



Office of the City Manager

BUDGET WORK SESSION

November 14, 2006

To: Honorable Mayor and Members of the City Council

From: *PK* Phil Kamlarz, City Manager

Subject: FY 2007 First Quarter Budget Update

INTRODUCTION

This report presents to Council a summary of the first quarter of FY 2007 budget performance and initial fiscal projections for the FY 2008 & FY 2009 Biennial Budget; focusing primarily on the General Fund. No specific action is requested at this time.

CURRENT SITUATION AND ITS EFFECTS

**FY 2007 First Quarter Results**

The national and Bay Area economies are shifting and impacts to Berkeley are very real. A national housing slow-down – as well as a significant Bay Area “bust” is resulting in decreased sales and housing prices. While in the last few years we have benefited from the housing market, we are now seeing a sharp decline in these related revenues. Interest rates, inflation and employment are also contributing to the changing Bay Area economy. The cost for goods has increased dramatically, with a direct negative impact on the City’s capital projects. For example, the national cost of steel mill products rose 23.3% over last year and costs for cement increased by 11%.

At this early point in the year, there are no significant expenditure variances (summary of year-to-date expenses in Attachment A). The mid-year analysis will provide a better idea of any variance trends. Currently, the only projected variance from the Adopted Budget is the expense of \$200,000 for unbudgeted Council staff benefits.

However, there have been significant changes in General Fund revenue. Attachment B provides a summary of all key General Fund revenues for the first three months of FY 2007. Of notable significance, net Property Transfer Tax revenues decreased \$1,172,057 or 24.2% for the same period in FY 2006. The number of residential property sales also declined 26.0% to 324 from 438 for the same period in FY 2006; and the average residential property sales price declined 2.0% to \$775,897 from \$791,773 in September 2005. While not entirely unexpected, this is a rapid decline that will have budgetary impacts.

Understanding the volatility of the Property Transfer Tax, Council established a recurring baseline for these revenues and adopted the policy that revenues in excess of the baseline would be considered one-time revenues and spent toward one-time expenses. The FY 2007 Adopted Budget projects \$12.5 million in Transfer Tax revenue, of which \$2 million is considered one-time and dedicated to one-time capital improvement allocations. The First Quarter revised projections reduces total projected Property Transfer Tax revenue to \$11.5M – a loss of \$1M.

Several revenues are projected to perform higher than originally forecast, including: interest income (locked into high rates before the decline), Transient Occupancy Taxes, and Parking Fines (improvement plan implemented). The net effect is a preliminary revenue projection for FY 2007 that is \$815,000 above original projections. After considering the projected over expenditure of \$200,000, the First Quarter Update projects a reduction in the planned use of the General Fund reserve of \$615,000 from \$2.8 million to \$2.2 million. Given the downturn in the Property Transfer Tax revenue, which was a key factor in the 5-year capital plan, and the uncertainties of the economy, no new recurring expenditures are recommended at this time.

Staff will present to Council the FY 2007 Mid-Year Budget Update next February during which time Council will review available revenues. Funding for a number of programs have been deferred to the FY 2007 Mid-Year review including continued funding for the Telegraph Avenue Improvement Plan and Fire Department staffing.

### **FY 2008 & FY 2009 Biennial Budget Outlook**

The City experienced a difficult fiscal crisis during FY 2003 – FY 2006. During these four years, Council made tough budget-balancing decisions that resulted in reducing the General Fund budget by \$20M and reducing the City's labor force by almost 10%. FY 2007 has brought a year of relative stability as the City continues to contain costs based on prior years' decisions.

However, our initial forecasts over the next few years indicate the return of a structural deficit, driven by reduced revenues and increased costs. These costs are attributed to State retirement rate increases, potential costs associated with the renewal of the City's labor contracts, and the continuation of recurring budget allocations made in FY 2007. In order to maintain a balanced City budget, the FY 2008 & FY 2009 biennial budget will require either new revenue or decreased expenditures. In the absence of increased revenue, new Council priorities may require reductions to current service levels. Council may be faced with decisions regarding the one-time use of the General Fund reserve to help mitigate budget reductions.

### *General Fund Reserve*

The City Council's policy is to maintain the Reserve at 6% of gross General Fund revenues. During the FY 2007 budget discussions, Council expressed a desire to increase the Reserve. We will revisit the policy during the FY 2008 & FY 2009 Biennial Budget process. The total Undesignated Reserve is currently at approximately 11%, with liquid reserves at 7%. Liquid reserves represent available cash, and the balance includes receivables due to the General Fund from other funds for grants and loans fronted by the General Fund.

