CITY OF RIVERSIDE

City Council Memorandum

City of Arts & Innovation

TO: HONORABLE MAYOR AND CITY COUNCIL **DATE:** FEBRUARY 23, 2016

FROM: FINANCE DEPARTMENT **WARD:** ALL

SUBJECT: BUDGET 101: OVERVIEW OF THE CITY'S FINANCIALS, KEY CHALLENGES AND OPPORTUNITIES IN ADVANCE OF THE TWO-YEAR BUDGET / FIVE-YEAR PLAN DIALOGUE COMMENCING IN MARCH 2016

ISSUE:

The issue for the City Council's consideration is to receive and provide comment on a high-level overview of the City's financial issues and opportunities ("Budget 101"). Budget 101 will set the stage for the two-year budget and five-year plan presentations and discussions that will commence in March 2016.

RECOMMENDATION:

That the City Council receive and provide input on the Budget 101 presentation as outlined below.

BACKGROUND:

Consistent with the City Council's direction at its December 8, 2015 meeting, staff is developing a two-year budget for fiscal years 2016/17 and 2017/18. That budget is being developed within the context of a five-year plan, which will identify critical challenges and opportunities, provide recommended actions to address them, and set a financial context to guide future policy and programmatic decisions by the City Council and management.

At the December 8, 2015 meeting, staff also outlined to the City Council and the public a much more transparent and participatory budget development process. The process, which began in January with internal budget discussions involving all City departments, not only incorporates multiple meetings with the City Council and the public, but also includes meetings with City employees and bargaining groups, community groups, and the business community. Today's presentation is the first of these public meetings and provides a general overview of the City's finances, along with a preview of fiscal challenges, both current and anticipated over the next five years. Additionally, general information will be provided on various budget-related matters recently raised by the City Council and/or the community.

A. Key Changes In This Budget

Key Theme: The underlying theme for the upcoming two-year budget is "*Taking Care of Essential Services and Infrastructure*". With the City's new executive team on board, the time is particularly appropriate to take a fresh look at where we are, assess where we are headed, and think strategically about any adjustments that need to be made to proceed with prudent budget development.

Five-Year Planning: The development of a five-year plan at the same time as the budget is being constructed will help identify the longer-term fiscal challenges facing the City, and naturally draws attention to the development of sustainable solutions to secure the City's fiscal strength.

Transparent and Participatory Process: For the first time this year, the budget process involves a variety of efforts designed to both inform and solicit feedback from the various internal and external stakeholders. As part of this presentation, the City Council will see a video soliciting input on the budget from the public, business community, City employees and unions.

Additionally, a "Community Report" publication has been developed to provide a high-level overview of the City's finances, along with key anticipated challenges and opportunities. Intended to both educate and solicit input, the brochure contains easy to understand infographics, and will be made available online as well as in print for the various internal and external constituents.

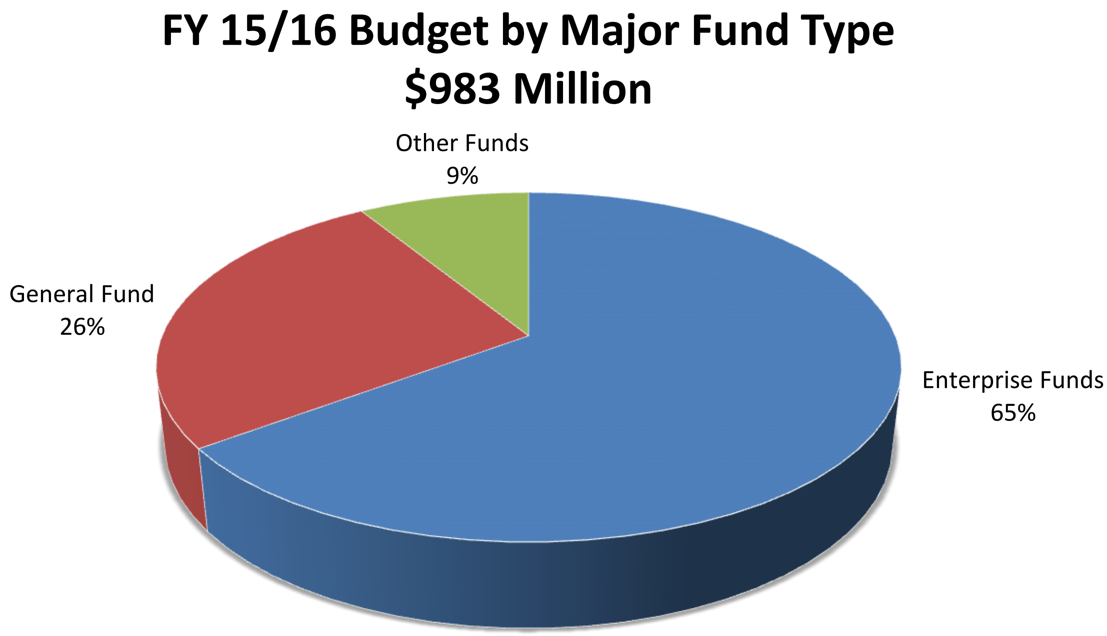
Lastly, our commitment to openness and transparency is manifested in the myriad of public meetings being held with the various internal and external stakeholders. These meetings will both provide information, but even more importantly, solicit feedback from those attending as to the City's most critical needs. Meetings have been scheduled throughout the community with residents, employees, various labor groups, and the business community. A schedule of the meetings is included as Attachment 4.

