 million in year 1 ($5.0 million less $1.1 million spent), a deficit of $250,000 in year 2 ($5.0 million less $5.25 million spent) and a deficit of $3.65 million in year 3 ($5.0 million less $8.65 million). An apparent $3.65 million deficit would be alarming for a City the size of Paso Robles, with a roughly $40 million total General Fund budget. However, in actuality, none of the projects has gone over budget; the total amount expended is exactly the same ($15.0 million) as the amount budgeted.

Additionally, this example focuses on the expense-side of the project. Many times, there are grant revenues associated with these capital projects. If the City were to secure a multi-million dollar grant, the existing reporting method would inflate revenues in the year (or years) that it is received, skewing year-over-year comparisons of revenues. This makes comparisons to previous years inconsistent and more difficult to understand, without the full context of the capital improvement made.

It is prudent for policy and decision making to know what the impacts an action has on City reserves. By creating a CIP Fund, the City can mitigate some of the problems that the current approach—which combines operating and capital expenditures in one budget--is causing.

The funding source will be the same, in that the General Fund will continue to fund these projects. Thus, rather than recording capital expenditures in the General Fund, a "transfer-out" of the General Fund and a "transfer-in" to the Capital Projects Fund would be recorded. This transaction simply moves money from one fund to another. The transfer out of the General Fund would be $5 million each year and allow for consistency in the changes in fund balance from year

to year. The Capital Project Fund would incur the same fluctuations as before, but the Fund would focus on each project staying within budget and not necessarily on total revenues exceeding total expenditures in a given year.

Furthermore, if there are funds remaining at the completion of the project, a transfer in the opposite direction (transfer out of the Capital Projects Fund and into the General Fund) can take place. At the discretion of City Council, project savings could be kept in the CIP Fund and allow for a set-aside of funds for future projects. A project can be unknown at the time of the Biennial Budget Report process but important enough to complete now (rather than waiting for the next budget cycle). Having this set-aside amount could help mitigate what might otherwise appear as adverse impacts to the General Fund.

2. Vehicle and Equipment Replacement Methodology -- Currently the City sets money aside (held in the Vehicle and Equipment Replacement Fund) annually for future replacement of vehicles and equipment in the current inventory. The amount annually set aside has traditionally been determined by taking the cost of the equipment, divided by its projected life. For example, the City would set aside $5,000 per year for a $25,000 vehicle that has an estimated life of 5 years. As soon as $25,000 is set aside, the annual $5,000 contribution stops until the vehicle is replaced.

   Although this practice has been followed for many years by Paso Robles and many other cities, it generally does not result in a sufficient replacement fund balance. One main component missing from this program is that the cost of a vehicle will escalate over the years beyond its original purchase price. As a result of this and the recession, many of the vehicles and pieces of equipment that are due for replacement do not have adequate funds for replacement.

   Moving forward staff is recommending the calculation for the annual contribution to be:
   a. Cost of equipment
   b. plus 3% annual escalation
   c. plus or minus replacement dollars over/under collected from previous equipment
   d. minus proceeds from sale of prior equipment
   e. divided by the estimated useful life

   Staff is also recommending that the set aside funding continue, even beyond the estimated useful life, until the piece of equipment is replaced, so as to correct for the under-collection in prior years. This practice will end once the fund is caught up.

   By implementing this methodology in the upcoming Biennial Budget, and based on the equipment anticipated to be replaced in the next two years, there would be an increase of $305,000 to the current funds being set aside, a 50% increase, in the first year and a $560,000 increase in the second year. These costs are based on the equipment requested to be replaced in the next two years. (These increased contributions over the two years would not make the fund whole; rather they are needed corrections in order to ensure the vehicle and equipment fund is appropriately funded in a given year.) A detailed listing of the vehicles and equipment scheduled for replacement will be provided to City Council during the CIP and Enterprise Funds Budget update report on May 15, 2018.

3. *Cost Allocation and Inter-departmental Charges* -- Currently the City allows each department to "charge" other departments for the goods and services they provide that benefit the receiving department; these are called Interdepartmental Charges (IDC). IDCs include general liability insurance, IT services, Finance, Accounting services, Budget services, City Clerk Charges, etc. An itemized list of these charges can be found in the City's Cost Allocation Plan. This is important so that the City and its citizens know how much it costs to provide Police services, Recreation

services, and all of the other services the City provides. In addition, it is important for the appropriate portion of those IDCs to be allocated to the Enterprise Funds, so that the General Fund is not subsidizing them; when a charge to the Enterprise Funds is incurred, it is accounted for as a transfer out of the Enterprise Fund and a transfer into the General Fund.

