

Finance Director's Overview

FY 2017 Adopted Budget Summary

The FY 2017 *Adopted* Budget is largely a status quo operating budget. However, there are significant proposed capital projects for FY 2017, particularly in Water, Wastewater, Gas Tax and various road related projects. The notable budgetary changes included in this FY 2017 Adopted Budget are:

- ◆ Funded \$1.0 million of new General Fund projects by unfunding prior year, budgeted General Fund projects
- ◆ No new General Fund monies were available for Capital Projects
- ◆ \$1.8 million in Energy Efficiency projects funded by a CEC loan
- ◆ \$12.1 million in Water infrastructure projects; funded by a State IBank loan
- ◆ Significant utility undergrounding projects in the beach area funded by \$2.6 million in Rule 20A PG&E funds
- ◆ Continued road projects funded by Measure H and a 2014 IBank loan
- ◆ Continued development of Monterey Bay Sanctuary Scenic Trail- Segment 7
- ◆ Continued implementation of the classification and compensation study
- ◆ Increase City Council salary by 5% per Charter Section 6.03 (*updated 5/17/16*)
- ◆ Net 1.53 General Fund positions added
- ◆ Net 3.0 Public Works positions added; 2.0 in Wastewater for development of an apprenticeship program
- ◆ Net 2.85 Water positions added; 2.0 in maintenance for development of an apprenticeship program; staffing for year-round system protection
- ◆ Conversion of contract security services to in-house Park Rangers
- ◆ Increase per Charter of City Council pay by 5% (*updated 5/17/16*)
- ◆ Implementation of AB 1826 to capture Organic Waste
- ◆ Relocation of the Emergency Operations Center to the 911 Center located within DeLaveaga Park (started in FY 2016)
- ◆ Increased funding to the Library JPA by \$70,000 annually (FY2017 through FY2021)
- ◆ Fully funded fleet replacement program with a policy update converting funding transfer into internal lease payments
- ◆ Implementation of the multi-year Cost Allocation and Fee subsidy program

In addition to these budgetary changes, there are some minor changes to this document, including relocation of the Budget in Brief as an introduction to the budget, followed by the City's Manager's Budget Message. Also, the Financial Summaries section has been moved to the back of the document within the supplementary/appendix section. Finally, the Golf Course operation was required to be reclassified as a unique cost center within the General Fund's Parks & Recreation department rather than as an enterprise fund.

It is important to note that, as mentioned in the City Manager's Budget Message, there are several large, notable projects underway in the developmental stage that are consuming a considerable amount of staffing resources. However, these projects are not yet funded nor at

the state to require capital budget authority; but will be considered in future budget deliberations or mid-cycle amendments. As an example, listed below are some of these near term, major projects:

- ◆ Ubiquitous Fiber to deliver gigabit internet speeds to the entire City
- ◆ Improvements and substantial replacement of the City’s two Library branches and the County’s main branch following a June 7, 2016 ballot measure
- ◆ Support of a Quality of Life Bond City Council subcommittee evaluating options to fund critical, unfunded capital projects and community improvements
- ◆ Development of new Water rate structure and funding structure towards a new water supply solution
- ◆ Planning for a new downtown parking garage
- ◆ Development of a potential downtown mixed use project with the Metro bus district
- ◆ Planning towards improvements from the Wharf Master Plan
- ◆ Planning towards the upgrade of the Civic Auditorium
- ◆ Planning towards a permanent downtown Arena
- ◆ Efforts to expand housing stock and create more affordable work force housing
- ◆ Combined efforts to address issues related to homelessness in our County

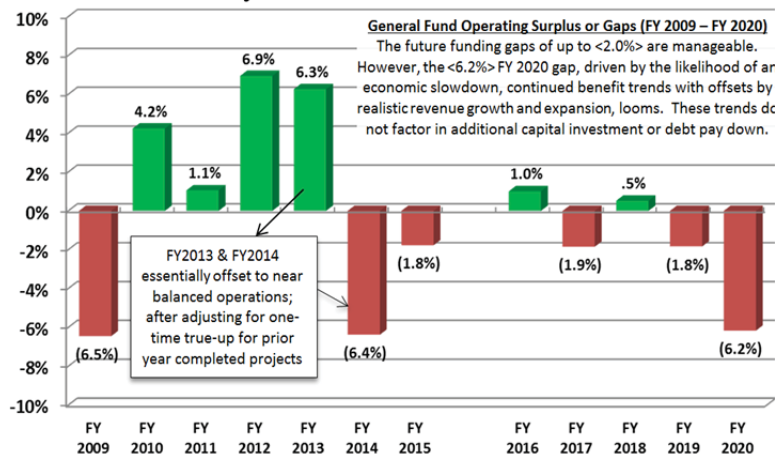
Refer back to the City Manager’s Budget Message for more details.

