



Office of the City Manager

WORKSESSION
January 22, 2013

To: Honorable Mayor and Members of the City Council
From:  Christine Daniel, City Manager
Submitted by: Teresa Berkeley-Simmons, Budget Manager
Subject: Fiscal Year 2014 and Fiscal Year 2015 Budget Forecast

INTRODUCTION

This report presents to the Council information on the budget projections for FY 2014 and FY 2015. If no balancing measures are approved, the projected FY 2014 deficit is \$3.0 million and the projected deficit in FY 2015 is \$2.1 million. Staff is currently developing solutions to balance the FY 2014 and FY 2015 biennial budget and there are three Work Sessions preliminarily scheduled in February and March to review budgets in several of the departments facing some of the larger financial challenges. The proposed City-wide balancing plan will be incorporated into the budget proposal to be presented to the Council on May 7, 2013.

The Budget Outlook: Lessons Learned

The City of Berkeley is currently in FY 2013 and is beginning the public process of developing the FY 2014 and FY 2015 Biennial Budget. The national economy is still unsettled as lawmakers prepare to address the debt limit. The State economy, although improving, is still a cautionary tale as November 2012 revenues were \$806.8 million below projections adopted in the 2013 State budget. According to State Controller John Chiang as reported in his November Cash update, "November's disappointing revenues stand in stark contrast to recent news that California is leading the nation in job growth, has significantly improved its cash liquidity to pay bills, and even long-distressed home values are starting to inch upward. This serves as a sobering reminder that, while the economy is expanding, it is doing so at a slow and uneven pace that will require the State to exercise care and discipline in how its fiscal affairs are managed in the coming year."

Just as the national and State economies continue to face fiscal challenges, so does our local economy. As our local economy slowly improves we should take heed from the State Controller and continue to budget conservatively. The Governor's budget will be released on January 10, 2013, after this report has been completed. Staff will provide an analysis of impacts from the proposed state budget during the Work Sessions in February and March.

The City's budget is a reflection of City policies, goals, and priorities. The budget process assigns resources to the goals, objectives, and community priorities set by the City Council. Over the past few years we have worked to implement reductions that minimized cuts to frontline services. Actions taken by Council and City staff over the last few years have allowed the City to effectively manage and balance its budget during some very difficult times. As we develop the FY 2014 and FY 2015 Biennial Budget it is critical that we identify both long-term and short term solutions. This report discusses the General Fund baseline budget for FY 2014 and FY 2015. It also touches on some of the other major funds struggling with operating deficits. Deficits in other major funds negatively impact the General Fund as they are a liability to the fund and a drain on the General Fund reserves.

Council's Budget Development Policies

The Council has established the following fiscal policies that have served the City well over the long term, and the budget development process abides by these important policies.

1. Focusing on the long-term fiscal health of the City by adopting a two-year budget and conducting multi-year planning;
2. Building a prudent reserve;
3. Developing long-term strategies to reduce unfunded liabilities;
4. Controlling labor costs while minimizing layoffs;
5. Allocating one-time revenue for one-time expenses;
6. Requiring enterprise and grant funds to balance and new programs to pay for themselves; and
7. Any new expenditure requires new revenue or expenditure reductions.

Another important element to the budget is a "fix it first" approach in which the City funds currently needed capital improvements before new projects.

General Fund Revenues

As we begin planning the FY 2014 and FY 2015 biennial budget, we are paying close attention to various sources of General Fund revenues. While some revenues appear to be slowly returning to a more healthy growth rate, others are not performing as well as they have in the past. One bright spot is Property Transfer Tax. This revenue results from the City's 1.5% tax on the sale price of properties. As property transactions begin to increase in number and value, the City's revenue from this tax also increases. Due to the recession's impact on property transactions, this revenue source had decreased significantly over the last several years. In FY 2007, the City received approximately \$16 million in property transfer taxes. In FY 2010 that had dropped to \$7.9 million and last year the City received \$8.4 million. This fiscal year, the market appears to be easing and more transactions are occurring. Accordingly, our projections are cautiously optimistic that the revenue source will grow to \$10 million in FY 2014. However, as noted above, other revenue sources are not behaving similarly.

