CITY OF
HAYWARD
HEART OF THE BAY

**DATE:** March 1, 2017

**TO:** Council Budget & Finance Committee Members

**FROM:** Director of Finance

**SUBJECT:** FY 2017 Mid-Year Budget Review & General Fund Ten-Year Plan Update

## RECOMMENDATION

That the Budget & Finance Committee reviews and provides comments on the report.

## SUMMARY


This report presents the mid-year review of the FY 2017 Adopted Budget and an update to the General Fund Ten-Year Plan for Committee consideration and comment before presentation to the full City Council. The review analyzes revenues and expenditures through the midpoint of the 2017 fiscal year (December 31, 2016), presents proposed changes, and projects year-end results based on current trends and data. While staff considers the entire City budget in its mid-year review, this report focuses primarily on the General Fund.

The General Fund revenues for year ending FY 2017 are expected to have a $3 million one-time revenue increase and an ongoing revenue increase of $3.8 million, for an overall $6.8 million adjustment to the General Fund revenue categories.

Mid-year expenditure adjustments total $5 million in the General Fund. Of this amount, $3 million is tied to the restricted revenue mentioned above. The balance of $2 million in expenditures is related to an increase to the transfer to the liability insurance fund for settlements ($1.5 million), an increase to overtime ($1.2 million - the majority of which is related to Police and Fire), and an increase to supplies and services ($2.2 million). The increase to supplies and services is broken down as follows:

- $714,000 in expenses for finance related services that were previously budgeted as reductions to revenue - an equal and offsetting increase has been made to the revenues these expenses were previously budgeted in;
- $650,000 for outside plan check services in the Development Services Department which is offset by an equal amount of offsetting revenues;
- $342,000 for Police Operations;
- $258,000 for election related expenses (addition of November 2016 election);
- $47,000 for Human Resources temporary staffing;
- $100,000 for a previously unbudgeted Fire academy; and
- $61,000 approximately for various services in other departments.

While there are increases to the above-mentioned expenses, there are also decreases to some expenditures proposed as well. These reductions, summarized in the table below, offset the increases by approximately $2.9 million and are mostly related to employee benefits coming in below adopted levels. The net change at mid-year results in a reduction of the projected use of General Fund reserves of $1.8 million less than originally budgeted.

| | Adopted FY 2017 | Change | MY Revised FY 2017 |
|---|---|---|---|
| **Total Revenue/Resources** | **144,665** | **6,802** | **151,467** |
| **Expenditures** | | | |
| **Net Staffing Expense** | **118,023** | **(1,166)** | **116,858** |
| **Net Operating Expense** | **31,005** | **3,125** | **34,130** |
| UUT Prior Year Payments Set-aside | | **3,027** | **3,027** |
| **Total Expenditures** | **149,029** | **4,986** | **154,015** |
| **Total Surplus/(Shortfall)** | **(4,364)** | **1,816** | **(2,548)** |

## BACKGROUND

The FY 2017 adopted Budget projected the use of $4.4 million of General Fund Reserves. While not entirely closing the gap, the City has reduced the projected use of General Fund Reserves by $1.8 million based on this mid-year report. While revenue projections have increased, there are also anticipated increases to expenditures.

The adopted General Fund Ten-Year Plan (the Plan) is updated to reflect FY 2016 actuals, current benefit rates (inclusive of changes resulting from new labor agreements reached during FY 2016), revised revenue projections, and requested FY 2017 mid-year expenditure adjustments.

## DISCUSSION

There have been several key changes in the City's economic outlook since the City Council adopted the FY 2017 budget in June 2016. While the projected use of reserves for FY 2017 has been reduced as a result of the changes recommended with this mid-year budget adjustment, there is still an ongoing structural deficit within the City's General Fund. While at times it is appropriate to use the General Fund Reserve (or one-time balancing measures), continually doing so perpetuates or increases structural gaps. The key changes for FY 2017 and influences on the General Fund Ten-Year Plan projections are discussed below.

### General Fund Revenues and Variance Analyses

FY 2017 General Fund revenues are projected to be $6.8 million (4.7 percent) higher than originally projected – $3.7 million of which are one-time and/or restricted revenue ($3 million in one-time and restricted Utility Users Tax prior year payments, and $646,000 in Real Property Transfer tax above Council's recurring annual threshold of $4.8 million). When the $3.7 million of one-time revenue is excluded, the General Fund revenue increases are projected to be 2 percent higher than reflected in the adopted FY 2017 budget.