Bridging the fiscal gap

By the mid 2020’s, significant financial resources may become available to the General Fund, creating a current need to build a fiscal bridge between now and then.

Despite the City’s recent growth in core revenue, like Transient Occupancy tax, Sales tax and Property taxes, larger operating increases are consuming much of the revenue gains. Such that, should our current forecast hold, the City could be faced with significant funding gaps by FY 2020 (see the chart of net General Fund operating results, repeated from the Budget in Brief).

General Fund Projection

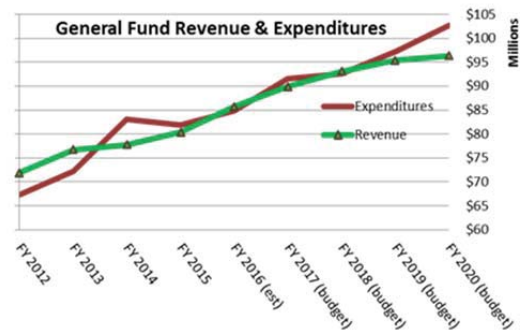


However, there are significant and likely changes that, by FY 2022, could provide much needed reductions in operating costs as well as significantly expanded revenue base. In 2010, the City invested in a refinance of a small portion of its CalPERS obligations that provides substantial

annual savings over the prior interest rates. These bonds are set to expire in FY 2022 and will free up \$3.3 million of annual, General Fund resources. In addition, a possible completion of a new La Bahia hotel property could also generate significant property tax, sales tax and transient occupancy tax gains for our community. And, by the mid-2020's, it is possible that pension rate increases will flatten out, reducing upward pressure on operations.

Together, these three events could produce a net \$5 million annually in resources for our General Fund. So, depending on the severity of future health increases, there is considerable relief ahead, albeit several years out.

Forecast versus Budget. In order to arrive at forecasted results, like those in our General Fund surplus/gap charts or long-term revenue/expenditure trends, we rely on complex forecast models. The model's primary principals are (1) to embrace continuous improvement and (2) focus on expected results based on a combination of historical trend data mixed with empirical evidence and known or very likely future changes.



These “expected results” models are in contrast with the purpose of the adopted annual budget, which is to set the maximum spending authority for the City. To bridge this difference, over the past several years, the budget document has been modified to more closely tie to expected events, while balancing against the need to allow operations to utilize their approved budget to effectively deliver their planned programs and services.

For example, staff have built in an operating savings expectation within the “other financing sources” section of this FY 2017 Adopted Budget. This can, at times, result with a presentation of a negative expenditure line item (see the Summary of Projected Expenditures and Other Financing Uses: Primary General Fund-Other Financing Sources). However, this additional layer of “expected results” precision can create budgetary risk, as the budget will no longer have as much “budgetary cushion” as the public or City Council may have historically been accustomed to.

Our FY 2015 General Fund forecast came within 0.9% points of the actual results when the audit was completed 18+ months later; unfortunately the forecasted gap turned into a real deficit.

As mentioned, the other primary principal is to continuously improve our forecast models. While this creates considerable work and some risk, this frequent review of the model produces results that contain a higher level of confidence. For example, updates to our payroll predictions have resulted in improving recent forecasts from 99.0% to 99.9% of actual and improve our overall results forecasting.

While this is reassuring, it must be recognized that many projections can be 6 to 18 months behind when the actual results occur; and our local and regional economy has presented many examples where unexpected events can materially impact our financial bottom line (i.e., prolonged drought

creating a longer vacation season and higher Transient Occupancy and Sales Tax revenues, depot field restoration costs, West Cliff drive significant repair costs, etc).

The table below discloses our model's key revenue assumptions within the General Fund's top revenue categories (that account for 85% of all General Fund revenue). The 2017 growth estimates are based on current information and projections of future events and represent our best estimates as of data through April 2016.