Interest income is projected to continue to decline in FY 2014 and then further again in FY 2015. This is due to the fact that the City's long term investments are maturing and the investments currently available are at historically low rates due to the Federal Reserve's interest rate policy. In FY 2011 interest income yielded \$5.4 million in revenue which declined to \$4.7 million in FY 2012 and is projected to decline again in FY 2013. For FY 2014, based on the available rates, we are projecting to receive only \$3.2 million, which is projected to decline to \$2.8 million in FY 2015. We are also concerned about continuing to receive healthy revenues from the business license tax for medical marijuana dispensaries. So far, the tax has not performed as well this fiscal year as it did last year, and we have reduced our projections accordingly for next fiscal year. Finally, revenues from parking citations are a continuing concern. As we have mentioned in prior reports, the number of tickets issued continues to decline month over month. While past due revenues are still being received, overall revenue is directly related to the number of tickets issued and thus ultimately this revenue source will be less than initially projected.

In sum, while some revenue sources are performing better, others are performing worse. Just comparing the projected increase in transfer tax with the projected decrease in interest income for FY 2014, we see that those two revenue sources combined are effectively flat. Even with the modest increases projected in other areas such as sales tax, business license tax and utility users tax, revenues are not projected to outpace expenditure growth, as discussed elsewhere in this report. For that reason, we continue to focus on managing expenditures, as described in more detail below, and approaching revenue projections conservatively.

General Fund Projections

Without balancing measures, General Fund expenditures are projected to exceed revenues by \$3.0 million in FY 2014 and by \$2.1 million in FY 2015.

In order to close the FY 2014 and FY 2015 General Fund gap, we asked the departments to provide the City Manager with 2 percent recurring General Fund reductions. A 2 percent target reduction in FY 2014 will reduce expenditures by \$3 million, balancing the budget in FY 2014. We asked that the proposed reduction solutions be recurring, and that the entire reduction be taken in FY 2014, so that the solutions will also eliminate the projected deficit in FY 2015.

Projected General Fund Deficit		
<i>(dollars in millions)</i>	FY 2014	FY 2015
Projected Revenue	\$150.4	\$153.0
Projected Expenses	\$153.4	\$155.1
Balance	(\$3.0)	(\$2.1)

The projections above are based on current fiscal trends experienced during the first two quarters of FY 2013 and assume the following:

- No additional Federal or State cuts
- No funding for new programs
- No increased funding for capital improvement programs
- No further decreases in revenue
- No cost of living (salary) increases

Special Funds Facing Deficits – Drain on General Fund Reserves

In addition to the projected deficits in the General Fund, several other major funds require balancing measures in FY 2014 and FY 2015. For funds that appear to be going into deficit in the long run, the target reduction for departments operating out of these funds is to balance the fund in FY 2014, however that may not be achievable in all cases. Staff is in the process of conducting comprehensive fiscal and operational reviews of several of the special funds including the Refuse Fund, Parks Tax Fund, and the Public Health Funds. Each fund facing a deficit will have a different target reduction determined by the amount of the deficit.

Major Funds Facing Structural Deficits in FY 2014

- | | |
|----------------------------------|------------------------|
| • General Fund | (\$3 million) |
| • Refuse | (\$0.5–1.0 million) |
| • Gas Tax and Measure B | (\$0.5 million) |
| • Parks Tax Fund | (\$0.8 million) |
| • Marina Fund | (\$0.3 million) |
| • Housing and Community Services | (\$0.7 million) |
| • Public and Mental Health | <u>(\$0.6 million)</u> |
| Total | (\$6.9 million) |

Department of Public Works

Solid Waste Operations – Refuse Fund

The Refuse Fund is a self-supporting enterprise fund that was created to support the activities related to the removal of waste in the City of Berkeley including recycling and transfer station operations and other related services. Fees for disposal of waste at the City's transfer station and refuse fees charged to owners of premises and places in the City from which garbage is collected generate revenue to this fund. Refuse charges are either collected through the payment of property tax bills or directly paid to the City of

Berkeley. Refuse collection fees are established by resolution of the City Council and the conduct of a majority protest process under Proposition 218. Fee amounts are currently determined by the size and number of receptacles, and the frequency of service.

