City of Emeryville
CALIFORNIA

MEMORANDUM

DATE: June 6, 2017

TO: Carolyn Lehr, City Manager

FROM: Susan Hsieh, Finance Director

SUBJECT: **General Fund 5-Year Financial Projections**

RECOMMENDATION

Staff recommends that the City Council receive a presentation on General Fund 5-year financial projections to inform its upcoming budget development. After hearing the presentation, staff requests preliminary City Council feedback on strategies and options to further develop a balanced two year 2017-19 budget. Based upon City Council feedback, staff plans to return with a menu of budget options for City Council consideration on June 20, 2017. No formal City Council action is proposed at this time.

BACKGROUND

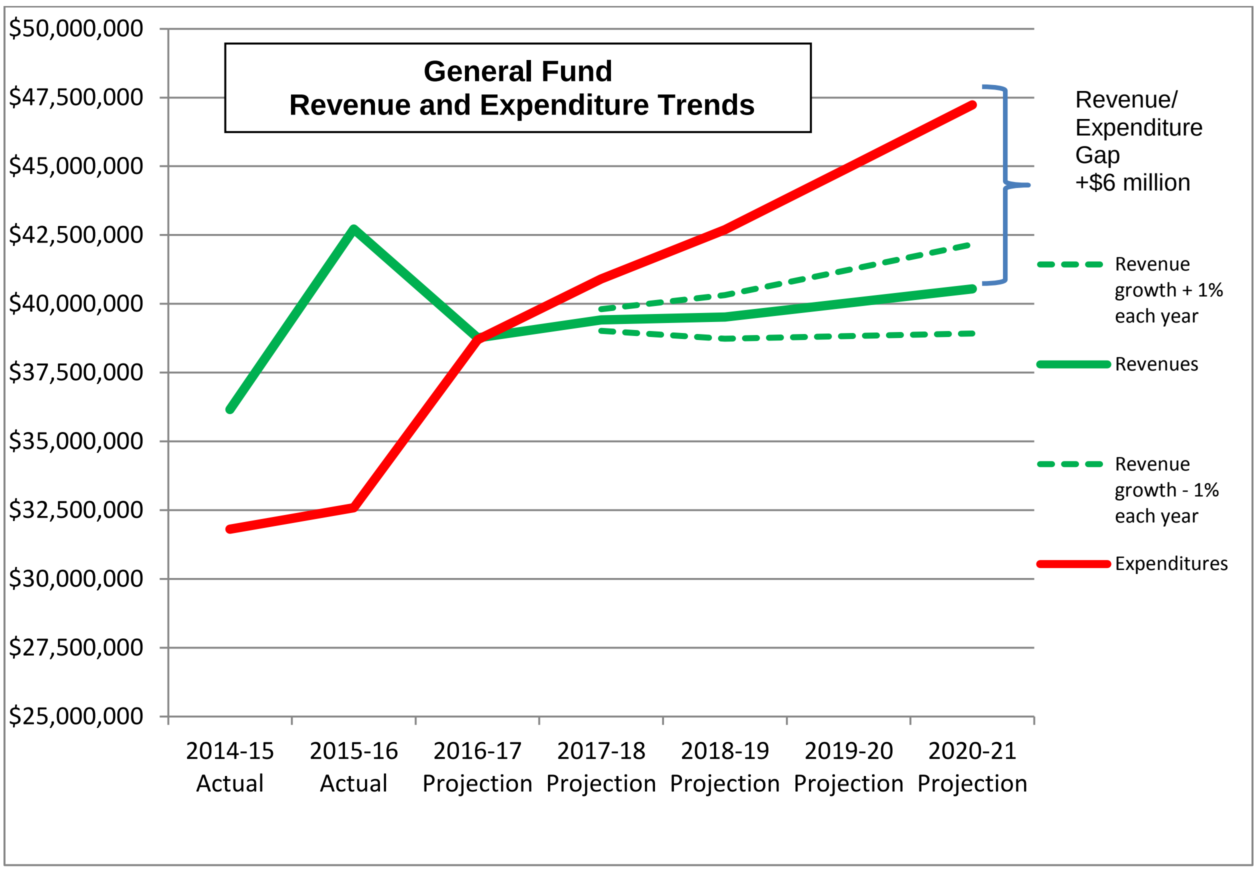
This report introduces a 5-year General Fund financial projection. It is also the first step in developing a new two-year 2017-19 budget for City Council consideration. The City has traditionally adopted a two year budget and anticipates continuing this practice to stay focused on long-term strategies to maintain the City's sound financial condition.