In addition to the numerous meetings, a video replay will be available to internal and external constituents to view at their convenience, and the EngageRiverside.com web portal will be used for ongoing education and communication on the budget.

In April, following the aforementioned public meetings, all City departments will present to City Council the details of their proposed FY 2016/18 budgets and five-year plans – which will take into account the input received in March through the various channels discussed earlier. We believe in an exceptionally transparent and participatory budget process, very different from that ever undertaken at the City – with the goal of collectively identifying the current challenges/critical needs and to propose solutions that give us the ability to address those issues.

B. Fund Structure Overview

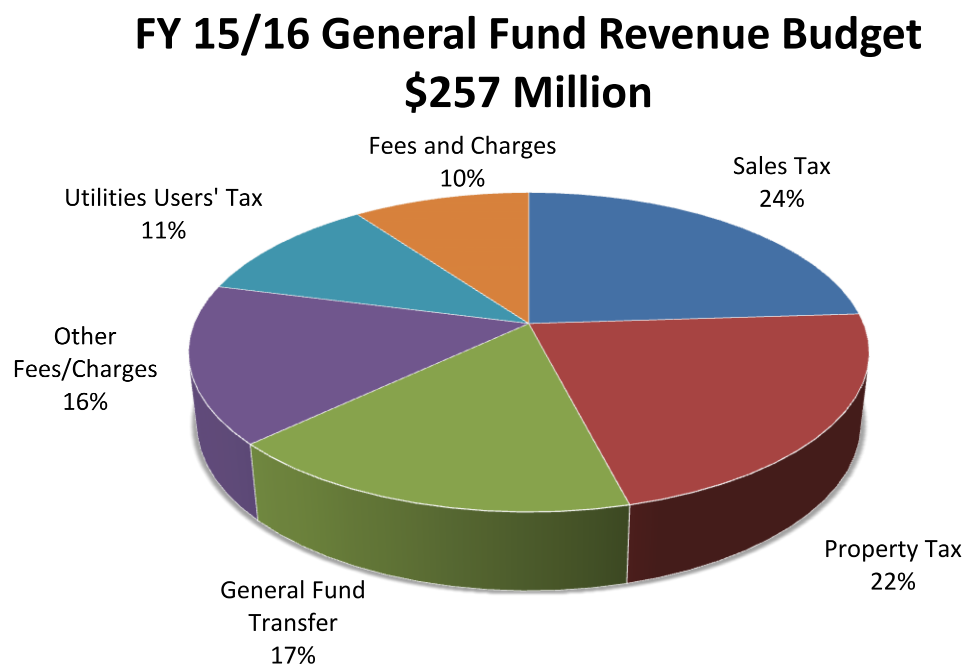
The City is a complex organization providing a wide array of public services. The City's financial system is designed to provide the appropriate accounting for each discrete operation. It does so through a variety of funds, departments and divisions. Most City funds are managed by a single City department (e.g., the Gas Tax Fund is managed by Public Works) and account for a single activity (e.g., street improvement projects funded with Gas Tax receipts). The City has approximately 100 individual funds; most exist to account for a specific funding source (such as transportation-related grant funding) or specific type of expenditure transaction (such as debt service payments).