The Reserve provides some flexibility to help balance the budget, to smooth out economic swings, revenue reductions, i.e., possible Utility Users Tax revenue loss, and address emergencies. As a part of the 5-Year Plan, \$4.6M of the Reserve is planned for one-time capital improvement projects. In addition the reserve includes set-aside designations for potential General Fund liabilities such as:

Affordable Housing Projects: The City is engaged in a number of affordable housing projects that require additional funding as separately communicated to Council, including the Brower Center and the Allston Way. \$2M is currently set-aside for this need.

Other Reserve Designations: In addition to the above, the City is involved in a number of legal actions that require the use of the General Fund Reserve. A designation of \$2M is set-aside for this purpose.

*Possible Revenue Loss*

In addition to the trending down of Property Transfer Tax revenues (and property-based revenues in general), the reduction of recurring Utility Users Tax (UUT) is a real possibility due to recent telecommunications legislation. FY 2008 –FY 2010 revenue for UUT is forecasted to be flat in anticipation of some losses. However, even this may be an optimistic assumption. The future of telecommunications revenues is uncertain and elimination of cellular phone revenues alone would result in a loss of \$3 million a year to the General Fund. This is not reflected in our current 5-Year Forecast.

*Labor Cost Impacts*

In the next several years, prudent decisions regarding long-term fiscal sustainability will be needed with the re-negotiation of the City’s labor contracts. The City received bad news that the projected medical insurance rate increase effective January 2007 is 24% over last year’s rates. In addition, PERS recently provided the City with its revised rates for FY 2008 and forecasted rates for FY 2009. These are higher than the rates previously provided to the City for these years. For FY 2008, the General Fund cost due to the increased PERS rates is \$600,000. This increase, and the possibility of future increases of this nature, will seriously impact the budget.

Attachment C to this report provides a “what if” analysis on the impacts of various levels of Cost of Living Adjustments (COLAs) following the conclusion of the City’s labor contracts. While implementation of zero COLAs maintain a positive fund balance through FY 2010, implementing a 3% COLA each year would result in a \$2M - \$3M annual structural deficit.

*Capital Improvement Needs*

Repairing the City’s aging infrastructure has been a priority for Council these past three years. Council has allocated one-time revenue (primarily generated from the Property Transfer Tax) toward many capital improvement projects (CIP) such as streets, roads, clean storm water, and street lighting. Unfortunately, these one-time revenues are now diminishing and General Fund funding for CIP is projected to decrease in future years.

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
<b>General Fund CIP</b>	\$4.6M	\$11.6M	\$10.3M	\$7.9M	\$6.8M	\$5.3M

As Council proceeds with the FY 2007 budget and prepares for the upcoming two-year budget development process, you will be faced with the challenges of limited resources and unlimited need. The future may hold the opportunity for possible ballot measures to help fund growing infrastructure needs such as storm water/creeks, a warm water pool, and street infrastructure. However, without new revenue through voter-approved measures or improved economic-based revenues, some expenditure reductions will be needed.

CONTACT PERSON

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Attachments:

- Attachment A = FY 2007 General Fund Expenditures
- Attachment B = FY 2007 First Quarter General Fund Revenue Projections
- Attachment C = Multi-Year General Fund Forecast: COLA Impacts

**FY 2007 General Fund Expenditures  
(7/1/06 - 10/30/06)**

**Attachment A**

<b>Department</b>	<b>FY 2007 Adopted</b>	<b>FY 2007 Adjusted</b>	<b>YTD Actuals</b>	<b>Balance</b>	<b>Percent Expended</b>
Mayor & Council	1,356,387	1,357,396	468,231	889,165	34%
Animal Care Services	1,300,012	1,300,621	475,848	824,773	37%
Auditor	1,659,843	1,659,971	486,646	1,173,325	29%
City Attorney	1,649,610	1,733,201	539,319	1,193,882	31%
City Clerk	1,797,112	1,803,165	452,038	1,351,127	25%
City Manager	3,166,610	3,181,332	840,892	2,340,440	26%
Economic Development	1,627,928	1,646,290	848,272	798,018	52%
Finance	6,003,482	6,083,143	1,931,744	4,151,399	32%
Fire	21,473,626	21,629,941	6,931,989	14,697,952	32%
Health and Human Services	9,216,312	9,322,701	3,085,872	6,236,829	33%
Housing	1,856,237	2,076,315	774,959	1,301,356	37%
Human Resources	1,795,370	1,821,218	548,998	1,272,220	30%
Information Technology	3,353,884	3,516,160	1,470,600	2,045,560	42%
Parks and Waterfront	4,324,282	4,424,002	2,052,961	2,371,041	46%
Planning	819,980	951,579	418,333	533,246	44%
Police	44,020,328	44,198,213	13,471,885	30,726,328	30%
Police Review Commission	540,608	563,877	126,989	436,888	23%
Public Works	1,617,694	1,814,112	1,005,065	809,047	55%
Non-Departmental	25,352,119	25,244,828	12,348,943	12,895,885	49%
<b>Total</b>	<b>132,931,424</b>	<b>134,328,065</b>	<b>48,279,584</b>	<b>86,048,481</b>	<b>36%</b>

**Assumptions:**

Non-personnel Year to Date Actuals are as of 10/31/06 and represent 33.3% expended year to date.