Attachment II and the following analysis highlights key revenue variances as they pertain to FY 2017 mid-year projections and the impact on future year projections as delineated in the Plan. These projections are based on year-to-date data, and will be closely monitored for the remainder of the fiscal year.

Representing fifty-four percent of total General Fund revenues, property and sales taxes are the two major revenues that influence the City's budget. Sales Tax revenues have rebounded to pre-recession levels, but have leveled off, with the long-term erosion of overall sales tax revenues in California and the ever-growing list of sales tax exempt transactions. Property Taxes continue to show steady growth from new construction and improved property values and are outpacing originally projected growth.

<u>Property Tax (plus $1.7 million)</u> – Property tax revenues are outpacing originally adopted projections primarily due to the rising property values trending throughout the region and state.

> <u>*Redevelopment Property Tax Trust Fund (RPTTF)*</u> –The RPTTF represents reallocated property tax increment previously allocated to the former Hayward Redevelopment Agency. With the dissolution of the agency, tax increment funds are now redistributed to all taxing entities in the County, including the City of Hayward. As the RDA dissolution process continues, the RPTTF distributions are beginning to stabilize as many of the one-time dissolution adjustments have concluded (e.g. audits, property disposition, asset transfers, etc.).
>
> Anticipated annual, recurring RPTTF funds (annual pass-through and redistribution funds) are $2.4 million for FY 2017 and future years. Until the dissolution process ends entirely, these are somewhat unpredictable revenues. The majority of these funds are allocated to funding the Economic Development budget, consistent with the Economic Development Strategic Plan adopted by City Council. Of this amount, approximately $800,000 annually is to repay a loan provided by the General Fund to the former Redevelopment Agency in 1975. Payment on this loan has been subject to the RDA dissolution process and has been significantly delayed. These funds are intended to replenish the General Fund Reserve. After receipt of the first installment payment, the current outstanding balance is $9.38 million.

<u>Sales Tax (plus $801,000)</u> – Although Sales Tax revenues have rebounded from pre-recession lows, they have experienced some regression. Projections for FY 2017 are approximately one percent higher than FY 2016 actuals and represent minimal growth. The FY 2017 adopted budget included projected contraction growth anticipated by the loss of two of the City's top businesses. The impact, however, has not been as significant as anticipated and other industries, specifically automobile sales, have increased higher than anticipated during the fiscal year.

At a time when the City is experiencing higher costs in municipal government and a growing demand for services from the community, the City is actually collecting less sales tax per person than in the early years of the tax.

- When the Sales Tax was established in 1933, there were four exemptions identified in the enabling legislations – today, there are over eighteen pages of exemptions in the California Tax Code.
- As an economy, we have shifted from a maker of goods to a service provider. The Sales Tax law remains based on goods and rarely, if ever, taxes services.

- On-line shopping is exploding and grows exponentially annually, yet laws and regulations remain far behind leaving most on-line purchases untaxed; or if they are taxed, the tax is applied, collected, and distributed where the goods are sold and not where they are delivered.

<u>Utility Users Tax (UUT) Prior Period Payments (plus $3 million)</u> –In FY2017, for the second year in a row, the City received payment from Russell City Energy Company (RCEC) for UUT resulting from the use and consumption of natural gas, for the period of October 2014 – September 2015. Said payment was made under protest and RCEC is challenging the City's determination that consumption of natural gas is subject to the UUT ordinance. Until the dispute is resolved legally, said funds are being set aside and are not available for expenditure.

<u>Property Transfer Tax (plus $646,000)</u> – This projected increase is a reflection of increased real estate sales activity and housing prices in Hayward. Staff continues to study the details of the various real estate transactions (commercial and residential) to determine the recurring or one-time nature of this market-driven revenue. Real Property Transfer Tax (RPTT) is a highly volatile revenue source and is directly subject to market fluctuations.

