CITY OF
**LA MESA**
JEWEL of the HILLS

***INTEROFFICE MEMO***

DATE: January 20, 2009

TO: Mayor and Councilmembers

FROM: Sandra L. Kerl, City Manager

SUBJECT: Council Study Session: Financial Background Material

The purpose of today's Study Session is to focus on the City's finances through the end of the 2008-2009 Fiscal Year, ending June 30, 2009. This is an opportunity for the City Council to provide any policy direction it deems appropriate to Staff on further cost cutting measures or deferral of expenditures for the preservation of cash flow in the General Fund to the end of the Fiscal Year. The policy recommendations for action on the City's finances are provided under Attachment "A."

It is the City's intent to be fully transparent in all of its financial matters. This memo will serve to provide information on how the City's budget is developed, adopted, and monitored. Information is presented to respond to a number of questions regarding the City's salary and benefits costs and obligations to PERS. Additionally, a number of questions surrounding the City's responsibilities and commitment to the community with the passage of Measure L will be addressed, including what the measure is anticipated to yield and what opportunities and threats exist in today's economic environment. This information will assist in setting the stage for the Council's Strategic Planning Session in March and prepare everyone for the opportunities and challenges that will face the organization in preparing the FY 2009-2011 budget. This will lead to the recommendation of policies for the City Council's consideration which will guide the development of the next budget and key work efforts. These recommendations will be presented at the March Workshop.

## Budgeting

One of the key responsibilities of the City Manager is to prepare and present a budget for the organization to the City Council for consideration on an annual basis. The City budget is on a two-year cycle with a mid-biennium update presented to the Council for approval prior to the beginning of the second year of the two-year budget cycle. The City prepares its budget using a line-item development and review process. The budget must be balanced which means that revenues and expenditures have to match for it to be adopted by the City Council.

The Preliminary Biennial Budget or Mid-Biennium Budget is presented to the City Council in June of each year at either a Regular or Special Meeting of the City Council. The City Council then approves a Final Budget, with usually minimal changes, reflecting year-end financial numbers, and transmits it to the State Auditor/Controller's Office, as required by State law. A copy of the Final Budget for FY 2007-2009 is provided as Attachment "A-1". The preparation of the next two year budget for FY 2009-2011 has begun and below is a schedule of the key dates in that process.

## 2009-2011
## Budget Calendar

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| January 20 | Council discussion of budget and policy directions through the end of fiscal year |
| February 3 | Town Hall Meeting #1 – Northmont Elementary School |
| February 5 | Town Hall Meeting #2 – Rolando Elementary School |
| March 17 | Council Strategic Planning Workshop |
| March 18 | Senior Management Group meeting to review budget direction from Town Hall Meetings and Council Strategic Planning Workshop |
| April 6 | Departments submit budgets to Administrative Services/Finance |
| April 27–30 | Individual budget review sessions with City Manager, Assistant City Manager, Director of Administrative Services, and department staff |
| June 9 or 16 | Council to review and adopt Preliminary 2009-2011 Budget |
| August 25 | Adoption of Final 2009-2011 Budget |

The City faces a number of challenges in the preparation of the FY 2009-2011 budget. Many of the City's General Fund expenses are subject to the fluctuation of the economy and measures outside our control such as retirement and healthcare costs, utilities, and services and supplies. Additionally, the City's revenue locally is impacted by the economy and the actions of the State in regards to their own budget. It is anticipated the economy, for at least the next 12 months, will fluctuate significantly and that the State will take some amount of the City's current revenue.

In regards to our Special Funds, there are several threats to them that are outside of our control. These include but are not limited to:

- Large liability or workers' compensation claim settlements
- Spikes in utility costs (e.g., fuel)
- San Diego sewer transportation/treatment costs
- Additional State Redevelopment takeaways

The City should avoid ongoing obligations which will require financial resources from the General Fund to continue support for grant funded services. Staff has previously secured several multi-year grants but has not made any ongoing expense commitments beyond the grant period. Many of our Police grants are funding overtime details and our Rides for Neighbors grant provides funding for a temp help position that could be eliminated if the funding is not renewed when the current grant expires.