Major General Fund revenue (85% of total)	FY 2017	Estimated Growth Rates through FY 2020			Assumption & risks
		Percent of Total	FY 2017 growth	Highest growth	
Property Tax (includes supplemental and VLF in lieu)	22%	6.6%	6.6%	2.25%	Home values will continue positive growth, with combined revenue growing greater than 2%. A repeat housing bubble could significantly alter this forecast.
Sales Tax	21%	3.7%	4.25%	1%	Reacts quickly to changes in consumer spending. A slowdown can significantly impact resources.
Charges for Services (recreation, planning, cost allocation and other fees)	16%	11.5%	11.5%	2.7%	Assumes implementation in FY2017 of new fee levels and annual, modest fee increases. A slowdown could impact development related fee estimates.
Utility Tax	13%	2.8%	4.0%	3.0%	Assumes no significant changes or additional growth in the tax base.
Transient/Hotel Tax	13%	13.6%	13.6%	3.0%	Assumes addition of 3 new hotels in FY2016, FY2017 and FY2018, expanded tax base for vacation rentals and continued growth trends. Does not include a La Bahia sized project.

As staffing vacancies have shrunk across the City, and in particular in public safety operations, the General Fund has not seen the same level of salary savings as it enjoyed previously. For FY 2017, total staffing is planned to reach 96% (with near full staffing in public safety). To the extent vacancy rates are smaller or larger, it could have a material impact on the final FY 2017 operating results (personnel costs are generally just over 40% of the total General Fund budget).

Future funding challenge- Infrastructure

Easily the biggest financial challenge for the City is funding its roadways, facilities, parks, sidewalks, storm drain and other critical infrastructure systems. Listed below are the current schedule of unfunded projects and examples of projects within the unfunded list.

Unfunded Project Categories	Amount (in millions)
Transportation	\$ 134.9
Facility Master Plan projects	30.5
Parking	30.0
Economic Development	29.2
Parks & Recreation (Civic, Wharf)	28.5
Storm Drains	10.6
Other (Fire, Citywide)	10.9
Total Unfunded	\$ 274.6

Major unfunded projects	Amount (in millions)
Facility Master Plan projects	\$ 30.5
Street overlay & construction	\$ 30.0
Downtown Parking structure	\$ 30.0
Civic Auditorium	\$ 22.0
Wharf improvements	\$ 29.2
Streets Master Plan- Schools	\$ 18.0
State Route 1 Bridge	\$ 16.0
Wharf East Promenade	\$ 15.0
MB Sanctuary Scenic Trail	\$ 11.9
Bikeway projects	\$ 10.0

As referenced previously and within the City Manager's Budget Message, the City Council and staff are actively working towards projects that could increase future funding sources as well as evaluating interest for possible Quality of Life ballot measures.

But, despite the level of unfunded projects and the lack of any new General Fund proceeds, the City still is recommending a robust Capital Improvement Program for FY 2017, totaling \$37.3 million. The table on the right breaks out by managing fund, the proposed projects total budget requested. Note that the bulk of the projects within the General Capital Improvement program have alternative funding sources, such as Rule 20A under grounding, former RDA Bonds, and other external funding sources (grants, private sector, etc.).

Fund Totals	FY 2017 Proposed Projects
Gas Tax	\$ 6,229,000
General Capital Improvement	9,127,300
Clean Rivers, Oceans, & Beaches	100,000
Arterial Streets & Roads	1,735,000
Water	11,945,000
Water- System Development Fund	150,000
Wastewater	4,580,000
Refuse	1,125,000
Parking	2,250,000
Storm Water	80,000
Capital Improvement Projects	\$ 37,321,300

Included within the FY 2017 Adopted Projects for the General Capital Improvement program are \$1.0 million of new projects that are being funded entirely from reusing formerly appropriated budget authority for projects either unable to move forward or deemed a lower priority. The table to the right lists these FY 2017 Adopted new projects.

More detail on the projects within these funds can be found within the Capital Improvement Program section of this budget.