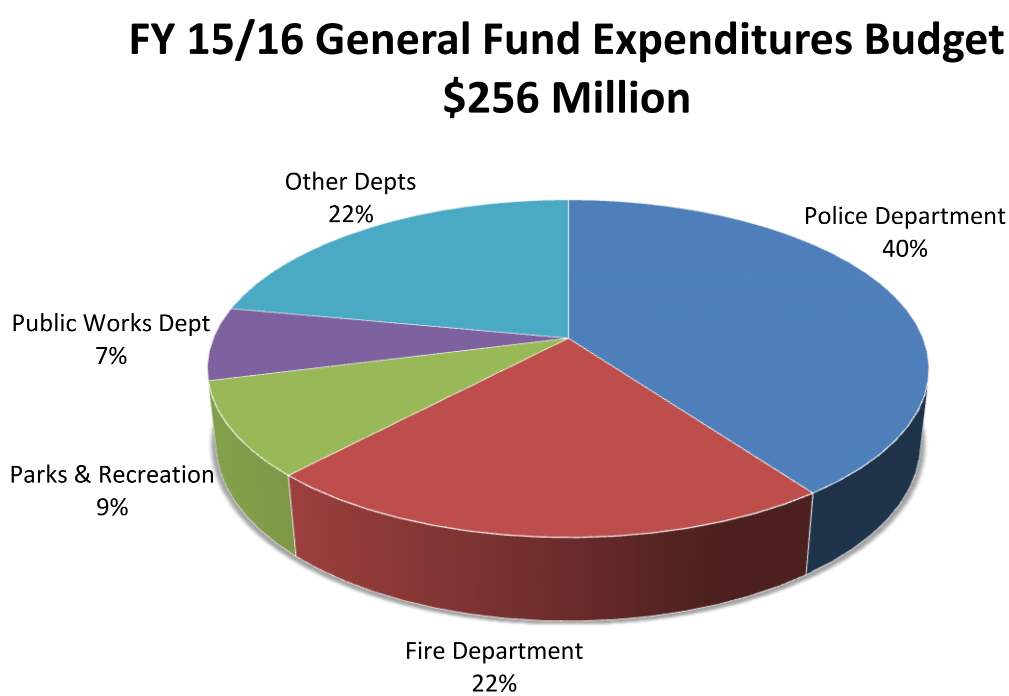


At a high level (and consistent with reporting in the City's financial statements), in addition to the City's General Fund, there are eight other "fund types," or groups of similarly purposed funds. These fund types include:

1. **Special Revenue** – Account for funds legally restricted for a specific purpose (e.g., Gas Tax Fund, Air Quality Management District Fund).
2. **Internal Service** – Capture costs and payments for services and goods provided by one City department to other departments (e.g., Central Warehouse Fund, Central Garage Fund).
3. **Enterprise** – Account for the operations that are financed and operated similar to that of a private business entity (e.g., Electric, Water and Sewer Funds, Airport Fund).
4. **Capital Projects** – Account for acquisition and construction of major capital facilities other than those financed by Enterprise or Internal Service funds (e.g., Storm Drain Fund, Transportation Fund).
5. **Debt Service** – Account for the accumulation of resources for the payment of long-term debt principal, interest and other related expenditures (e.g., General Debt Service Fund).
6. **Agency** – Account for special assessments that service no-commitment debt (e.g., Various Community Facilities District and Special Assessment District funds).
7. **Permanent Fund** – Used to report resources that are legally restricted to the extent that only earnings on those resources are available for expenditure for general government purposes (e.g., Library Special Fund).
8. **Private Purpose Trust Fund** – Used to account for the resources received and expended on behalf of another legal reporting entity other than the primary government (e.g., Successor Agency Private Purpose Trust Fund).

The most complex fund is the City's General Fund. As in all other municipal entities, in Riverside this fund gets the most attention, and is most often associated with the question "How is the City doing financially?" The City's General Fund has the accounting structure to track major revenue sources (such as Property and Sales taxes), and the expenditures for 16 departments (including Police; Fire; Public Works; Parks, Recreation and Community Services; Community and Economic Development; Library; Museum and Cultural Affairs; City Manager; the elected offices of City Council and Mayor; City Clerk; City Attorney; and the internal functions of Finance, Human Resources, Information Technology and General Services).