The City adopted a 2016-18 two year budget in June 2016. Since that time, the City's revenue growth rate has softened and expenditure pressures have increased, prompting reconsideration of the City's budget objectives and discussion of sustainable levels of core municipal services. During a budget workshop on March 13, 2017, City Council requested that staff adjust the two year budget cycle to align with the City Council election cycle, and to return with a new two year 2017-19 budget that reflects current financial projections as well as City Council values and service priorities.

The City currently enjoys a sound financial condition. During recent periods of budget surplus, the City has strategically invested in prudent reserves to ensure the continuity of services during economic downturns and as a contingency for unexpected events.

However, despite its sound reserves, the City faces emerging long-term financial conditions that are impacting the City's ability to balance its annual operating budget. Most notably, these changes include 1) the slowing of tax revenue growth as consumers evolve their buying habits; and 2) sharply increasing pension funding requirements from the CalPERS pension system due to lowering of investment income assumptions.

To inform the City Council's consideration of its upcoming 2017-19 budget, this report provides a 5-year projection of General Fund revenues and the costs to provide currently authorized staffing and services. This projection shows an increasing annual shortfall between expenditures and revenues, primarily due to the seven-year phase-in of new CalPERS pension funding requirements. For the purpose of this 5-year projection, the impact of changing pension costs have been estimated using guidance issued by CalPERS in its January 2017 Circular letter to participating employers. Contemporaneously, by request of City Council during the March 13, 2017 budget workshop, the City has contracted with a third party actuary to provide City Council with a second opinion, more precise projections, and funding options to address the City's burgeoning pension costs. The actuary's presentation is scheduled to follow this report on the June 6th City Council agenda.



The projected revenue/expenditure gap deepens over the 5-year projection period and exceeds $6 million by 2020-21. These projections are based upon current City services with no net increase or expansion of service. ***The significance of the annual deficits indicates that the City is unable to sustain its current General Fund annual service costs within its current revenue structure.*** Through this report and accompanying presentation, stakeholders can drill down into the range and cost of current City services with an eye towards the revenues available for their support. Solutions will require the affirmation of core services and the application of City Council priorities to achieve a balanced long-term financial plan while maintaining a sound financial position into the future.

At a subsequent City Council meeting currently scheduled for June 20, 2017, staff will introduce options and impacts of proposed program changes that could be available to the City Council as it considers policy direction to rebalance the City's proposed 2017-19 two-year budget. Contemporaneously, the City continues to explore revenue enhancement options to increase the City's capacity for future service delivery.

DISCUSSION

The focus of this report is the City's General Fund. As the primary operating fund for the City, the General Fund receives unrestricted tax revenues to support the City's core municipal services including police, fire, public works, development services, community services, and general administrative services. Other restricted grant, development, and enterprise revenues are typically held in dedicated accounts outside of the General Fund. Budgets for these restricted funds, and an update on the capital improvement program, will be presented later in the 2017-19 budget process.

Cost of Services: Salaries and Benefits

As a service provider, the primary driver of the City's cost of services is its employee salary and benefit structure. Using salary and benefit rate assumptions, annual costs have been projected for the currently authorized 156 positions through the 2020-21 fiscal year. Detailed projections by compensation type and by City program are provided in **Attachments A to C**, along with a listing of key benefit rate assumptions. In total, City-wide salary and benefit costs are projected to grow from $26 million in 2017-18 to $30 million in 2020-21. ***The General Fund share grows from $22 million to $26 million during this period.***

Salaries - For planning purposes, salaries are projected at the contract rate for employee groups with existing contracts, and with 2% annual increases for groups and years not under contract. With scheduled step increases, the average total increase in salary costs during this period is 3% per year. Specific salary terms are subject to labor negotiation process, and may ultimately differ from these projected rates.

Pension - The City contracts with the State CalPERS to administer pension benefits for its retirees. A supplemental PARS retirement plan is also provided for certain Police officers. Facing an aging participant base, CalPERS is experiencing a change in cash flow since the number of system-wide retired annuitants is outpacing the number of active members. ***Because of this change, the CalPERS system is bracing for ongoing negative cash flow as retirement benefit payments exceed current employer and employee contributions.*** The CalPERS board is updating its investment asset allocation strategy to provide required cash flow. This change in investment strategy follows with a lower earnings assumption, called the 'Discount Rate." In a defined benefit pension system, the employer bears the risk of the investment returns, and must pick up shortfalls when earnings fall short of expected results. In December 2015, CalPERS announced a long-term strategy to lower its discount rate from 7.5% to 6.5% to be phased in over 20 years. One year later, in December 2016, following a fiscal year with an approximate 0% investment return, CalPERS announced an accelerated plan to reduce its discount rate assumption from 7.5% to 7.0%, with corresponding increases to employer contributions to be phased in over 7 years.