Effective FY 2016, City Council adopted a baseline threshold for recurring RPTT revenues, establishing that all revenue over $4.8 million is considered one-time revenue and should be used according to Council policy regarding one-time revenues, such as for replenishing the General Fund reserve or for capital expenses. The delta of $3 million (difference between projected of $7.8 million and the $4.8 million threshold) will be used to fund expenses that can be considered one-time in nature in the General Fund– such as the $1.7 million in capital expenses and $1.5 million in settlement expenses identified in this report.

<u>Charges for Services (plus $650,000)</u> – This increase in revenues directly reflects the increased demand for plan checking in Development Services. This amount directly offsets the increase of $650,000 in outside plan check expenses being requested.

**General Fund Expenditures and Variance Analyses**

FY 2017 General Fund expenditures are projected to be $5 million (3.3 percent) higher than anticipated in the adopted budget. Of this amount, approximately 3 million is a one-time expense set-aside related to the payment received for UUT from prior periods. The detailed table in Attachment II and the following analysis highlights key expenditure variances as they pertain to FY 2017 mid-year projections and the resultant impact on future year projections as included in the General Fund Ten-Year Plan. These are projections based on year-to-date data, and will be closely monitored for the remainder of the fiscal year. Note that while the City's revenues grow to pre-recession levels, the City continues to be challenged with cost drivers that affect the long-term structural deficit. The main cost drivers are the growing costs of PERS and the impact of the change to PERS discount rates, employee benefits, resource needs, and deferred capital needs.

***Staffing Expense Variances***
Overall, the staffing expense budget decreased by $1.5 million or 1 percent and is attributable to the following:

- <u>Medical Benefits (minus $1.6 million)</u>. There are a few factors at play here; first is while we budget benefits for positions when they remain vacant, the benefit costs don't actually exist. While we see a rise in overtime costs there are not additional medical premiums paid for these hours. Additionally, many of the new labor agreements have “cost-share” components in the area of benefits, reducing the City’s burden.

- Overtime (plus $1.5 million). For the second year in a row, the State has experienced a very aggressive fire season. Requests for Mutual Aid were extremely high during the first half of FY2017. As a result of Mutual Aid and minimum staffing requirements, the Fire Department overtime budget for the year has almost been fully expended. It should be noted that Fire Department mutual aid time is fully reimbursable to the City. The Police Department has also experienced an increase to overtime in the first half of the fiscal year as well.

- Staffing Vacancies (minus $3 million). The City continues to experience vacancies in positions in many departments. This lends itself to savings in Salary and some benefits, it directly impacts overtime.

- PERS (minus $854,000). The City will see a reduction of PERS expenses for FY 2017 because of vacant positions and an underestimation of the cost share component negotiated into many of the new bargaining agreements. This savings is temporary, however, as rates for FY 2018 will be increasing and as the phasing in of PERS newly reduced discount rate, this burden will increase for the City in future fiscal years.

***Operating Expense Variances***

A number of adjustments are needed at mid-year in order to accommodate new grant revenues received during the fiscal year, fund necessary or unexpected expenditures, and to appropriate prior year encumbrances (contractually obligated expenses) that have carried forward into FY 2017.

Encumbrance Carryforwards and Budget Carryforward Requests (plus $1.38 million) – This number is comprised of $759,000 in prior year encumbrances (Purchase Orders and Contracts) and $622,000 in funds not encumbered in FY 2016 but intended for professional services contracts ($459,000 from Development Services; $163,000 from the Police Department).

General Fund transfer to Liability Insurance Fund (plus $1.5 million) – This request was previously approved as part of the FY 2016 Mid-Year process; however, the transfer did not take place in FY 2016.

Grant Carryforwards and Grant Appropriations totaling $224,000 – This amount reflects both new FY 2017 Grant Appropriations (with offsetting revenues) and unexpended Grant monies from FY2016 which have been carried forward to FY 2017.

GAAP Standards expenditures (plus $714,000) – In compliance with GAAP Standards, items previously recorded as offsets to revenues are now being recorded as expense items. These expenses are for the annual Property Tax Administrative Fee charged to the City by the County, as well as for sales tax, business tax, UUT, in-house parking collection, and other revenue audit costs. While this is identified as an increase to expenditure authority in order to appropriately expend the related costs, this is actually a net zero impact to the budget as there is also a corresponding increase to revenues.