*Expenditures over 33.3% are related to the encumbrance of non-personnel, such as construction contracts.*

Personnel Year To Date actuals are through 10/26/06 and represent 30.8% expended year to date.

*All departments are tracking at or below 30.8% in personnel expenses.*

### General Fund Revenue Projections

<b>FY 2007 Three-Month General Fund Revenues (7/1/06 - 9/30/06)</b>						
Revenue Categories	Adopted FY 2007	Actual 7/1/06-9/30/06	% Received To Date	Projected FY 2007	Change over Adopted %	\$
Secured Property	\$32,284,204	\$381,698	1.18%	\$32,286,949	0.00%	\$2,745
Unsecured Property taxes	2,063,645	1,669,282	80.89%	2,081,160	.85%	17,515
Transfer tax	12,500,000	3,666,036	29.33%	11,500,000	8.00%	(1,000,000)
Sales taxes	14,320,996	3,561,054	24.87%	14,320,996	0.00%	0
Utility users taxes	14,704,583	3,551,242	24.15%	14,704,583	0.00%	0
Transient occupancy taxes	2,900,000	881,792	30.41%	3,200,000	10.34%	300,000
Business license	10,990,719	121,379	1.10%	10,990,719	0.00%	0
Vehicle in lieu taxes	7,538,481	289,965	3.82%	7,692,546	2.04%	154,065
Parking Fines	9,190,630	2,637,798	28.70%	9,690,630	5.44%	500,000
Moving Violations	750,000	179,177	23.89%	750,000	0.00%	0
Interest income	3,700,000	1,286,169	34.76%	4,500,000	21.62%	800,000
Ambulance fees	2,465,923	518,489	21.03%	2,465,923	0.00%	0
Supplemental taxes	1,800,000	223,588	12.42%	2,000,000	11.11%	200,000
Franchise fees	1,539,224	189,366	12.30%	1,562,639	1.52%	23,415
Other revenue	6,697,176	1,488,473	22.23%	6,514,244	-2.73%	(182,932)
Transfers	6,683,414	1,804,975	27.01%	6,683,414	0.00%	0
<b>Total revenue:</b>	<b>\$130,128,995</b>	<b>\$22,450,483</b>	<b>17.25%</b>	<b>\$130,943,803</b>	<b>.63%</b>	<b>\$814,808</b>

### General Fund Revenue Variance Analysis

#### Property Transfer Tax -\$ 1,000,000

FY 2007 Adopted Budget	Revised Projection	Difference	YTD Revenue (9/30/06)	Comments
<b>\$ 12,500,000</b>	<b>\$ 11,500,000</b>	<b>(\$ 1,000,000)</b>	<b>\$ 3,666,046</b>	YTD Revenue decreased by 24.2% from the same period in FY06

*During the first quarter of FY 2007, net Transfer Tax revenues decreased \$1,172,057 or 24.2% to \$3,666,046 from the total of \$4,838,103 for the same period in FY 2006. This decline resulted primarily from a \$91,912,768 or 28.9% decline in residential property sales from \$318,474,600 in the first quarter of FY 2006 to \$226,561,832 for the first quarter of FY 2007. The number of residential property sales also declined 26.0% to 324 from 438 for the same period in FY 2006; and the average residential property sales price declined 2.0% to \$775,897 from 791,773 in September 2005.*

*September 2006 property sales and Transfer Tax revenue results (revenue to be received by the City in October 2006) snapped back with year-over-year increases of 20.6% and 22.2%,*

respectively. However, this increase was primarily caused by two huge commercial property sales (one for \$26,500,000 and another for \$10,828,500). Residential property sales and Transfer Tax revenue continued to decline in September, but at a much slower pace than in the previous three months.

Total property sales in September 2006 decreased by \$1,972,908 or 3.1%, and Transfer Tax revenue decreased \$39,561 or 4.8%. If the rate of decline experienced in the first four months (June through September 2006) continues for the full year, Transfer Tax revenues for FY 2007 would total approximately \$12.2 million or \$300,000 below the adopted budget amount. Staff has lowered the FY 2007 projection for this revenue source by \$1,000,000 to \$11.5 million as October 2006 Transfer Tax revenues (revenue to be received by the City in November) declined by 27.8%. Staff is closely monitoring results for this revenue source.