The cash flow impact to participating CalPERS agencies is daunting. In its January 2017 Circular to participating employers, CalPERS estimated normal cost increases averaging 3.5% for Safety members and 2% for Miscellaneous members. Normal cost rate increases will begin to phase in effective in 2018-19. Further, the City's payments towards its unfunded liability for past actuarial shortfalls will accelerate by a CalPERS estimate of 35% over 7 years. With the current workforce of 156 employees, City-wide annual pension employer contribution costs are expected to reach over $6 million by 2020-21, and will continue to grow until the end of the seven year implementation period in 2025. Fortunately, the City holds $13 million in a CalPERS reserve that is available to buy down the long-term impact of the City's pension obligations. The actuary will discuss strategic options with the City Council on how to best leverage these reserves to mitigate long-term pension funding requirements. ***The 5-year projection will be updated after City Council hears and considers strategies to invest or draw on the available $13 million pension reserve.***

<u>Workers Compensation</u> - The City is self-insured for Workers Compensation claims up to a self-insurance retention threshold and purchases excess insurance for larger claims. To assess the sufficiency of the internal rates paid by City programs to the City's Worker's Compensation Fund, staff considered 5 years of actual claims history by program. The existing rate structure continues to effectively allocate workers compensation costs to specific programs based upon the proportion of five years of actual claims history, with the exception of a nominal undercharge to the Child Development program. No change to the Workers Compensation rate structure is proposed at this time.

<u>Medical Insurance</u> - Medical insurance premiums are projected to increase 7% per year based upon recent provider discussion about estimates for the upcoming calendar rate year. The City currently covers 80% of medical premium increases and employees pick up remaining 20%.

<u>Total Salaries and Benefits</u> - With these assumptions, after filling vacancies, total salary and benefits grow 5-6% per year through the 2020-21 projection period.

<u>Cost of Services - Fire Contract</u>

The City provides fire services through a contract with the Alameda County Fire Department (ACFD). ACFD has provided 5-year estimates of the cost to maintain the current staffing model of two 3-person companies. This contract is expected to reach $7.8 million by 2020-21.

These ACFD cost estimates include anticipated increases to ACFD pension funding for their employees based upon the CalPERS January 2017 Circular. In addition to ACFD pension costs included within the ACFD contract, the City also pays CalPERS directly for its unfunded pension liability for legacy fire service credits earned when the City provided its own fire service.

For analysis purposes, ACFD has separately provided 5-year cost estimates for an alternative expanded service option that adds a fourth person to each of the current three person companies. In this scenario, the cost of fire service increases by $2.5 million, from $7.8 to $10.3 million, by 2020-21. This alternative service level would increase the size of the City's projected annual deficit. from $6.7 million to $9.2 million by in 2020-21. ***In the context of a balanced budget, this alternative service level would require a corresponding $2.5 million further reduction in other City programs, or alternatively new revenues prioritized for expanded fire service***.

The 5-year projection offered assumes the current base-line service level of two 3-person fire companies.

Cost of Services – Non-Salary Operating Costs

The General Fund's non-salary operating cost trends are detailed on **Attachments D and E**. These costs have been projected by program staff with an aggregate 2-4% annual increase during the projection period. The most significant cost lines are the professional service contracts used to support Planning, Building, and Engineering during years with significant development activity. These development costs are recovered through corresponding program revenues and create year-to-year fluctuations on both the revenue and expenditure sides of the budget.

Cost of Services – Inter-fund Transfers

The General Fund regularly contributes between $2 million and $3 million per year to programs outside of the General Fund, including Child Development, PBID (Emery-Go-Round), Debt Service, and the Litigation Internal Service Fund.

Child Development Program - The City's Child Development program operates outside the General Fund. It receives fees and grants to support teacher salaries and other operating costs. The program relies upon the General Fund for additional support to close its gap between revenues and expenditures. During 2016-17, the projected gap subsidized by the General Fund has been reduced from prior projections due to staff vacancies and is now $1.1 million. If enrollment improves in 2017-18, and if the City Council considers significant fee increases of 10% in 2017-18 and beyond to offset rising program costs, General Fund program support would range from $1.1 million to $1.4 million during the 5-year projection period.