C. Key Revenues

Just as the City has a large variety of funds, it has a similar number of revenue sources. The General Fund accounts for many of these, but significant revenues exist in other funds too. The following is a summary of the key revenues received by the City, the fund in which they are accounted for, and key assumptions on revenue changes in the next five years.

<u>General Fund</u>

- **Sales Tax** – The City receives one percentage point of the local tax assessed by merchants on taxable sales throughout the City/County. Currently the sales tax rate in Riverside is 8.00%. This compares to a higher rate of 8.25% in San Bernardino, and the same 8.00% rate in Moreno Valley, Corona, Temecula and Ontario. The Sales Tax rate can generally be increased with a local vote by adding as little as 0.25% and as much as 1.00% to the existing rate.

  The Sales Tax accounts for 24% of the General Fund revenue, and is projected to generate $63 million in FY 2015/16. Staff uses both historical trends and consultants/economists to aid in the projection of subsequent years' receipts. Current five-year projected increases range from 4.4% to 5.7%.

- **Property Tax** – The City shares the 1% Statewide property tax revenues in the distribution with other governmental entities throughout the County (schools, County, etc.). This tax is assessed on real and certain personal property. Of each property tax dollar paid within Riverside, approximately 12 cents is received by the City to help fund local municipal services.

  The Property Tax accounts for 22% of the General Fund revenue, and is projected to generate $54 million in FY 2015/16. Staff receives indications from the County on the anticipated growth of property values (called "assessed valuation"), which is used for projecting future revenues. Current five-year projected increases range from 4.2% to 7.3%.

- **General Fund Transfer (GFT)** – The City Charter permits an 11.5% charge against gross operating revenues of the City's own Electric and Water operations. Utility staff provides an estimate of future operating revenues subject to the 11.5% rate. The GFT represents 17% of total General Fund revenue. A slight decrease in the GFT for FY 2016/17 is anticipated, with moderate increases ranging from 1% to 3% to follow in the remaining four years of the five-year plan.

- **Utility Users' Tax** – The City Charter sets a 6.5% tax on most utilities (except for cell phone service), which service providers include on their billing statements, collect, and remit to the City on a periodic basis. Staff's knowledge of the factors affecting the various utility services enable it to make a reasonable projection based on an adjustment to the current year's level of activity. The UUT represents 11% of total General Fund revenues and are projected to increase between 2.0% and 3.0% over the next five years.

- **Fees and Charges** – The City periodically conducts Fees and Charges studies, which set rates of recovery for hundreds of services provided by various City departments. Historical trends and staff's knowledge about the factors affecting the demand for its services are used to project this revenue stream. Fees and Charges collectively represent approximately 10% of total General Fund revenue. Fees will remain at current levels until a new study is undertaken, which is likely to occur within two years.

- **Transient Occupancy Tax (Hotel Tax)** – The City's 13% tax is assessed on most hotel/motel room night lodging bills. Projections are made based on historical trends, information provided by an economist, and staffs' understanding of the strength of the City's key hotel operators. The Hotel Tax accounts for 2.4% of General Fund revenues and is projected increases range from 4.3% to 5.3% over the next five years.
- **Franchise Fees** – Various non-City utilities are required to pay this fee to reimburse the City for impacts on streets from large service vehicles and the opportunity to use the public right of way for installation of equipment necessary to provide their service. Projections are made based on historical trends, information provided by an economist, and staff's knowledge of issues affecting the respective utilities' business demand. Franchise Fees represent 2.1% of the General Fund and are projected to increase between 3.0% and 9.6% over the next five years.

<u>Electric, Water, Sewer and Refuse Funds</u>

- **Fees for Service** – These revenues are collected from users of the services based on rates adopted by the City Council. Estimates of future years' receipts are generally based on the anticipated future demand for service. Electric and water fee revenues are more difficult to project, as they are subject to variables beyond staff's control. Sewer and refuse fees are a more predictable revenue source. Total fee revenues for these four primary City-provided utilities are projected to be $491.8 million in FY 15/16.

<u>Gas Tax Fund</u>

- **Taxes** (passed through from other governments) – These revenues represent a portion of the taxes collected on a per gallon basis of fuel purchases made within the state of California. Funds are remitted to the state by local fuel merchants, and the local portion is returned to the City based on State formulas. Estimates of future receipts are generally provided by the state. Gas Tax revenue is estimated to be $6.6 million is FY 15/16.