Lastly, the preparation of the next budget will be challenging given the need to address new State mandates that are unfunded. The most significant of these is the implementation of AB 32 and SB 375. These two bills address the reduction of carbon emissions in all jurisdictions and will be very similar to the implementation of NPDES in terms of scope. Other areas of governmental regulation which may impact the City are related to water conservation. The scope and breadth of the City's responsibility in this area is not known at this time.

Economists vary in their predictions of how long the recession and the housing downturn will last. If the recession deepens it will further drag down housing prices and retail sales activity. Staff will continue to review economic projections and will present our revenue assumptions and estimates during the six-year Financial Forecast presentation at the March 17 Council Strategic Planning Workshop.

**Civic Engagement**

Prior to the preparation of the City's budget, the City Council has for many years sought community input to guide its policy direction to Staff. The City embarked on a Civic Engagement process which provides for receiving input from the community on priorities and desired allocation of resources on an annual basis. The Civic Engagement process began 12 years ago and entailed a Community Summit every two years and in the off year a Citizen Satisfaction Survey would be conducted. The process evolved over time, including community meetings on critical issues to the current format of two annual Town Hall meetings and an every two year Citizen Satisfaction Survey. The receipt of community input is followed annually by a Strategic Planning process with the City Council. During the Strategic Planning Workshop, the City Council considers the collective input from the community and develops the Targets for Action, the key projects to be completed in the upcoming year, and sets the policy direction for Staff to use in preparation of the biennium or mid-biennium update budget.

A copy of the responses to the Civic Engagement process for 2008 is included in the notebook as Attachment "B". This includes the results of the two Town Hall meetings in 2008. The 2009 Town Hall meetings will be held on February 3, at Northmont Elementary School, and February 5, at Rolando Elementary School. Both meetings will start at 6:30 p.m. and end at 8:30 p.m.

## Strategic Planning

Annually, the City Council holds an all day Strategic Planning Workshop. The purpose of the Workshop is to evaluate data from a number of sources. These sources include the City's updated six-year financial forecast, recent community input, anticipated financial and personnel resources, and recommendations from the City Manager. This information is used by the Council to affirm or amend the Strategic Directions and Five Year Goals and develop policy direction for the Staff's preparation of the upcoming budget and revision of the Targets for Action. A copy of the City's Strategic Direction, Five Year Goals, and 2008-2009 Targets for Action are provided as Attachment "C".

## Monitoring

The financial position of the City is monitored on a continuous basis through a number of methods in a transparent manner. The City Manager and Department Heads receive monthly financial reports which show expenditures and revenues to-date and how that compares with both previous years and percentage of the year completed.

The Director of Administrative Services provides a Quarterly Budget Monitoring Report to the City Council which contains an assessment of the National, State and local economy, its impact on the City's financial position, and the experience to-date on revenues and expenditures in the General Fund. A copy of the 2008 Quarterly Budget Monitoring Reports is provided as Attachment "D". Beginning this fiscal year, a Cash Flow Report is provided to the City Council showing the balance of General Fund monies each month. All of the monthly Cash Flow Reports are part of Attachment "E" as well.

An annual audit is conducted by a third party accounting firm and presented to the City Council. This year, in compliance with new Governmental Accounting Standards Board rules, the City Council created an Audit Committee. The Audit Committee consists of the Mayor, one Councilmember, and the City Treasurer. This Committee communicates directly with the third party auditor and previews the audit results with the ability to look at the details and assess the completeness and validity of the audit. Following the Audit Committees review of the audit, it is then presented to the entire City Council for approval.

Finally, the City maintains a Performance Measurement System which provides for accountability for every department. The data for 2008 is being assembled now and will be provided to the Council at the Workshop in March. Within this measurement system, quarterly police department reports are provided to the City Council to monitor crime activity and Police Department response.

All of these tools assist the Staff in managing the resources of the City and provide the City Council and public full disclosure on a timely basis of the City's financial situation and service levels provided to the community. Upon completion of any monitoring reports, financial or operational, being presented to the City Council at a regular meeting, those reports are posted on the City's web site for easy community access.