FY 2017 PROPOSED NEW PROJECTS

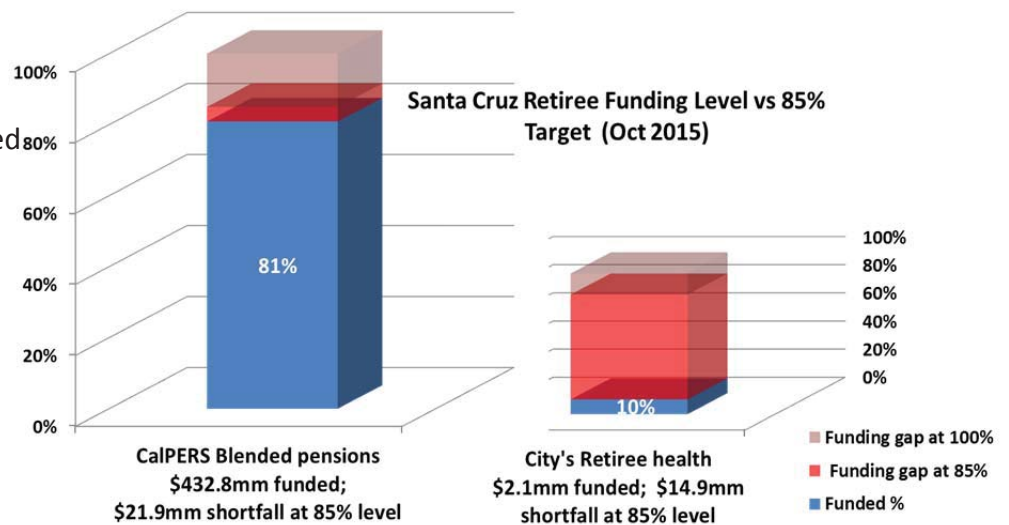
Fund	Dept	Project #	Title	General Fund
311	PW	c401507	Bay Drive Storm Damage Repair	50,000
311	PW	c401709	CMP Storm Drain Pipe Replacement	50,000
311	PW	c401501	West Cliff Drive Revetment Repair	250,000
311	Citywide	c601504	City Hall Campus Emergency Generators	200,000
311	Citywide	c601701	Corp Yard Stormwater Pollution Prevention Plan and Implementation	15,000
311	Citywide	c601303	IT Five Year Strategic Plan	170,957
311	Citywide	m609195	Public Facilities - Maintenance CEC	200,000
311	Citywide	c601403	San Lorenzo River Lagoon Management Program	75,000
				\$ 1,010,957

Summary of Retiree Obligations

The City of Santa Cruz participates in the State of California’s Public Employee Retirement System (CalPERS) to provide pension benefits for past, current and future employees. In addition it provides modest, capped health retiree obligations as required by the CalPERS health program and as negotiated locally by City employees. The “Santa Cruz Retiree Funding Level” chart provides a summary, consolidated analysis of the funding levels of the pension and retiree health plans as compared to a minimum funding level of 85%.

Pensions. In the past several years, the City and State have implemented complimentary reform measures to reduce the pension cost for all future City’s hires. In 2012, the City’s lower “second” tier retirement systems went into effect that reduced benefits for all future hires. On January 1, 2013, the State’s “third” tier

reform measure went into effect (known as PEPR). This measure provides a lower benefit for all “new” hires (excluding any hires from other CalPERS agencies). Because the City is one of the State agencies that adopted its own “second” tiers, it ensures that all future rehires will be within one of the City’s lower cost pension systems. Those agencies who did not adopt a second tier still bring in new hires from other CalPERS agencies into their “classic,” higher cost pension benefit. Annually, CalPERS provides the City with a revised actuarial report that provides the total liability by major

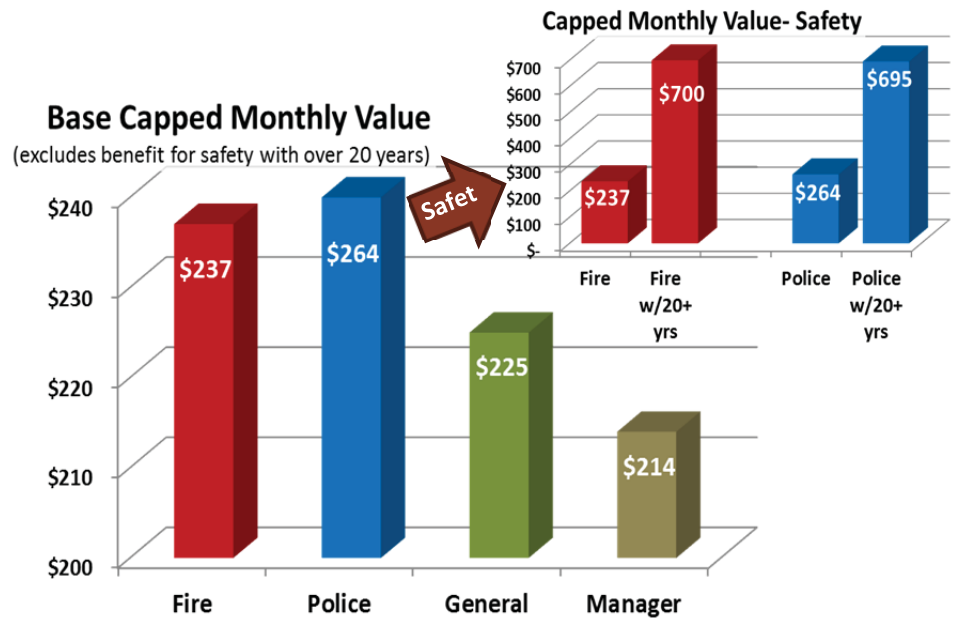


plan: (1) all general employee’s pension plan; (2) police and fire base (“classic”) pension plans; and (3) lower police and fire pension plans.