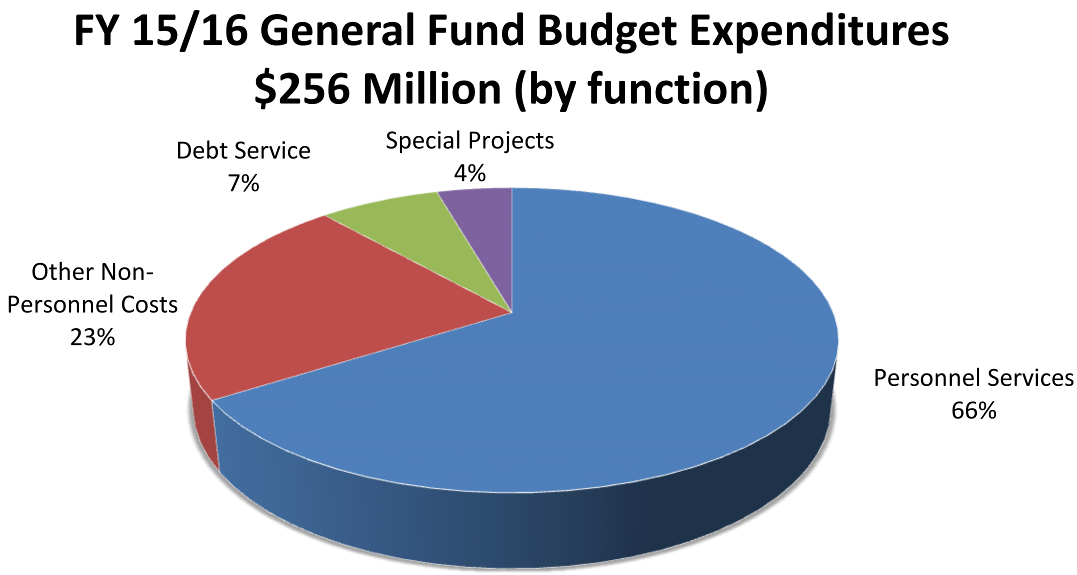
<u>Measure A Fund</u>

- **Sales Tax** – The City receives a portion of the special ½ cent sales tax collected throughout the County dedicated to transportation. Projections are based on historical trends, periodic information provided by the County, and general assumptions associated with the projection of sales tax revenue (noted above). Total Measure A revenue for FY 15/16 is estimated to be $6.8 million.

D. Key Cost Drivers

<u>Personnel Costs</u>

For the City's various operating funds, personnel costs are typically the greatest driver of expenditures. In the General Fund specifically, personnel expenses (comprised of salary and benefits) make up nearly 66% of total budgeted costs.



- **Salaries**: City employee salaries account for 48% of the General Fund budget. Most City employees' compensation increases are governed by negotiated contracts with employee bargaining units, which lay out salary increases and benefit changes over some fixed period of time. As part of this two-year budget / five-year plan development process, City management is discussing with labor groups the idea of discontinuing the traditional cost-of-living increase approach to salaries, and replacing it with a new model that would result in raises being tied to the success of the City's revenue base – if revenues are strong, a better raise occurs; if revenues are weaker, then a lesser raise results.

- **Pensions**: Pension cost account for 15% of the City's General Fund budget. There are two components of the pension costs: 1) the required employer contribution (which currently ranges from 21.012% for non-safety to 31.549% for safety); and 2) employee contribution (8% for non-safety and 9% for safety in most cases). For most employees, the City has traditionally paid both the employer and employee portion. In January 2013, changes were made pursuant to a new State law to require *new* City employees to fully pay the employee share. Currently, 30% of non-safety City employees and 15% of safety employees pay their full share of retirement.

  Pension cost increases is the single largest variable the City is currently facing. These increases are set by the State pension fund in which the City participates, CalPERS, and are generally based on CalPERS' assumptions regarding the City's employee census vis-à-vis the desirable level of pension funding.

  The issue of pension funding has received significant media coverage in recent years, largely since the economic recession and poor market results caused huge losses to the CalPERS investment portfolio several years ago. In response to the losses, CalPERS has taken a closer look at several aspects of their business (such as the assumed investment return), all of which ultimately affect the City's pension contribution rates and cause them to increase. In each case, CalPERS has made conservative decisions for the pension plan (such as decreasing the assumed investment return rate from 7.5% to 6.5%). These changes will work substantially toward securing the long term financial health of the plans, but in turn have resulted in a significant increase in pension rates in recent years. Further rate increases are planned over the next several years.