**Financial Policies**

The City Council has an adopted policy regarding financial reserves for the City's General Fund. The purpose of the policy is to guide the use of resources to ensure that sufficient funds are maintained to address emergency situations and maintain cash flow. The Reserve Policy adopted by the City Council (Attachment "F") calls for the maintenance of a 15% reserve of General Fund expenditures. While this has been viewed as an appropriate level, information gathered during a review of the City's finances by a bond rating agency suggest that the City should have higher levels of reserves, given the limited number of revenue sources and their volatility based on the economy. They shared a survey of similar sized cities that showed the average city had reserves of about 40%. The monthly Cash Flow Report has demonstrated the need for a reserve target of about 25%, just to cover cash flow needs during the year. It will be a challenge to get reserves to the necessary level due to the current balance between revenues and expenditures; however, proceeds from one-time land sales and the anticipated increased sales tax revenue will assist in meeting that level over time.

The General Fund has ended several months in FY 2008-2009 with a negative cash balance. There have been no transfers between funds to cover for cash flow shortages in the General Fund so there are no "due to" entries in our financial statements. Rather, we have let the General Fund balance be negative at month-end and adjusted investment interest allocations to account for the cash positions of each fund. Effectively, the General Fund is paying interest on these shortages based on our investment earnings rate. These cash flow shortages have been reported in the new monthly General Fund Cash Flow Report that we began preparing this fiscal year.

Investments for the City are governed by the adopted Investment Policy and are made based upon consideration of the Investment Committee which consists of the City Treasurer, City Manager, and Administrative Services Director. A copy of the Investment Policy is provided as Attachment "G". Each year, the City Treasurer reviews the Investment Policy and takes any changes to the City Council for approval. This Policy is important so that the types of investment made on the City's behalf are in safe products to ensure the security of the funds. Investments are important to the City's bottom line because the interest earned is part of the City's anticipated annual revenues.

**Salary and Benefits**

The City maintains Memorandums of Understanding (MOU) with all three of the labor groups. The MOUs provide for the understanding between the City and the labor groups about the terms and conditions of employment and are negotiated under the Meyers-Milias-Brown Act which governs the collective bargaining process.

During the collective bargaining process, the terms and conditions of employment are renegotiated for a specific period of time. Any changes to salaries or benefits (e.g. retirement benefits) must be bargained with each of the City's three bargaining units. Retirement changes mandated by the State Legislature or through the initiative process would be effective prospectively for new hires as of a certain point of time (i.e., creating a two-tier system).

The City analyzes the total cost of compensation as part of the collective bargaining process. This has typically been accomplished as separate looks at La Mesa's salaries compared to the other cities with like classifications and an overall look at how our benefits match up with other jurisdictions.

Combining the value of benefits with salaries and comparing the total compensation value to other cities is possible but significantly more complicated. In this analysis, the comparison typically excludes pension costs because the cost of the pension plan varies not only based on salary and the plan's benefit levels, but also based on demographics (e.g., the age of the workforce and the number of disability retirements). Another complication is with educational incentives. These incentives are easy to quantify, but not everyone achieves them.

Although we have salary comparisons for all of our safety classifications, we do not have them for each non-safety classification. This is because there are not exact matches for some of our non-safety classifications. For these classifications, we benchmark the position to another position in a similar classification.

The data for any of these comparisons in more readily available in the public sector than in the private sector. In San Diego County, cities work together each year to keep a database of salary information updated as changes in their compensation plans are made. This database has some information on benefit levels but does not currently allow for a total compensation comparison to be made.

One of the key components of the employee benefit package is retirement. The City of La Mesa has been a member of the California Public Employees' Retirement System (CalPERS) since 1948. CalPERS offers a variety of defined benefit retirement plans. In San Diego County all cities are CalPERS members except the City of San Diego who has its own retirement plan. The City's retirement formula is 3% at 50 for safety employees and 3% at 60 for miscellaneous employees. Plans offered by the City were negotiated as part of the collective bargaining process.