The Refuse Fund has a structural deficit between \$500,000 and \$1 million. Over the last several years, annual operating costs have been reduced by approximately \$2.5 million through various cost controls, including the implementation of 1-person routes and the elimination of 16 FTE. Staff are developing additional balancing measures which are likely to involve further reorganization of the Division with a focused approach on meeting the City's zero waste goals.

Streets, Sidewalks, Bike and Pedestrian Programs – Gas Taxes and Measure B Funds

The City is projected to receive approximately \$5.6 million in annual revenues for the Highway Users Tax (Gas Tax) and Measure B Local Streets and Roads, and Bike and Pedestrian funds in FY 2014. These funds are used to perform street maintenance and repairs, traffic signal maintenance and bike and pedestrian improvements. Based on current projections, expenditures for programs supported by these funds will exceed revenue by approximately \$527,000 and require the use of fund balance to cover expenditures. Without balancing measures the fund balance for these funds will be exhausted by FY 2015.

Other Concerns – Sewer Program

The City has not raised Sewer fees since FY 2006 and the Sewer Fund has maintained a healthy balance primarily through salary savings and other year end cost savings. However, the City has not yet concluded negotiations with the EPA and the Department of Justice on the final Consent Decree concerning sanitary sewer overflows (SSO's). The Consent Decree is likely to require significant additional capital improvements. Current Sewer Fund projections, before any additional requirements, will still require the City to consider a rate increase in FY 2016. Like a rate increase in Refuse Collection rates, a Proposition 218 process is required.

The Department of Public Works is working closely with the Information Technology Department to implement a computerized maintenance management program system (CMMS), which will be initially deployed within the sewer program. CMMS will allow for greatly improved information management leading to more efficient allocation of resources and improved service delivery. As the system matures and is populated with additional data, it will be useful in tracking and projecting our unfunded liabilities.

Department of Parks, Recreation and Waterfront**Parks Tax Fund**

The Parks Tax is a special tax charged to Berkeley property owners on a square foot basis, is collected through the property tax bill, and is used to fund the maintenance of parks, city trees, and landscaping in the City of Berkeley. Berkeley voters approved the tax in May 1997. The tax rate was initially set by the voters and is adjusted annually based on the Consumer Price Index. The Parks division is comprised of the Urban Forestry, Landscape Maintenance, and Building Maintenance Units. It operates, maintains, and manages the City's parks, street medians, triangles, park building, pools and 45,000 street trees. The park inventory includes 52 parks, 124 street medians, 263 potable water and irrigation systems, 51 play areas, 19 public restrooms, 15 sports fields, 4 recreation center and 2 pools.

The Parks Tax Fund has a structural deficit of approximately \$850,000. To fund operations the Parks, Recreation and Waterfront Department has been relying on a combination of annual revenues and the fund balance in the Parks Tax Fund. Staff is developing balancing measures for the Parks Tax Fund that will decrease the reliance on fund balance through FY 2014 and FY 2015 and provide the opportunity for the Council to consider putting an increase in the tax on the ballot in November of 2014. Revenues from such a tax increase would be realized in FY 2016. However, if such an increase is not approved, additional reductions would need to be taken in order to avoid fully exhausting the fund balance.

Marina Fund

The Marina is part of the San Francisco Bay and therefore, the property is owned by the State of California. The City holds the Marina in trust for the State. Fees generated from vessels that berth at the Marina, along with the commercial ground leases within the Marina zone, provide the revenue that funds the operations of the Marina. The Marina division maintains and manages the Berkeley Marina and its related facilities. This division is responsible for negotiation and management of the agreements/leases with Marina businesses, the maintenance of docks and other infrastructure, the management of over 1000 boats and berth rentals, as well as the operation and maintenance of Cesar Chavez Park, the Shorebird Nature Center, and the Adventure Playground.

The Marina Fund has a structural deficit of approximately \$450,000. Staff is developing balancing measures which are a combination of expenditure reductions and increased revenues. The new revenues could include an increase in parking fees at the Marina for special events such as the July 4th fireworks display and the Kite Festival. Increasing the fee for event parking from \$10.00 to \$15.00 per car would result in increased annual revenue of about \$15,000.