As an example, the City's overall bill for telephone charges gets sent by the vendor to the City's Information Technology program manager, as the entire phone costs are now carried in the IT budget. Those costs are then allocated to each program based on a formula developed during the budget process that considers the number of telephones and recent patterns of usage. Once the allocation is determined, the programs cannot directly control that year's charges. However, they can control the charges they are allocated in future years by reducing the number of telephones or restricting their usage, so that the costs that are billed to IT by the vendor go down.

Charging out the IDC costs to the other General Fund programs doesn't change the City's total costs or the General Fund balance. However, it does increase the complexity of the General Fund budget and year-round accounting; an analogy is taking money from one pocket and putting it back in another pocket, and doing so numerous times, while keeping a full set of records of each move. Staff is working on addressing these issues, and will return to the Council with a proposed approach to be included in this year's budget.

General Fund Revenues

Approximately 75% of the City's General Fund revenues are derived from sales, property, and transient occupancy (TOT) taxes and are estimated to be $32.5 million in FY 2018-19 and $33.4 million in FY 2019-20. Total General Fund revenues are estimated to be $42.4 million and $43.4 million in FY 2018-19 and FY 2019-20, respectively. This represents a 5% decrease in FY 2018-19 when compared to FY 2017-18 and a 2 % increase in FY 2019-20 when compared to FY 2018-19. Table 3 provides a two-year revenue history and a four-year forecast:

Table 3	FY 2016-17 Actual	FY 2017-18 Projected	FY 2018-19 Proposed	FY 2019-20 Proposed	FY 2020-21 Forecast	FY 2021-22 Forecast
Taxes						
Sales and use tax	14,499,567	15,504,000	15,560,000	15,810,000	15,968,000	16,127,000
Property taxes	9,734,032	9,901,985	10,299,000	10,718,300	11,151,500	11,599,500
Transient occupancy	5,406,440	5,839,000	6,593,000	6,857,000	7,132,000	7,417,000
All other taxes	4,196,437	4,347,589	4,311,200	4,367,500	4,384,500	4,385,000
Total taxes	33,836,476	35,592,574	36,763,200	37,752,800	38,636,000	39,528,500
Charges for services	1,973,970	2,317,779	2,419,100	2,466,000	2,521,700	2,570,500
Licenses and permits	815,034	570,589	800,000	800,000	800,000	800,000
Fines and forfeitures	179,671	185,808	185,500	186,500	188,500	190,500
Grant revenues	1,286,361	1,862,393	102,500	104,500	106,500	108,000
Use of money and property	343,015	471,031	340,000	340,000	340,000	340,000
Other revenues	297,892	193,222	115,500	116,500	117,500	118,500
Interfund transfers	2,312,910	3,653,327	1,681,500	1,681,500	1,681,500	1,681,500
Total Revenues	41,045,329	44,846,723	42,407,300	43,447,800	44,391,700	45,337,500

The apparent decrease in revenues in the first year, as mentioned earlier, is due to two reasons. First capital grant revenues will now be accounted for in the Capital Improvement Program Fund and not in the General Fund. As shown above, grant revenues in FY 2017-18 are $1.9 million and then decrease to $102,500 in FY 2018-19. The $102,500 remaining in the General Fund are operating grants the City typically receives every year including SB 90 claims, POST training reimbursements, and motor vehicle in-lieu fees.

The second apparent decrease in revenues when compared to the previous fiscal year is due to one possible approach to changing the way the budget deals with Interdepartmental Charges (IDCs, as discussed above). If IDCs are not charged to the other General Fund programs, this will lead to a corresponding decrease to expenses for other General Fund programs; the $1.7 million remaining in the future years represents the Enterprise Fund portion of the IDCs.

Sales and use taxes are anticipated to stay near the same in the first year with a slight 1% increase in the 2nd year. The City has received an extraordinary amount of sales taxes in the 2017-18 fiscal year from a high volume of vehicle sales. This trend is not sustainable and a decrease in motor vehicle sales is anticipated over the next several years. With that being said, all other sales tax sources are anticipated to increase and as a result, total sales taxes will remain the same in the first year.

