

May 14, 2004

Mayor and City Council
City of Modesto
1010 Tenth Street
Modesto, California 95354

SUBJECT: Proposed Operating Budget & CIP for Fiscal 2005

Honorable Mayor and Members of the City Council:

Transmitted herewith is the Fiscal Year 2005 Proposed Operating Budget & Interim CIP.

The Proposed Operating Budget totals \$288.8 million in all operating funds. Total revenues are estimated at \$282.9 million, and the budget projects the net use of \$5.9 million from reserves City-wide. Proposed General Fund expenditures total \$107.1 million, compared with revenues of \$103.0 million. \$4.1 million in General Fund reserves will make up the difference, leaving a projected \$10.6 million ending General Fund balance. The projected balance exceeds the 8% minimum reserve policy which has been endorsed by the City Council.

The proposed budget adds no new permanent City staff positions, and eliminates thirteen permanent positions, including three executive-level managers. In addition, the proposed budget exchanges one vacant position for another with a different classification within the Personnel department. No existing employees are reclassified in the proposed budget.

Overview

Between fiscal 1991 and 2004, the State of California diverted \$34.8 million in local revenues from the City of Modesto into its own coffers. In the current fiscal year (2004), the State diverted \$6.6 million, more than double the previous year's diversion. For fiscal 2005, we are estimating a total impact of \$6.8 million from a combination of long-standing diversions (such as the ERAF shift) and more recent inventions, such as the "triple flip." This will bring the cumulative total diversion to \$41.6 million.

New impacts next year – which include a \$900,000 increase in the ERAF shift, a \$300,000 impact from the "triple-flip" and an anticipated \$2.6 million loss due to "delayed" VLF backfill payments – are expected to cost Modesto's General Fund \$3.8 million. Moreover, recent news from Sacramento suggests that the impact to the City could be \$1.2 million higher than we have assumed.

Complicating the fiscal landscape is the fact that the exact scale of the State impact will remain unknown throughout the City's budget process – and may not be clear until several months into the next fiscal year, depending on when the State's budget is finally adopted.

Negotiations underway in Sacramento hold out the hope that the State's diversions of local revenues may cease to grow two years down the road. But the outlook for the next twenty-four months remains highly uncertain.

Adding to the challenges we face, the California Public Employees Retirement System (CalPERS) has notified the City of significant rate hikes to make up for the lackluster performance of the system's investment portfolio and increased benefits to certain employee classes. These will raise the City's required payments to CalPERS by over 30%, at a cost of \$2.6 million to the General Fund.

The combination of a \$3.8 million estimated revenue diversion by the State and a \$2.6 million cost increase due to CalPERS has, needless to say, greatly increased the difficulty of developing the 2005 Proposed Budget. However, thanks to hard work and creative energy of our managers and staff, as well as the members of the City Council, I am able to present a Proposed Budget which addresses these challenges prudently, and with the minimum possible impact on the services we provide to the public.

Holding the Line

The City's general fund – which primarily pays for services like police, fire, parks, and recreation – faces a shortfall of \$8.7 million. More than three-quarters of this gap is due to State and CalPERS impacts described above. Our priority in this budget process has been to address these impacts responsibly while preserving critical City services.

Over the past few years, the City of Modesto has prudently positioned itself to withstand such a challenge. In each of the past two years, we have reduced department budgets and deliberately slowed hiring in order to build up our "rainy day reserve." Now, the rainy day has arrived. In keeping with the City Council's direction, the Proposed Budget addresses just under half of the shortfall (\$4.1 million) by tapping our reserves. We expect that this will leave a General Fund

balance of \$10.6 million at the end of fiscal 2005, which exceeds the minimum reserve established by Council policy (8% of General Fund expenditures, or about \$8.8 million).

The remainder of the shortfall is addressed with a combination of non-tax revenue measures, one-time savings, and operating budget cuts. The Proposed Budget includes \$3.3 million in budget cuts, which will result in the loss of thirteen permanent City staff positions (of which five are presently filled).

We have worked throughout the budget process to minimize the impact of these budget cuts on the general public. However, given the scale of the reductions that have been necessary, some visible impact to the community is inevitable. Some examples include the following:

- Funding for the Convention and Visitors Bureau (CVB) will be reduced by approximately 16%, overriding the existing funding formula which ties CVB funding to the level of Transient Occupancy Tax (TOT) revenue
- Funding for public access cable television (Channel 26) will be eliminated
- Funding for local arts groups, festivals and most events will be eliminated. Community groups will be asked to pay the cost of City services – such as police, fire and clean-up – provided at local events.
- Maintenance of nine “pocket” parks in various neighborhoods will be ended, except for safety-critical tasks
- Watering of parks will be scaled back, and tree replacement will cease
- City Hall at the Mall (CHATM) will be closed, though a police presence will remain at the site
- The multi-purpose recreational facility at Somerset Middle School will no longer be available through City recreation programs
- The open swim program will no longer be available at Davis and Downey High Schools
- Certain tennis courts will be closed and lighting will be deactivated at all City tennis courts

Preserving Critical Services

Funding for critical services and key priorities has been preserved in the Proposed Budget. For example:

- At the direction of the City Council, the Police and Fire departments have been excluded from cuts in the 2004-5 budget
- An additional \$720,000 has been budgeted to partially or fully replace grant funding for Police staff, and to provide the required local matching funds for other Police grants
- An additional \$500,000 has been added to the Police and Fire department budgets for increases in the cost of the emergency communications and dispatch center
- The Leisure Bucks program remains available to City youth

Organizational Change to Improve Efficiency

In this budget, I am proposing significant organizational changes to prepare city government to meet the uncertain future. Specifically, I am proposing:

- To transfer responsibility for the maintenance of our parks (as well as other facilities maintenance) from the Operations & Maintenance department to the Parks, Recreation and Neighborhoods department. This will put full responsibility for Modesto's parks system under one roof.
- To combine the remaining responsibilities of the Operations & Maintenance department with the responsibilities of the Engineering & Transportation department to create an integrated Public Works department.
- To combine the positions of Finance Director and City Manager, for additional cost savings.

These steps will result in the elimination of three executive management level positions and two support positions, yielding an ongoing city-wide savings of almost \$600,000 per year, of which between \$400,000 and \$450,000 will accrue to the general fund. Transition costs of up to \$100,000 are anticipated in 2004-5 fiscal year.

More important than the savings, however, are the long-term organizational benefits I believe will flow from establishing fully integrated Parks and Public Works departments. This structure will streamline operations and create opportunities for efficiencies which might have been overlooked in the past.

Fiscal Prudence

The Proposed Budget strikes a prudent balance between fiscal conservatism and protecting vital community services, in line with the City Council's policy guidance. Specifically, the Council has directed:

- That we should assume a “most likely” scenario for calculating the available balance of the City's General Fund as of June 30, 2004, estimated at \$14.7 million
- That we should preserve a minimum reserve in the General Fund not less than 8% of General Fund expenditures (approximately \$8.8 million in fiscal 2005)
- That we should provide funding for the workers compensation and general liability self-insurance funds at a level consistent with the actuarially determined expected cost of losses
- That we should provide funding for the post-retirement health benefits reserve sufficient to keep that unfunded liability from growing in fiscal 2005
- That we should establish an Elections fund to account for the costs of municipal elections, allowing the City to set money aside for elections on a steady annual basis

Utilities

Another issue facing the City – and being addressed on a “parallel track” with the budget process – is the physical and financial condition of its water, sewer and storm drainage utilities. A major effort is currently underway focusing on the improvement of the water system, with similar efforts on sewer and storm drainage to begin soon.

A confluence of factors is leading Modesto's water utility to rely increasingly on treated surface water to replace wells: stricter water quality standards, falling pressure in many wells, and concerns about potential contamination. This shift towards surface water use is intensifying the need to invest in a major expansion of the existing water treatment plant, and to make additional capital improvements in the overall water system. Current water rates are not adequate to finance these improvements, and a process is underway to identify and implement rates which are both financially adequate and equitable to all of our customers

The City's sewer utility faces a major backlog of deferred maintenance and capital improvement needs, and the storm drainage utility is in a similar situation. New master plans are being developed in both of these areas, and rate increases will be called for. The drainage utility poses a special challenge because a rate increase would require an affirmative public vote.

Interim CIP

Along with the Proposed Operating Budget, I am submitting an Interim Capital Improvement Program (CIP). The City has embarked on a wide-ranging review of its capital improvement projects, as well as the processes and procedures for managing them. In order to allow adequate time for this review, we are submitting an Interim CIP which includes only existing projects which are being continued into 2005 and a small number of selected new projects which must get underway before the target date for the “full” CIP. The Interim CIP also includes water utility projects which have been identified as part of the parallel process described above.

Policy Issues & Staff Papers

This year’s Proposed Budget document includes an expanded *Policies & Issues* section which highlights a range of policy questions and topics for discussion by the City Council, supplemented with a set of staff papers prepared by City departments on selected topics. Key policy areas include:

- The condition of Modesto’s streets and the funding needs of street maintenance
- Staffing options for the Police and Fire departments
- Revenue options
- Parks maintenance service needs & impacts
- Post-retirement health benefit liabilities

Conclusion

The good news in this budget is that we have planned for the ongoing losses due to the State’s revenue diversions, and we will be able to survive the upcoming year with only incremental reductions in the level of most of the services we deliver. There is also bad news, however. Our community still has many unmet needs – and the City simply lacks the resources to make major progress towards meeting them.

More than one quarter of the City’s streets are in poor or very poor condition, and the cost to repair them is estimated at over \$95 million. Increasing Police Department staffing to a level of 1.85 sworn officers per 1,000 population would cost approximately \$16 million per year, with additional increases needed each year to keep pace with the growth in population. Adding firefighters to meet the NFPA standard of four trained personnel per engine and truck company would cost \$5 million per year, and adding three rescue companies could cost another \$1.5 million annually. And this list does not even begin to address the parks, ball fields, pools, and cultural facilities that truly make a community blossom.

As the City's finances now stand, services like these are out of reach.

I am confident that the City will meet these challenging financial times with creativity and innovation. The City Council and City staff are working well together to streamline City services, reduce costs and balance our budget. This will be an ongoing effort during the year to come.

Respectfully Submitted,

Jack R. Crist
City Manager