Capital Improvements

In addition, the Parks capital program has historically been underfunded and much information is needed on the condition of existing park and marina facilities. Currently between \$200,000 and \$350,000 of Parks Tax funds and about \$250,000 of Marina funds are allocated annually to capital projects. The Department has worked closely with the Department of Public Works to develop a detailed facility inventory. The Public Works Department has issued a Request for Qualification to obtain a consultant to complete a thorough condition assessment of all City facilities including park and marina buildings, ramps, and floats, and camp facilities at the City's three resident camps. The results of the assessment will inform decisions about the form and nature of the Department's capital program in the years to come.

A Council Work Session on the City's Capital Improvement Program is preliminarily scheduled to be presented by the Department of Public Works and the Department of Parks, Recreation and Waterfront on March 19, 2013.

Department of Health, Housing and Community Services

Housing and Community Services Division

Even though Congress recently passed legislation that included revenue increases to mitigate the impact of the "fiscal cliff", they postponed discussions pertaining to cuts in federal expenditures needed to balance the budget. The bill did not address the planned across-the-board cuts to domestic and defense spending, known as sequestration, and pushed a decision back to March 1, for a new Congress to tackle. In light of these events, the Housing and Community Services (HCS) Division continues to project an 8.2% cut to all federal funding sources for FY2014. This will result in reductions in overall funding levels of the following funding sources:

- \$360,000 less in CDBG¹;
- \$77,000 less in HOME;
- \$21,000 less in ESG; and
- \$208,000 less in Shelter Plus Care.

These federal funds are used for City staffing, funding for community agencies, funding for affordable housing development, and rental subsidies for homeless clients.

CDBG funds are used to fund community agencies. The 8.2% decrease will mean a reduction of about \$40,000 in the funding available for agencies in FY 2014. For the last two years, the HCS Division has projected an elimination of the federal Community Services Block Grant, which is awarded to the City through the State. Since this funding source has weathered the last two federal budget cycles, we are now projecting that the City's allocation of \$250,000 in FY 2014 will be available. Staff will recommend that the portion of CSBG funding available for community agencies will be used to cover the \$40,000 gap created by the projected decrease in CDBG funding. Absent further

¹ Includes reductions in program income and carryover expected to be available in FY2014.

reductions from the federal government, staff is estimating that community agency funding in FY 2014 is approximately the same as in FY 2013.

The impacts to HCS staffing of an 8.2% reduction in federal funds are:

- \$35,000 less for administration of the CDBG program;
- Almost \$8,000 less for the administration of the HOME program;
- \$16,600 less for the administration of the Shelter Plus Care program; and
- A small decrease in funding for the administration of the ESG program.

While federal funding for the administration of these programs continues to decline, the United States Department of Housing and Urban Development (HUD) has increased reporting and monitoring requirements, placing added burdens on a shrinking staff.

In addition, with the dismantling of Redevelopment agencies by the State of California, the City of Berkeley may lose approximately \$100,000 initially budgeted for administration in FY 2014, \$40,000 of which covered staffing costs in the HCS Division.

Public Health and Mental Health Services

The goal of the Public Health and Mental Health programs is to ensure that everyone in the Berkeley community has an opportunity to make choices that lead to a long and healthy life, regardless of income, education, or racial/ethnic background. The Mental Health Division provides mental health prevention and intervention services with a focus on high-risk adults, transition age youth, children and families. The Public Health Division provides community-wide protection against communicable diseases and emerging health threats.

The Divisions are developing expenditure reduction plans to address both the 2 percent decrease in General Fund and decreased revenue from outside funding agencies. For FY 2014 and FY 2015, in the Mental Health Division the General Fund reduction amounts to \$37,000. In addition there is a \$216,000 reduction in the Mental Health Services Act Innovation program revenue.

The Public Health division also has a number of issues to be addressed:

- The 2 percent General Fund reduction of \$72,500;
- Elimination of an Alameda County HIV grant in the amount of \$75,000;
- A structural problem resulting from decreased revenue and increased costs for a number of public health funding streams amounting to approximately \$300,000.

The Department is preliminarily scheduled to present further information about its budget priorities at a Work Session on February 19, 2013.