The City's five-year plan incorporates the projected rates from CalPERS, as follows:

	Required Rate	**Projected Future Employer Contribution Rates**			
	2016-17	**2017-18**	**2018-19**	**2019-20**	**2020-21**
Safety	34.8%	37.6%	40.3%	43.1%	43.7%
Non-Safety	23.0%	24.9%	26.9%	28.8%	29.2%

Currently, the City's two plans (for safety and non-safety employees) are each at about 82% funded. CalPERS' current rate actions will further improve the plans' funded status, and the City simply needs to continue making the required payments.

To help address the pension funding issue, City management is assessing a transition of "Tier 1" employees, for which the City currently pays the full pension cost, to make their full contribution towards the employee share, as discussed above. This will reduce a portion of the pension cost, create compensation equity among same classes of employees, and generate resources to continue providing the City's essential services. This action requires consent of labor groups.

- **Retiree Medical Benefits (Other Post-Employment Benefits, or OPEB)**: Another topic often heard about in the media these days, sometimes more threatening than the pension matter, is "Other Post-Employment Benefits," or OPEB. This is traditionally when a government has promised lifetime benefits of one kind or another (most typically healthcare) to an employee and is simply funding it on a "pay as you go" basis (as opposed to pre-funding). In many cases, OPEB benefits have placed an increasing financial burden on government entities. As the "baby boomers" are beginning to retire, the cost of this obligation is growing many times larger, and government revenues are not growing proportionately. With people retiring earlier and living longer, the math for some cities, and also for the state of California, is staggering.

  In Riverside, the City has not directly made promises of post-retirement healthcare to employees. Instead, pursuant to negotiated contracts, the City currently makes monthly contributions of $100 per employee to fund a stipend designed to offset a portion of the cost of retiree healthcare. The City contribution to the funding of this stipend can be negotiated higher or lower in subsequent contract agreements. Accounting rules, however, dictate that despite the specific terms of our labor contracts, full obligation of the OPEB liability related to labor union-funded benefits is required to be disclosed in the City's financial statements. Consequently, the City's audited statements show the unfunded OPEB obligation at $28 million.

  One other OPEB related item is the inclusion of retirees in the City's rate-setting negotiations with our healthcare providers. The logic is that by offering below-market health insurance rates to retirees by virtue of including them in a larger group plan, we are creating a long term post-retirement obligation. Again due to accounting rules, the City's financial statements disclose an unfunded liability of $19 million related to the retiree rate subsidy.

<u>City Debt Portfolio</u>

The City currently has an outstanding debt portfolio of approximately $2 billion. This is considered by the bond rating agencies to be a moderate debt load for an organization of our size. Riverside has incurred a significant increase in its overall debt load in the last ten years, but this has been primarily to address the deferred necessary enhancements to the aging infrastructure systems (Sewer and Water) throughout the City. Other significant additions were a General Fund Certificates of Participation issue, and a Tax Allocation Bond issue by the former Redevelopment Agency for improvements, and new construction associated with the City's Renaissance Initiative. See Attachment 3 for a comprehensive list of all City bonded indebtedness.

Any time a City department contemplates issuing a bond or entering into a lease, the first question asked is always "How are we going to pay for it?" With the utilities, this is factored into the rate analysis. For the General Fund, a sustainable revenue source is identified, which is adequate to meet the obligation. For all of the currently outstanding debt the City holds, there are identified and adequate repayment sources available to make repayment. The City makes sure of this during the debt planning process, and the bond rating agencies provide further review and assurance of debt sustainability.

<u>Interfund Loans</u>

Since last May, the subject of interfund loans has been discussed publicly on several occasions. These internal borrowings, approved by the City Council over the years, fund smaller, shorter term projects for which outside financing would have been significantly more costly. These loans consist of one fund making a loan to another fund using resources it does not immediately need. The interfund loans have always received City Council approval, bear interest at the same rate the loaning fund would have received if the funds were left in the City's invested cash pool, and have always been accounted for properly. The Sewer Fund has historically been the fund most commonly tapped to fund these loans, and a special audit of that activity was accomplished about one year ago to confirm that the accounting and use of these funds was appropriate and properly handled. Nevertheless, the repayment of these loans is a priority for the City.