Retiree Health. While some agencies provide large, indexed health retiree benefits that can cover the full cost of health insurance, the City of Santa Cruz provides a capped benefit to all current and future employees that varies between general employee and public safety (professional fire and police) employees. The benefit rate includes a required, CalPERS minimum amount that is currently \$125 per retiree per month while the retiree remains within the CalPERS health system. This amount grows slightly as mandated by CalPERS. In addition, the City also provides retirees an additional capped amount that varies by employee bargaining unit; and for police and fire employees, can grow for those with over 20 years of service. However, a big difference between the required CalPERS amount is that the City’s amount has a limited duration that ends when the retiree reaches Medicare eligibility age (currently 65).

The charts below show the difference in the monthly benefit values for retirees between base benefit levels and, for Police and Fire, the additional benefit available after 20 years of service.

To calculate the retiree health unfunded obligation, the City contracts with an actuarial service provider to arrive at a composite, aggregate total. This liability is based primarily on the (1) capped City values and indexed CalPERS required contribution; (2) the length of the benefit (shorter for the City’s contribution); and (3) the difference between what a normal retiree’s monthly premium would be for a health plan as compared to the CalPERS required, lower monthly premium for CalPERS retirees.



Future Budget and Revenue Policy development

In the past several budget cycles, the City has adopted additional budgetary and funding policies; 2-month and unfunded obligation policies; economic development trust policies; and implemented an improved funding process for future fleet replacement. To continue in these developments, several new policies or processes will be evaluated in the coming year. In the fall, the City Council will evaluate the desired level of fee subsidy within core General Fund operations (like planning and building fees, recreation fees, street closure or special event fees). It is

anticipated that staff will recommend new fee recovery levels and convert to annual, indexed increases to avoid future, large increases such as those that will be considered. In addition, the City Council will hold a Pension study session to consider establishing a trust to fund future retiree obligations as well as long-term strategies to ensure continued progress towards funding future obligations. The City will also evaluate an extension of the new fleet replacement procedure to start funding known, large equipment replacements. Currently, large necessary equipment like Fire Engines and tractors, along with smaller but costly equipment like mowers and safety equipment has been funded on an as needed basis, often competing against new programs or projects.

Future policies also under consideration will include ongoing funding strategies for City existing facilities (to extend their useful life and/or for planned building system improvements) and for long-term infrastructure renewal.

Thank you

It takes a collective partnership between our community, our Elected Officials, City Leadership, and City staff throughout the organization to annually produce a comprehensive, detailed budget plan for the coming year. Much of the content of this budget document began nearly 6 months ago, based on principals and past policies implemented in years past. Since early January, City staff throughout all departments worked tirelessly on preparing for a status quo budget while trying to maximize the resources to deliver new programs and initiatives.

There have been countless budgetary meetings with and across departments, considering the priorities of this budget in alignment with the City Council's Strategic Plan. In many respects, this year's budget preparation was technically more challenging than prior year's, even dating back to the peak of the recession. While the consequences of the budget during a reduction period are different and likely more impactful, preparing a budget plan in times of limited net growth presents its own challenges. As many departments and programs are in need of additional staffing, equipment or infrastructure following long periods of reductions and deferrals, the City's fiscal ability to meet their needs to serve a growing community is limited.

Therefore, it is with sincere gratitude that I thank our City Leadership, City Department heads and their management and budget staff for their efforts to work together and voluntarily withdraw certain requests or allow other priorities to take precedent.

Finally, I want to personally thank the members of our region's strongest Finance Department who have worked for many months planning for and producing this document, and who will continue to finalize and update materials through budget adoption. In particular, the leadership of Cheryl Fyfe, Assistant Finance Director, was instrumental in financial modeling and budget compilation that has resulted in the receipt of the Distinguished Budget Presentation Award from the national Government Finance Officers Association.

Marcus Pimentel, Finance Director