Increased Costs in FY 2014 and FY 2015

Although some revenues are increasing modestly, overall revenue growth is not keeping pace with expenditures. The impact of increasing costs combined with a lack of corresponding growth in revenues results in a projected structural deficit in the General Fund and several of the other major funds if recurring expenditure reductions are not taken. Employee salary and benefits make up 77% of the City's General Fund operating budget. Thus, controlling labor costs is the primary method to manage expenditures and address the City's structural deficit. However, there are other costs related to the operation of the City organization which have also experienced increases that must be managed. In addition to labor related costs, such as retirement and health care, other costs such as insurance premiums are discussed below.

CalPERS Retirement Rates

Rising pension costs continue to be a contributing factor to the projected General Fund deficit in FY 2014 and FY 2015. Each year, the California Public Employees' Retirement System (CalPERS) sets retirement contribution rates and the City reviews these rates with an outside actuary. On March 14, 2012, CalPERS' Board of Administration voted to reduce the discount rate from 7.75 percent to 7.5 percent. The .25 percent reduction in the discount rate means that employer rates must now make up the amount that CalPERS is no longer assuming will come from investment returns. Below are new CalPERS employer rates for FY 2014 and actuarial estimates for FY 2015.

Fiscal Year 2014 and FY 2015 CalPERS Employer Rates				
	CalPERS Actuals FY 2013	CalPERS Actuals FY 2014	Actuary Estimates for FY 2015	\$ Increase (in millions)
Police	42.0%	45.7%	45.9%	\$.826
Fire	29.1%	31.5%	32.0%	\$.446
Miscellaneous	19.2%	20.9%	21.1%	\$1.36

The cost of the increase for all plans across all funds in FY 2014 and FY 2015 is projected to be \$2.6 million, based on the actual rates CalPERS has provided for FY 2014 and actuarially estimated rates for FY 2015. If rates increase further in FY 2015, the budget for that year would need to be adjusted. For reference, based on the current base payroll, a one percent increase in the CalPERS rate for all plans results in an additional cost to the General Fund of almost \$700,000 and a combined cost to all funds of about \$1.2 million

Health Care Costs

While we have experienced unusually low health rate increases in FY 2012 and FY 2013, our outside brokers have advised us to plan for larger increases in FY 2014 reflective of historical trends. Since 2000, health premium increases have ranged from 4 percent to 20 percent. The average annual increase for the Kaiser medical active plan has been 9.26 percent per year over the last 10 years; and the average increase for dental has been 4.60 percent per year over the last 10 years. The baseline budget for FY 2014 reflects a rate increase for the Kaiser medical plan at 9 percent. The FY 2014 baseline budget reflects an increase in dental cost of 5 percent.

Sick Leave and Vacation Leave Accrual

In FY 2002, the City learned that it had achieved a position where it had enough funds in its account with CalPERS that it did not need to pay CalPERS the miscellaneous employee contribution rate for FY 2002. The adopted FY 2002 and FY 2003 Biennial Budget included provisions setting aside approximately six percent of what would have been the contribution for the miscellaneous plan in those years in a dedicated fund to be used for payouts of unused and terminal sick and vacation benefits. In addition, this fund receives an annual transfer of funds based on a percentage of payroll in all funds. Over the years the fund balance created by the initial transfer in 2002/2003 has been depleted. At the end of FY 2012, expenditures from the fund exceeded revenues by approximately \$500,000 and General Funds were used to cover those costs.

In order to correct the shortfall and strengthen the fund, the rates were adjusted for FY 2014. The FY 2014 calculated rates will increase from 3.25 percent of base salary for sworn employees to 3.75 and from 1.25 percent of salary for all other employees to 1.90 percent. The result is a \$233,000 increased cost to the General Fund and a \$744,000 increased cost on an all funds basis in FY 2014. Going forward, staff projects that these rate increases will balance the revenues and expenditures within this fund.