General Capital – Corporation Yard Remediation Project
The Successor Agency recently received State notification that its Corporation Yard remediation project has not been approved for tax increment funding. While the City considers its options for this project, the City's General Fund is estimated to receive an additional $600,000 in residual tax increment beginning in 2017-18 for its share of tax increment revenue no longer approved for Successor Agency spending on the Corporation Yard project. Half of this revenue windfall is proposed to be retained in the

General Fund to support General Fund programs ($300,000), and half is proposed to transfer to the General Capital Fund ($300,000) to begin to address the corresponding and significant City responsibility for the Corporation Yard remediation project.

General Fund Revenues

Detailed General Fund revenue trend information is detailed in **Attachment F.**

2016-17 - The City's General Fund revenue base has been subject to significant year-to-year fluctuations because of the recent expansion of the real property transfer tax; the opening of a new hotel with related transient occupancy tax; and transaction-related development revenues. After analysis of year-to-date trends, 2016-17 revenues are expected at $38.7 million. Note that these 2016-17 results remain estimates and are subject to achieving tax revenues that will become final when the State Board of Equalization releases final June 30, 2017 sales tax results in September 2017.

2017-18 - The General Fund will benefit from two new revenue sources in 2017-18. Based upon policy direction adopted with the 2016-18 budget, 25% of Residual Tax Increment will be dedicated to support General Fund operations. These are unused tax increment revenues from the former Redevelopment Agency that now flow back to taxing agencies since the 2012 State-wide redevelopment dissolution. This new General Fund revenue is now projected at $1.3 million in 2017-18 and is higher than prior estimates due to the recent State denial of the Successor Agency's funding of the Corporation Yard remediation project. A second new revenue in 2017-18 is a $500,000 transit to support the PBID Emery-Go-Round shuttle service. The grant has been awarded for two years. For planning purposes, this projection optimistically assumes the grant will continue through 2020-21 based upon long-term planning projections provided by the grantor. Total General Fund tax and fee revenues for 2017-18 are expected to increase by over 8%. However, program revenues such as transaction-related development fees are expected to decline, bringing the total 2017-18 revenue increase to 1.7%, at $39 million.

Property Taxes - Property Tax revenues are projected to increase approximately 2% per year. Emeryville's property tax revenues are particularly variable since Alameda County does not use the Teeter Plan to allocate assessed taxes to its taxing agencies, and instead distributes actual cash receipts. Emeryville's property tax is also limited since a significant geographic area of the city is within its redevelopment project area footprint. Increases in property assessed values within the project area are captured by the Successor Agency then returned if unspent to taxing agencies in the form of Residual Tax Increment.

Sales Tax - The City uses a third party, Muni Services, to analyze and project local retail Sales Tax activity. A summary of the consultant's projections is provided **as Attachment G**. Sales Tax projections are provided both *with* and *without* an assumed 1% economic cycle contraction during the projection period. Gross revenue projections assume annual increases of 2%+ in retail sales activity. ***For the purpose of planning for sustainable General Fund service costs, this 5-year General Fund projection includes the smoother, gross sales tax revenue projection, without an assumed economic***

contraction, since the City holds a separate reserve to brace for inevitable economic cycles and corresponding tax revenue fluctuations.

Economic Cycles - Muni Services has estimated the impact of a 1% economic contraction, with a three year sales tax revenue risk of $2.7 million. The total economic cycle impact to Emeryville would extrapolate when adding in Transient Occupancy Tax and Business License revenues. For the purpose of assessing revenue growth sensitivity in the 5-year projection, a 1% change in total annual General Fund annual revenues is calculated at $400,000, and 5% is $2 million. For further perspective on the range of possible revenue outcomes, the General Fund Revenue and Expenditure graph presented earlier in this report demonstrates the range of General Fund revenues if growth rates were to increase, or decrease, by an additional 1% per year. In each of these scenarios, the General Fund still faces a significant operating deficit**.** ***Given the City's reliance on revenue sources that are sensitive to economic fluctuations, it is essential to maintain a sound Economic Contingency Reserve to brace for inevitable annual tax revenue fluctuations.***

Net Annual Surplus (Deficit)

The net annual surplus (deficit) of revenues over expenditures is summarized by year on **Attachment H**.