CalPERS actuaries annually establish the employer contribution rate based on actuarial projections that take into account the demographics of the active and retired employees and actual and projected investment earnings on plan balances. Complicated smoothing formulas limit variability in the rates. The City must pay the rate CalPERS determines.

The City pays 100% of the cost of the required employee contribution and reports this amount as additional employee compensation for calculation of the retirement benefit. Employee contribution rates are constant based on each plan's benefits. The rate for the 3% at 50 safety plan is 9% and the rate for the 3% at 60 miscellaneous plan is 8%. Because employee contribution rates have been negotiated, the employees currently do not share directly in the costs when PERS rates are increased. These increases are directly connected to investment returns from the PERS fund controlled at the State level.

Comparison of La Mesa with other cities in San Diego County is summarized below:

Safety:
- All 18 cities 3% at 50
- 13 cities pay 100% of the cost
- Of the cities where employees pay a share of the cost the share ranges from 1% to 9.02% of pay

Miscellaneous*:
- 10 cities 3% at 60
- 4 cities 2.7% at 55
- 3 cities 2.5% at 55
- 1 city 2% at 55
- 10 cities pay 100% of the cost
- Of the cities where employees pay a share of the cost the share ranges from 1% to 8.68% of pay

*Does not include new 2nd tier plan for City of San Diego miscellaneous employees

Of a total pension budget of $5.4 million in FY 2008-2009, $3.6 million is the employer contribution and $1.8 million is the City paid employee contribution. Each 1% of pay that the employees paid would save the City about $190,000.

Three cities in San Diego County are in Social Security for their miscellaneous employees (Coronado, Imperial Beach, and La Mesa). This is the result of irrevocable employee elections in 1981 that locked in this benefit. Both the City and the employees contribute 6.2% of salary into the Social Security system. The City's cost is about $0.5 million for FY 2008-2009. Employees pay the same amount.

Attachment "H" is a table showing the history of retirement costs as a percent of personnel costs and total General Fund.

Because of the way the actuarial smoothing formulas work, there is a three year lag between investment performance and the impact on future rates. CalPERS has already issued our rates for FY 2009-2010 and the safety rate is down 0.706% and the miscellaneous rate is down 1.286% from the FY 2008-2009 rates (close to what we projected in last year's Financial Forecast). The 2010-2011 rates are expected to be very similar as the 2007-2008 investment loss experienced by CalPERS is more than covered by surpluses built up over the prior three years when returns were better than expected. The losses being experienced in FY 2008-2009 will impact rates beginning in 2011-2012. Depending on investment performance during the second half of this fiscal year, CalPERS estimates that the impact on rates will be about 0.2% to 0.5% if the annual loss is 10%, 1% to 2% if the annual loss is 15%, and 2% to 5% if the annual loss is 20%. Each 1% change in our rates costs about $160,000.

## Major Projects

No major revenue generating projects are on hold from the City's perspective. Developers are continuing to work their way through the planning process on several large development projects including the Alvarado Creek and Kitzman projects, and the Fairfield project continues to be under construction with residents now moving into the first phase. Certainly, with the housing crisis continuing on into its third year, some projects will likely continue to be on hold (e.g., Reynolds and Hilltop projects). It is unknown when economic conditions will make it profitable to move forward with these projects. Most economic forecasts for the region predict the earliest time frame for a turn around will be 2010 although it could be 2-3 years for a significant recovery.

## Capital Purchases

Staff has been closely evaluating equipment replacement purchases and has moved forward with some, while delaying others. For example, we moved forward on replacing some large Public Works vehicles that did not meet new emissions standards. We have grants that paid for most of the cost of the replacements. After a cost-benefit analysis, we moved forward on our annual replacement of police vehicles this fall in order to avoid price increases that were going into effect. Several other vehicle purchases have been delayed or are currently under review. The same analyses have been undertaken for replacement technology equipment with some moving forward and others being delayed.

## Measure L

In November 2008, the voters approved an increase of ¾ cents in the sales tax to maintain vital City services. Information provided in this section is intended to put in writing how the measure will be implemented, what commitments were made to the community with the passage of the measure, and the impact of the measure on the City's financial position.