Property taxes continue to rebound from the 2008 recession and a 4% average annual increase is anticipated in the next four years.

Transient Occupancy Taxes included in the forecast only include existing hotels and those hotels under construction, including the Oxford Suites on 4th St and the Casa RV Park on Golden Hill. With the addition of these two projects, TOT is anticipated to increase by 13% in the first year and a conservative projection of 4% increase in the second year. Assuming construction starts soon on some of the other entitled hotels, a budget amendment for the anticipated revenues can be requested at the appropriate time. This is important, since the improvements in the Emergency Services Department that were approved by the Council in August 2017 were based on the anticipation of additional revenues due to growth. If we see any additional increases in short term home rentals, revenues may increase even more. TOT revenues increased by 8% in FY 2017-18 when compared to FY 2016-17.

General Fund Expenses

There are many unknown costs the City will incur in the next two fiscal years, including changes to labor agreements (for all labor groups), General Fund capital projects, and General Fund Supplemental Budget Requests. All of these will be addressed on May 15. The proposed amounts presented below are known as of today.

The budget includes salary and benefit costs based on the current labor agreements, known or anticipated employee step increases, and estimated health and retirement benefit increases. It is anticipated that salary and benefits will comprise approximately 60% of General Fund operating expenses over the next two years. This is a similar ratio when compared to other cities in San Luis Obispo County. Total salary and benefits in FY 2018-19 are currently estimated to be $22.2 million and $22.9 million in FY 2019-20. To reiterate, those amounts are based on current labor agreements. Any new agreements reached with labor groups are not reflected in this amount.

One of the costs associated with employee benefits are the contributions made by the City to the California Public Employees Retirement System (CalPERS). Based on what we know today, CalPERS contributions will experience significant increases over the next three to four years due to the CalPERS approved decrease in the assumed rate of return (ROR) that the plan assets are expected to generate. This affects every retirement plan. Over three years, beginning in FY 2018-19, the assumed rate of return will decrease from 7.5% to 7.375% to 7.25% to 7.0%. CalPERS, along with other experts in the industry,

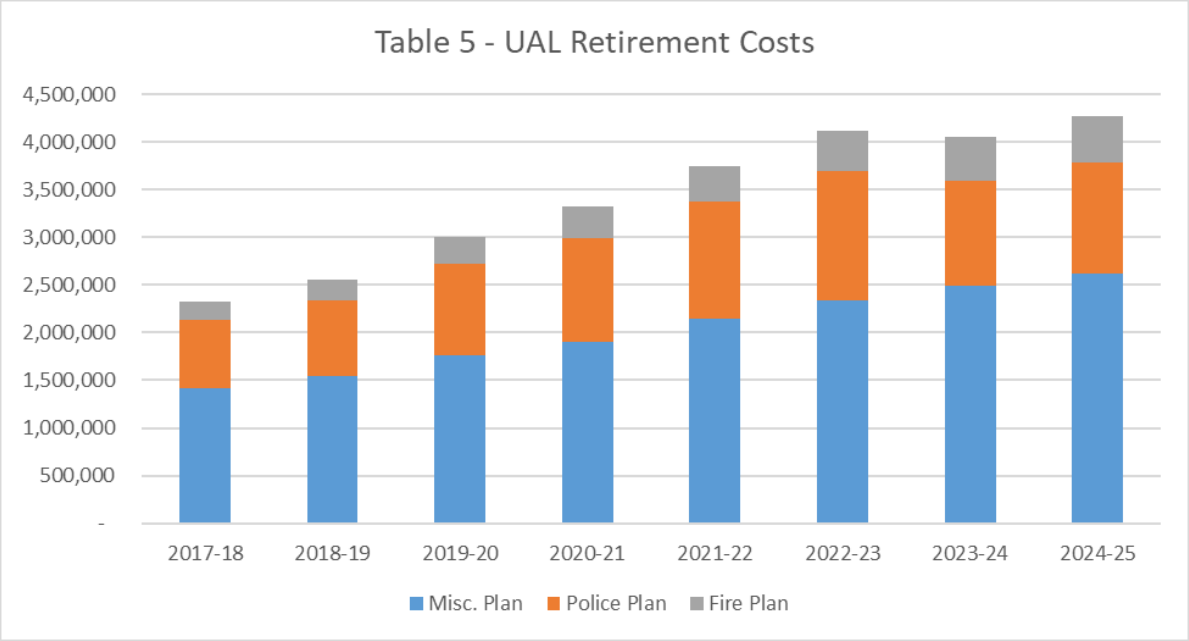
believe that receiving a ROR of 7.5% is not achievable in the long-term. This change does not influence current normal retirement costs as significantly as it affects the unfunded accrued liability (UAL).