_2016-17_ - The City Council received a midyear budget report on April 4, 2017 and formally amended the 2016-17 budget to address current revenue and expenditure trends. At that time, the General Fund was projected to incur a $500,000 annual deficit to be funded from a draw on reserves. Since then, both revenue and expenditure projections have been updated with year-to-date trends. ***Strong expenditure control and deferred hiring of vacant positions have further reduced cost estimates to bring the 2016-17 General Fund annual operating back into a projected break-even position.***

2017-18 through 2020-21
If vacant positions are filled and new CalPERS pension rates are implemented, the City's General Fund faces sharply increasing annual deficits from $1.4 million to $6.6 million in 2020-21. These deficits are caused by expenditures growing significantly faster than revenues. The cost of services is expected to grow by a cumulative 22% from 2016-17 to 2020-21 while revenues are projected at a slower cumulative 5% growth rate during the same period. These projected results are before consideration of an economic cycle downturn, for which the City holds an economic contingency reserve. The primary driver of cost escalation is employee benefit costs and CalPERS pension funding in particular. The pension bill is coming due on past state-wide actuarial assumptions that have proven inadequate. The City must begin to implement structural changes in its revenue and expenditure budget to rebalance its operations while funding pension obligations.

Reserves

Fortunately, the City holds strong reserves that can sustain cash flow while budget strategies are considered and implemented for long-term stability. Total General Fund reserves by year are summarized on **Attachment I.**

Pension Reserve - Positioned better than many comparable cities, Emeryville has set aside a $13 million pension reserve that is available to invest or to buy down its CalPERS liability to reduce and stabilize future pension funding requirements. The City's actuary is preparing options to deploy this reserve for the City Council's consideration. The reserve can mitigate but not eliminate long-term pension cost increases.

Economic Contingency Reserve – The City's budget policy targets a 50% economic contingency reserve and currently holds $21 million in this reserve. The projected benchmark percent of expenditures fluctuates with the annual growth in expenditures. At $21 million, this reserve is currently projected to exceed the 50% target through 2018-19, but absent expenditure adjustment or additional funding, would drop to 45% of expenditures by 2020-21. Further, this reserve is intended to brace for tax revenue fluctuations that are inevitable during natural economic cycles, and would likely be partially drawn for this purpose sometime during the projection period.

Unassigned Balance – With projected annual deficits, the unassigned fund balance is extinguished by June 2018. The cumulative operating deficits captured in this account then reach $15 million by 2020-21, further quantifying the unsustainable cost of current City services. To maintain its 50% economic contingency benchmark and avoid exhausting its reserves, the City must fairly quickly change financial direction to close this four-year cumulative $15 million gap between revenues and expenditures.

CONCLUSION

The City continues proactive financial planning through the development of this 5-year projection to inform City Council on the cost and capacity to support General Fund municipal services. The projection shows that the City faces increasing General Fund deficits over the 5-year projection period and beyond due to slowing revenue growth and increasing CalPERS pension funding requirements. To address these deficits, the City must embrace changes to its service delivery, cost structure, and/or revenue capacity. By changing policy direction through this budget process, the City can begin to implement changes to rebalance its biannual budget and demonstrate sound financial stewardship over a long-term financial planning horizon.

Questions for City Council Consideration and Feedback

1. For projection purposes, does the City Council wish to continue to assume current, baseline service levels? Should any particular programs be expanded or reduced?

2. Staff plans to return with a list of potential service reductions to address the projected budget shortfall for 2017-18 and 2018-19. Would the City Council like to discuss general priorities or direction for service reductions at this time?

3. The General Fund holds fund balance reserves that can temporarily sustain cash flow during a phase in of budget balancing solutions. Does the City Council have general direction on how to best leverage its reserves during a phase in period?

4. Are there any other assumptions in the 5-year projection that the City Council would like to discuss or revisit?

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APPROVED AND FORWARDED TO THE CITY COUNCIL OF THE CITY OF EMERYVILLE:

Carolyn Lehr

Carolyn Lehr, City Manager

ATTACHMENTS

A City-wide Salary and Benefits by Type
B City-wide Salary and Benefits by Program
C Salary and Benefit Assumptions
D Expenditure Summary by Type
E Expenditure Summary by Program
F Revenue Summary
G Sales Tax Projection
H Fund Balance Projection – Unassigned
I Total Fund Balance Projection – With Reserves