The La Mesa Vital City Services Measure pledged "To maintain essential City services including natural disaster response/preparedness programs; youth anti-gang/anti-drug prevention; retaining quality firefighters/paramedics and police officers; increasing street paving/pothole repair; enhancing trolley station security; maintaining the senior community center, after school tutoring and recreation programs; and other general services..."

Provided as Attachment "I" is the Resolution approved by the City Council on July 22, 2008 which outlines why the measure is necessary and what sales tax increase will pay for. Two key components are included in the Resolution. First, it states that City services will be maintained. This means that today's level of service will continue with the passage of the measure. Measure L proceeds are expected to be sufficient to provide the staffing necessary to maintain those service levels.

Secondly, the Resolution states that reserves will be maintained at accepted industry standards. This is important in that the City has had to spend one-time monies to balance the budget and maintain services. Reserves are wholly inadequate at this time based on any accepted "industry" standard. Use of the measure proceeds will require the reserves to be restored and enhanced, as noted earlier in this memo. This will require disciplined control of Measure L funds to ensure that this requirement is met and that services are maintained. This has been made further challenging by the fact that the economy continues to shrink. It is unclear what the final leveling out of the economy will look like in the future.

The original annual estimate of $7.2 million was provided to the City by its sale tax consultant HdL Companies in early 2008. Based on the downturn in the economy since the estimate was prepared, we lowered this estimate by 10% to $6.5 million. In the updated six-year financial forecast presented to the City Council in March, detailed historical sales tax data will be presented, along with revised anticipated future sales tax estimates.

The tax will be effective on April 1 and the first payment to the City will come from the State Board of Equalization (SBOE) in June. The June, July and August payments are what is known as advances based on tax collection estimates. Clean up payments to true the advances up with actual collections are made in September, December, March, and June. The City will accrue the July and August advance payments back to 2008-2009 to reflect the period that the tax was collected in. The September clean up payment relates back to the April, May, and June sales period and is not timely to accrue back to the prior fiscal year.

The sales tax is collected by businesses at the time of the transaction. The tax is transmitted by businesses to the SBOE the following month. The SBOE distributes the quarterly advance to the City based on 90% of the net sales tax collections from the same quarter in the prior year. This quarterly advance amount is distributed in monthly installments of 30%, 30%, and 40% of the 90% amount. These advances compensate for the lag between the sales period and the time the tax is remitted to the City.

As the basis for the tax is different than for the regular 1% Bradley Burns sales tax, the new tax will collect less per quarter percent than the Bradley Burns sales tax. This is primarily the result of how the tax applies to vehicle sales. The new tax will only be collected on vehicles sold to La Mesa residents (even if the transaction takes place outside of the City) as opposed to the Bradley Burns tax which is applied to all vehicle sales that take place in La Mesa (even if the vehicle is purchased by a non-resident).

The new Measure L transactions and use tax will be accounted for separately in our budget and in our financial reporting. The community will receive quarterly reports on the amount of funds taken in from Measure L and how the enabling Resolution commitments are being made. This information will be timely and easily accessible through the City's website.

## Conclusion

The City's budget has been very lean for many years. While there are line items in any budget our size that some may consider necessary while others may consider them unnecessary, staff believe that we do a good job of stewarding our limited resources to assure that our residents get the most "bang for the buck."

The Staff and I look forward to working with the City Council to address the organizations financial future in March and chart a course that will lead to long-term financial stability with the ongoing provision of the City's vital services.

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| Attachment A | Short-Term Budget Actions and Recommendations Memo |
| Attachment A-1 | Final Budget 2007 – 2009 |
| Attachment B | 2008 Town Hall Meeting Data |
| Attachment C | Targets for Action |
| Attachment D | 2008 Financial Monitoring Reports |
| Attachment E | 2008 Cash Flow Monitoring Reports |
| Attachment F | Reserve Policy |
| Attachment G | Investment Policy |
| Attachment H | General Fund Retirement and Personnel Cost Analysis 1991 - 2009 |
| Attachment I | Resolution on Proposition L |