**Interest Income at +\$800,000**

<b>FY 2007 Adopted Budget</b>	<b>Revised Projection</b>	<b>Difference</b>	<b>YTD Revenue (9/30/06)</b>	<b>Comments</b>
<b>\$ 3,700,000</b>	<b>\$ 4,500,000</b>	<b>\$ 800,000</b>	<b>\$ 1,286,169</b>	YTD Revenue increased by 65.0% over the same period in FY06

During the first quarter of FY 2007, Interest income totaled \$1,286,169, which was \$506,767 or 65.0% more than the \$779,402 received for the same period in FY 2006, as the effects of locking in rates at or near the highest levels reached in several years kicked in.

Staff expects the yield curve (i.e., the relationship between long-term and short-term interest rates) to remain inverted and for the Federal Funds rate to remain at 5.25% for a few months. In mid- 2007, staff expects the Fed to slowly start lowering the Federal Funds rate. The reason for the anticipated decline is the expected slowdown in the economy, which should occur due to the negative impact on consumer spending caused by 17 straight Fed increases in short-term interest rates, a slowdown in the housing and auto markets, and higher energy costs. With the economy already showing signs of slowing, staff's current investment strategy is to purchase more investments with maturities of three to five years. This strategy enabled staff to lock in higher yields before rates started falling (i.e., long-term rates have since fallen .50% since rates were locked in).

**Transient Occupancy Tax (TOT) +\$300,000**

<b>FY 2007 Adopted Budget</b>	<b>Revised Projection</b>	<b>Difference</b>	<b>YTD Revenue (9/30/06)</b>	<b>Comments</b>
<b>\$ 2,900,000</b>	<b>\$ 3,200,000</b>	<b>\$ 300,000</b>	<b>\$ 881,792</b>	YTD Revenue increased by 13.7% over the same period in FY06.

During the first quarter of FY 2007, revenue totaled \$881,792, which was \$106,287 or 13.7% more than the \$775,505 received for the same period in FY 2006, as six of the nine largest hotels had growth rates near or exceeding 20%.

**Parking Fines +\$500,000**

<b>FY 2007 Adopted Budget</b>	<b>Revised Projection</b>	<b>Difference</b>	<b>YTD Revenue (9/30/06)</b>	<b>Comments</b>
<b>\$ 9,190,630</b>	<b>\$ 9,690,630</b>	<b>\$ 500,000</b>	<b>\$ 2,637,798</b>	YTD Revenue decreased by 51.7% over the same period in FY06.

*During the first quarter of FY 2007, revenue totaled \$2,816,975, which was \$1,856,859 or 51.7% more than the \$960,116 received for the same period in FY 2006 (this increase included \$120,897 of delinquent parking fines collected by a collection agency). Staff raised the FY 2007 projection by \$500,000 due to the successful implementation of the parking improvement plan.*

**General Fund Forecast  
Cost of Living Adjustment (COLA) Impacts**

<i>(in millions)</i>	Projected FY2007	Projected FY2008	Projected FY2009	Projected FY2010
<b>Total GF Revenue</b>	\$ 130.94	\$ 133.74	\$ 136.50	\$ 139.81
<b>Total GF Expenditures</b>				
<b>@ Zero COLAs</b>	\$ 133.1	\$ 134.8	\$ 134.9	\$ 136.9
<b>Structural Deficit</b>	\$ (2.2)	\$ (1.1)	\$ 1.6	\$ 2.9
<b>@ 2% COLAs</b>	\$ 133.4	\$ 135.6	\$ 137.2	\$ 140.3
<b>Structural Deficit</b>	\$ (2.5)	\$ (1.9)	\$ (0.6)	\$ (0.5)
<b>@ 3% COLAs</b>	\$ 133.5	\$ 136.0	\$ 138.3	\$ 142.3
<b>Structural Deficit</b>	\$ (2.6)	\$ (2.3)	\$ (1.8)	\$ (2.5)

*COLA assumptions are phased and based on the expiration dates of the various labor contracts.*

*Major assumption: 1-Time Capital funding decreases from \$10 million in FY 2007 to \$5 million in FY 2010.*

**Analysis**

The above chart reflects the structural deficit between revenues and expenditures and does not take into account the use of the General Fund Reserve. Reserves can be used to balance the budget, but since the Reserve represents one-time funding, its use does not address the structural deficit. The growing structural deficit will require deeper reductions or increased revenues generated by economic development strategies or voter approval in future years. A balance between the one-time use of the Reserve and recurring expenditure reductions is delicate.

The total Undesignated Reserve is presently at about 11%, and includes the planned use of \$4.6 million of the Reserve per the adopted FY 2005 – FY 2010 plan for one-time capital projects.

Every 1% of Reserve equals approximately \$1.3 million.