The remaining anticipated expenditure variances include: (1) $650,000 for Plan Check Services (which are offset by increase in revenues mentioned above); (2) $100,000 for Fire Academy expenditures; (3) $258,000 for Election Expenses; and (4) approximately $61,000 in other miscellaneous department expenses.

## Staffing Changes

Limited staffing changes are proposed as part of the mid-year review – with an addition of 2.0 FTE positions. While there remains a critical need for additional resources throughout the organization, these will be better addressed during the upcoming FY 2018 budget process so that these decisions can be considered within the context of the full budget and all competing priorities. Of the changes summarizes in the Chart I below, the General Fund is impacted by $41,526 in FY 2017 and $371,611 in FY 2018.

### Chart 1 – Staffing Changes Summary

| POSITION CHANGES SUMMARY | FY2017 | FY2018 |
|---|---|---|
| Development Services | | |
| Add 1.0 FTE Supervising Permit Technician | $ 17,306.98 | $ 99,145.39 |
| Delete 1.0 FTE Permit Technician I/II | $(16,299.04) | $ (94,309.79) |
| Total Cost to General Fund | $ 1,007.94 | $ 4,835.60 |
| | | |
| Add 1.0 FTE Assistant Engineer | $ 23,720.87 | $ 136,567.22 |
| Delete 1.0 FTE Development Review Specialist | $(22,695.99) | $ (13,704.09) |
| Total Cost to General Fund | $ 1,024.88 | $ 122,863.13 |
| | | |
| Public Works-Engineering & Transportation | | |
| Add 1.0 FTE Deputy Dir. of Public Works | $ 37,257.18 | $ 206,013.39 |
| Delete 1.0 FTE Assistant City Engineer | $(34,537.74) | $(190,801.68) |
| Total Cost to General Fund | $ 2,719.44 | $ 15,211.71 |
| | | |
| Add 1.0 FTE Senior Management Analyst (PLA) | $ 27,014.44 | $ 158,360.52 |
| PLA Offset Charges to CIP Accounts | $(13,500.00) | $ (80,000.00) |
| Total Cost to General Fund | $ 13,514.44 | $ 78,360.52 |
| | | |
| **Summary of All Positions Total Cost to General Fund** | **$ 18,266.70** | **$ 221,270.96** |

## Measure C

During the June 3, 2014, municipal election, the voters of the City of Hayward passed a ballot measure (Measure C) to increase the City’s Transaction and Use (Sales) Tax by half a percent for twenty years. This half cent increase became effective October 1, 2014, bringing Hayward’s Sales and Use Tax to 10.0 percent. This is a general tax that is considered discretionary in nature. Staff originally estimated that the new sales tax would generate approximately $10 million annually in locally controlled revenue that can be allocated by the City Council and will remain in place for a period of twenty years.

The City Council, as well as the ballot language, established a number of spending priorities for these funds. These priorities include a mix of capital projects and funding allocations toward operating services. Measure C revenues are to primarily be used to fund debt service for construction of the new Library and Community Learning Center, completion of fire station retrofits and improvements, and rehabilitation and expansion of the existing fire training center. On September 30. 2015, the City issued Certificates of Participation (Certificates) to provide immediate funding for these capital projects. Remaining debt service payments for the

Certificates is approximately $5.5 million annually through 2034. Remaining Measure C revenues will be allocated among police and maintenance services, and street repairs, consistent with the identified funding priorities.

Revenue: The City began receiving allocations of the Measure C Transaction and Use (sales) Tax effective January 1, 2015. The City received $8 million in revenues from Measure C for FY 2015, which was higher than originally projected. Based on recent projections from the City's Sales Tax consultant, FY 2017 revenues are projected to be $14.1 million.

Expenditures: Recommendations at mid-year do not include increased appropriations for FY 2017, except for some program-related capital costs. The City has worked diligently to fill the positions authorized using Measure C funds in FY 2017, and to date have filled many Measure C funded positions. Of the $2.8 million appropriated for salary and benefit related expenses, only $1.3 million has been spent to date in FY 2017.

Staff will return to the Budget & Finance Committee and the Council at future dates to further discuss Measure C projections and expenditures.