Simply put, the UAL is the difference between the amount that should be held in investments (for future retirement payouts) and the actual amount held in investments. The City's total UAL at June 30, 2016 was $42.6 million. The City's funded status for all plans at June 30, 2016 was 65.2% and is summarized by each plan in Table 4 below:

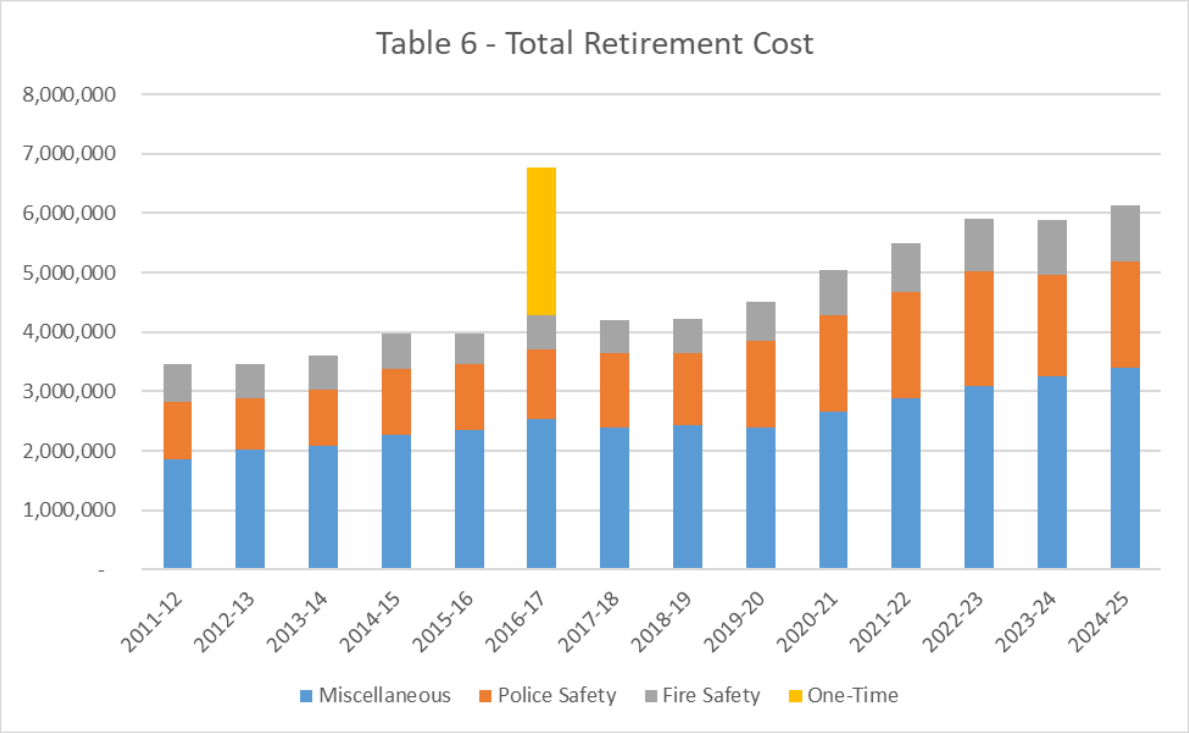
Table 4 – Funded Status

Plan	Total Accrued Liability	Market Value of Assets	Unfunded Accrued Liability	Funded Ratio
Misc. T1/T2/T3	70,309,354	43,474,229	26,835,125	61.8%
Police Safety T1	37,533,896	25,617,746	11,916,150	68.3%
Police Safety T2	504,676	476,447	28,229	94.4%
Police Safety T3	144,025	130,052	13,973	90.3%
Fire Safety T1	14,043,194	10,255,029	3,788,165	73.0%
Total City	122,535,145	79,953,503	42,581,642	65.2%

As mentioned earlier, CalPERS has approved a decrease in the ROR from 7.5% to 7.0%. Because the UAL was expected to receive 7.5% ROR and it no longer is, the unfunded status increases significantly along with the annual cost to repay the liability. Table 5 represents the actual and projected UAL costs from FY 2017-18 to FY 2024-25. Keep in mind that UAL payments are fixed amounts (not charged as a percentage of payroll) and will not change with the changes in personnel. This should be considered known costs that will be incurred.