In conjunction with this year's financial and performance audits, the balance of the loans (outside the Sewer Fund) will be evaluated. The outstanding balance of these loans was approximately $30 million at June 30, 2015, about half of which were the obligation of the Successor Agency to the former Redevelopment Agency. With the recent approval by the State Department of Finance of the City's Redevelopment financials, these loans are now getting repaid. Approximately $7 million in outstanding balance is being repaid by June 30, 2016 and the remaining loans are being repaid per their original terms.

Attachment 5 provides a listing of the current interfund loans and repayment plans for the next five years.

E. Key Financial Challenges

The City faces a number of financial challenges. The five-year plan is designed to identify others that may exist as well, and that process is underway. Key challenges currently known include the following:

- **Lack of funding for the City's basic infrastructure needs**: General Services has prepared a preliminary assessment of the known challenges related to the funding of the repairs and replacement of the City's core government facilities. The General Services report is being presented in conjunction with this Budget 101 report. In addition, inadequate levels of funding exist today for maintenance and replacement of all (not only core government) City facilities, vehicle replacement and technology. Additionally, there is a need for street lighting infrastructure that has no current funding source available.

- **Operating budget challenges**: In addition to capital funding deficiencies, there are also operating budget challenges, which place stress on the City's ability to balance the budget every year. As noted earlier, pension costs are increasing every year for the next several years.

- **Liability reserves**: The Insurance Trust Funds (for General Liability and Workers' Compensation) are not funded at the level deemed optimal. Staff is working on a reserve policy to address this issue. This will require additional funding, competing against many other critical needs.

City management's intention with the five-year plan is to identify these needs and propose solutions that address them over a reasonable period of time. In the next section below, potential "Key Opportunities" are discussed to address the above and other potential challenges.

F. Key Opportunities

City management is already working to identify possible solutions to the fiscal challenges presented above. These opportunities will enable the City to put resources toward the list of critical needs being developed. Currently contemplated potential solutions include the following:

- **Sale of City properties**: City staff is assessing all properties owned by the City and/or the Successor Agency, and will be recommending sale of some of them in order to generate proceeds for other capital needs, such as facility repairs and replacement.

- **Additional Effectiveness and Efficiency Measures**: As part of the two-year budget / five-year plan process, City departments have already been asked to identify additional effectiveness and efficiency measures to help address the currently unfunded and new programs. Some of the recommendations will likely come from the performance audits currently performed for Finance, Human Resources and Riverside Public Utilities. In addition, FY 2016/17 the City will embark on a performance measurement program to evaluate the effectiveness and efficiency of the City's various operations, and recommend improvements. Such improvements would allow for greater productivity from the same set of resources as currently exist.

- **New Revenues**: The City will need to generate significant additional revenues to fund its existing obligations, particularly related to capital facilities, fleet, information technology infrastructure, and new essential programs. Such additional revenues may take the shape of new or updated fees for services, economic development initiatives that bolster existing revenue sources like property and sales taxes, or new innovative revenue opportunities. Tax increases must also be given a careful consideration, given the magnitude of the City's unfunded critical needs.

G. FY 2016/18 Biennial Budget Process

This meeting is the first public discussion of the two-year budget / five-year plan. As discussed earlier and reflected in Attachment 4, additional extensive meetings will take place with the various internal and external constituents

Following the numerous public meetings, staff will finish compiling the final draft of the two-year budget / five-year plan, and set it for public hearing in May in accordance with the City Charter requirement. Final budget approval will take place in June.

FISCAL IMPACT:

There is no direct fiscal impact associated with this report. However, the report points out significant financial challenges facing the City in the next five years – challenges that must be addressed with significant additional resources.

Prepared by:	Brent A. Mason, Finance Director/Treasurer
Certified as to availability of funds:	Brent A. Mason, Finance Director/Treasurer
Approved by:	Marianna Marysheva-Martinez, Assistant City Manager
Approved as to form:	Gary G. Geuss, City Attorney

Attachment:

1. Presentation
2. Community Report
3. Citywide Debt Summary Schedule
4. Public Meetings Schedule
5. Interfund Loan Balance and Repayment Schedule