**Ten-Year General Fund Plan Update**

The updated General Fund Ten-Year Plan (Attachment II) includes a reduction to the projected structural gap in FY 2017 from $4.4 million to $2.5 million (inclusive of all mid-year adjustments – including one-time adjustments) that grows to over $23 million by FY 2026 without additional balancing measures. This Plan reflects the assumptions contained in the FY 2017 adopted budget and is updated with the mid-year expenditure and revenue projections discussed in this report.

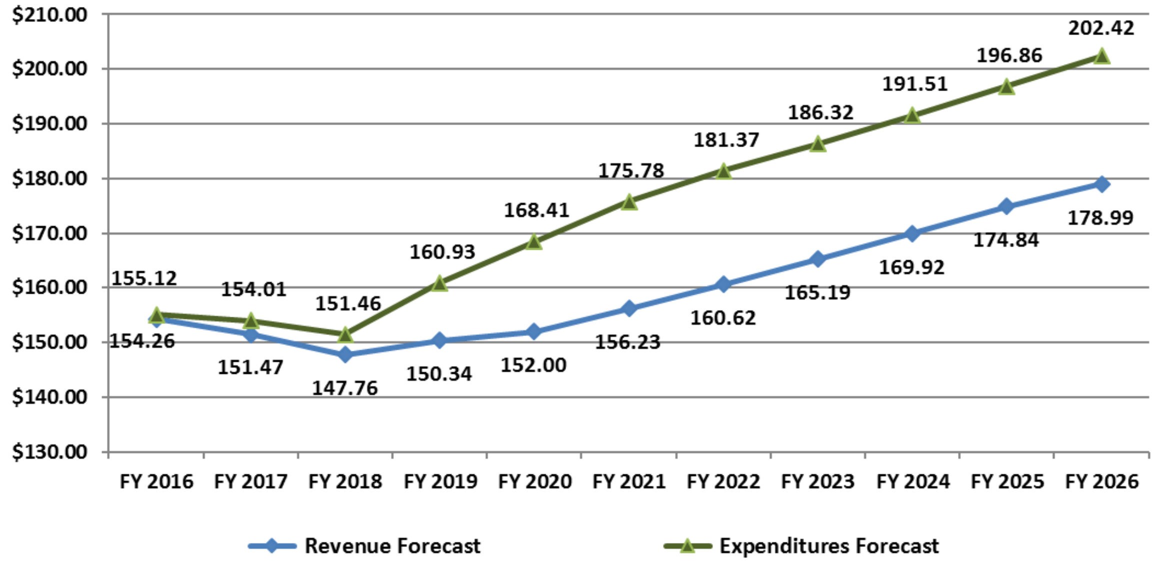
The current General Fund Reserve goal is 20 percent of General Fund expenditures. Based on the updated Plan, the City is falling short of this goal by 2 percent in FY 2017 according to projections.

Chart 2 below depicts the revised General Fund revenues and expenditures gap. Unfortunately, even with improved revenues, rising costs associated with employee benefits (primarily retirement benefits) and deferred capital maintenance continue to grow the City's General Fund deficit.

There have not been significant assumption changes made to the forecast. The City is currently working with Management Partners to update the forecast and the underlying assumptions. The expected completion of the update is summer 2017.

**Chart 2: General Fund Ten-Year Forecast: Revenues & Expenditures**

*(Displayed in millions)*




## FISCAL IMPACT

The overall fiscal impact of the proposed adjustments results in an increase to General Fund revenues of $6.8 million, of which $3.8 million is considered recurring; and an increase to General Fund expenditures of $5 million, of which $460,000 is considered recurring. The net General Fund changes result in a shortfall of $2.5 million in FY 2017. Expenditure adjustments in all Other Funds total $4.9 million. A more detailed description of these changes and their impact will be provided to the full Council on March 7, 2017 as part of the discussion of this item at the regularly scheduled Council meeting.

## NEXT STEPS

Staff will implement any recommended changes to the reports and present the FY 2017 Mid-Year and updated General Fund 10 Year Plan to the full Council for review on March 7, 2017.

*Prepared by:* Dustin Claussen, Director of Finance
Guy Ferguson, Management Analyst

*Recommended by:* Dustin Claussen, Director of Finance

Approved by:

Kelly McAdoo, City Manager