As shown in Table 5, UAL costs were approximately $2.3 million in fiscal year 2017-18 and are projected to be $4.3 million in FY 2024-25. That represents an 83% increase over that 8-year period. Table 5 represents only the UAL portion of the retirement costs. Table 6 shows total retirement costs, including the normal cost of retirement. In FY 2011-12, the total retirement cost the City incurred was $3.45 million. In FY 2017-18, it is anticipated to be $4.2 million and in FY 2024-25, $6.14 million.



As shown in Table 6, in the 2016-17 fiscal year, the City made a one-time payment of $2.5 million to CalPERS to help lower the UAL. The City could elect to make another payment or change its amortization periods with CalPERS directly. Reducing its amortization periods would pay down the UAL quicker by increasing costs now and saving on interest in the long-term. However, once changed with CalPERS, the City cannot revert back to longer amortization periods. Staff is currently analyzing options and may propose an e option as part of the Supplemental Budget Requests the Council will consider on May 15.

In addition to the one-time payment to CalPERS, the City also established and contributed $2.5 million to a Section 115 Trust Account (not shown in Table 6). This Section 115 Trust is a restricted savings account, where the City can set funds aside for future pension costs and have the investments not be restricted by the California Government Code. By contributing money to the Section 115 Trust, the City is restricting money solely for the payment of retirement costs.

In addition to the items mentioned above, the City is addressing rising retirement costs by negotiating cost share agreements with labor groups. Through cost sharing, the required employer contribution is lower because the employee is contributing not only to their own required contribution, but picking up a portion of the City's required contribution as well. Salary offsets do not positively impact the City's budget in the near term; they do so the long term, however.

The City can, and should, do more to address these rising costs. With retirement costs expected to be 13-15% of the total revenues in fiscal year 2024-25, the City could treat retirement costs as 13-15% of revenue today. If the City adopts these costs as the new norm today, it will be easier to manage in four years when it becomes the norm.

Required retirement contributions in the FY 2018-19 and FY 2019-20 are estimated to be $4.2 and $4.5 million, respectively. This represents approximately 9.9% and 10.3% of General Fund revenues. By increasing retirement costs (by sending the additional amounts to the Section 115 Trust) to 13-15% of revenue, the City could set aside an additional $850,000 in FY 2018-19 and $730,000 in FY 2019-20 with

additional amounts funded from the Enterprise Funds. By doing such over the next four years, the City could have approximately $2.9 million of additional monies added to the Section 115 Trust. Combined with the $2.5 million already invested, the City would have close to 90% of a year's worth of retirement costs held in the account.

City Department Executives and Managers were asked to keep the operating base budget the same as in the 2017-18 fiscal year. In some instances, base budgets increased because known contracts will automatically increase, such as the Animal Shelter Services provided by the County of San Luis Obispo. When available, departments were asked to absorb those increases with decreases in other budget areas. As a result, operating expenses are proposed to be $10.7 million in FY 2018-19 and $10.8 million in FY 2019-20. In the 2017-18 fiscal year, the General Fund's operating base budget was $10.3 million.

The City has been extremely fiscally responsible as shown by the approximately 50% reserve balances projected at the end of the 2017-18 fiscal year. The adopted goal presented in the FY 2016-17 and 2017-18 Biennial Budget of maintaining fiscal stability by living within our means, maximizing revenues, aggressively capturing lost revenue, and minimizing expenditures has been addressed and will continue to be a foundation of this budget process and future budgets and operations.

Fiscal Impact
There is no fiscal impact on this item at this time. This report is for presentation and reporting purposes only. It is anticipated that the City Council will formally adopt the FY 2018-19 and 2019-20 Operating and Capital Project Budget on June 19, 2018.

Recommendations
Receive and file this report and provide direction on the preparation of the FY 2018-19 and 2019-20 Budget.

Attachments
None.