Catastrophic Loss Trust Fund-Insurance Premium Payments

The City is a member of the Bay Cities Joint Powers Insurance Authority (BCJPIA) which provides the City's excess coverage for insurance claims. The annual premium payments for this coverage are made from the Catastrophic Loss Trust Fund. In addition, this fund can be used to pay the costs of a deductible for a claim (for example the "flood" in the 1947 Center Street building last year). As insurance premium costs have increased over the years, the fund balance in the Catastrophic Loss Fund has been depleted. This fund is also funded by annual transfers from the General Fund and special funds. In order to avoid depletion of the fund balance entirely, the FY 2014 Budget will propose an increase in the transfers to this fund of approximately \$700,000.

Managing Unfunded Liabilities

The projected General Fund deficit does not address other needs such as deferred capital improvements and other unfunded liabilities. On May 29, 2012, Council requested that the City Manager develop a biennial report of current City liabilities and projections of future liabilities. The Council's action directs that the report is to be published initially in February 2013 and subsequently in February of the second year of the City's biennial budget. Staff is currently developing this report to present to Council in February. Included in the report will be the following:

- A preliminary cost estimate of capital improvements and major maintenance for City facilities over the next five years
- An assessment of the City's current unfunded liability for streets, with the goal of a Pavement Condition Index of 75 within five years.
- A summary of employee costs with an analysis of what it would cost to reach an 80% funded level in each of the CalPERS pension plans over a 10 vs 15 year horizon.
- A summary of the City's debt service obligations updated to reflect the changes as a result of the refinancing of the 1999 Bonds and the 2003 Certificates of Participation.

The City has proactively managed the City's unfunded liabilities, including contracting with outside actuaries to complete annual actuarial valuations. It is critical that the City continues to manage its liabilities to ensure long-term fiscal stability.

The General Fund Reserve

The City Council's current policy is to maintain a reserve at 8 percent of gross General Fund revenues. The reserve provides some flexibility to smooth out economic swings, buffer the loss of state and federal revenues, and to support City operations in the event of a catastrophic event (such as an earthquake). On December 11, 2012, we reported a FY 2012 year end General Fund reserve of approximately 12 percent of General Fund gross revenue. The National League of Cities estimates that in 2011 cities' General Fund reserves averaged about 15.4 percent.

Next Steps

There are a series of Work Sessions and public hearings regarding the Budget preliminarily scheduled for February through May as follows:

- February 19, 2013: Unfunded Liabilities; FY 2013 Mid-Year Budget Update; Health Housing & Community Services Budget Priorities
- March 5, 2013: Parks, Recreation & Waterfront (PRW) Budget Priorities
- March 19, 2013: Public Works and PRW Capital Improvement Program
- May 7, 2013: Presentation of Proposed FY 2014, FY 2015 Biennial Budget
- May 21, 2013: Budget Public Hearing #1
- Date To Be Determined: Budget Public Hearing #2

In an effort to ensure that Council has received public comments on the FY 2014 and FY 2015 Proposed Biennial Budget in the form of two public hearings, prior to Council providing recommendations to the City Manager on the FY 2014 and FY 2015 Biennial Budget, staff is recommending that the Council schedule another meeting in May for a second public hearing. Council is scheduled to provide recommendations on the FY 2014 and FY 2015 Biennial Budget to the City Manager on June 4, 2013, and the FY 2014 and FY 2015 Biennial Budget is scheduled to be adopted by Council on June 25, 2013.

Conclusion

We know that FY 2014 will bring higher retirement and other costs to the City, increasing the cost to the General Fund and the other special funds. As we anticipate these cost increases in the upcoming years, we continue to update projections for FY 2014 and beyond. In response to revenue trends, the City must continue to actively manage expenditures. The proposed budget will recommend implementing 2 percent recurring General Fund budget reductions in FY 2014. These recurring solutions will also eliminate the projected deficit in FY 2015. In addition, balancing measures for other special funds facing deficits are needed.

As we develop a balanced budget for FY 2014 and FY 2015, we will work with departments and labor to discuss the related operational and service impacts of the budget cuts. A series of Budget Work Sessions will be held from January through March to review and inform the development of the City Manager's proposed budget on May 7, 2013. Additional meetings will be held after submission of the proposed budget, including two public hearings prior to the adoption of the FY 2014 and FY 2015 Biennial Budget scheduled for June 25, 2013.

CONTACT PERSON

Teresa Berkeley-Simmons, Budget Manager, City Manager's Office, 981-7000