Agenda Item #:____

Staff Report
City of Manhattan Beach

TO: Honorable Mayor Wilson and Members of the City Council

THROUGH: Geoff Dolan, City Manager

FROM: Bruce Moe, Finance Director
Russell J. Morreale, Assistant Finance Director
Henry Mitzner, Controller

DATE: February 1, 2005

SUBJECT: Presentation of Fiscal Year 2004-2005 Mid-Year Budget Review

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RECOMMENDATION:
Staff recommends that the City Council receive and file this report.

FISCAL IMPLICATION:
There is no budgetary impact from receiving and filing this report.

DISCUSSION:
Executive Summary of the Mid-Year Budget Results
As we enter the second half of FY 2004-2005, the City remains in sound financial position. Revenues are within budget projections but clearly reflect the negative impacts of the California State budget, particularly as it relates to reduced Vehicle License Fees (VLF) and the deferral, reclassification, and re-scheduling of 25% of Sales Tax to Property Tax (known as the State's "Triple Flip"). In the end we stand to lose $700,000 in General Fund revenue this year and next because of these State cuts. As of December 2004 expenditures are within budget estimates, however, as discussed in the presentation of the 2004 financial audit escalating expenses, particularly in several key labor-related areas, are apparent. These cost increase areas include salaries, medical benefits, pension liabilities, and workers compensation costs.

While we reported a sound 2004 General Fund during the audit presentation last month, and have a tradition of doing so as a result of conservative budgeting and prudent spending habits, current trends suggest that the City's surplus levels will fall. At this point in the year it seems that the 2005 surplus will be much less than that experienced in the past two years. Certainly the loss of VLF revenue is one main factor as staff remains attentive to those legislative changes that threaten our ability to provide the services our community expects. In this regard, the passage of Proposition 1A provides local governments with some level of comfort against future State budget shifts, but we are aware that these protections are not absolute. The decrease in surplus levels is also expected due to minimal revenue growth (including interest income) coupled with increasing operating expenses. Such a combination of trends translates into challenges that need to be addressed in the current year as we prepare for the FY 2005-2006 budget. Maintaining our AAA credit rating has everything to do with prudent financial policies and proactive financial planning. Remaining true to these policies and practices will help us to remain in good financial shape.

The City's primary revenue sources, with the exception of VLF, remain in line with our conservative budget estimates. Our highest priority capital project, the Police & Fire facility, is adequately provided for, as are scheduled Strand and Metlox improvements. The City remains in compliance with established financial and investment policies as set forth by City Council, although current year insurance trends suggest that a transfer may be needed from the General Fund at year end to assure policy fund levels.

As of December 31, 2004, General Fund expenditures are trending 2% below original estimates and remain in line with five year average levels. Overall, General Fund revenues are projected to exceed budget estimates by 3% ($1 million) at year end, even after considering the loss of $700,000 from the State. It is critical to note that this growth projection will again be mostly powered by Property Tax which is anticipated to exceed budget by 7% ($800,000). Overall growth trends for 2003-2004 and 2004-2005 have stalled compared to past year gains reported at double digit levels. Sales Tax is showing little growth, while Hotel Tax has recovered somewhat after the large post 9/11 drop. Lastly, interest income has fallen on a year to year basis as predicted given the use of significant capital project reserves, including $28 million for Police & Fire, and the persistent low interest rate environment.

City departments continue conservative spending patterns while maintaining the high standards of service that have been established for our community. On the other hand, costs are trending higher in several key areas including employee wages, benefits and PERS pension costs. The economic challenges discussed over the past couple of years are a reality and are compounded by slow economic recovery and the budget crisis at the State level. This year’s budget performance reflects a dramatic increase in PERS retirement costs accounting for nearly $1.8 million in increased expenses.

As we evaluate the City’s financial position at mid-year, we remain in compliance with the financial and investment policies established by City Council. Fund equity, reserves, and designation balances are at prudent levels and City funds are invested with utmost care, with safety and liquidity in mind. Having said this, current expenditure trends within the Insurance Fund, described further below, will most likely require a General Fund transfer at year end to assure required policy reserve levels. While we clearly have significant infrastructure expenditures this year, fund and cash balances at December 31, 2004 are adequate to maintain current operating service levels.

Further discussion of mid-year revenue and expenditure performance, fiscal policy compliance, future financial challenges, and contingency plans are presented below.

Financial Review

General Fund Revenue:

General Fund revenues through December 2004 are 5% below budget as compared to 3% this time last year. This is attributable to a number of factors including seasonal collections for Property Tax, Sales Tax and Business License tax. Additionally, the State's diversion of $700,000 in tax revenue has added to the apparent revenue shortfall. Despite these factors, we are projecting General Fund revenues to exceed budget by 3% ($1 million) for the full year.

As we review the progress of our key revenues through December 31, 2004, it appears as though we are well off our estimates for Sales Tax and Vehicle License Fees (VLF). These apparent shortfalls are the result of actions the State took in balancing their own budget for FY 2004-2005. The first State action is commonly referred to as the "Triple Flip." Simply put, the Triple Flip takes 25% of our Sales Tax revenues and replaces it with an equal amount of Property Taxes. The other State action reduced our VLF by $700,000. It also replaced the majority of the remaining VLF revenues ($1.2 million) with an equal amount of Property Taxes. The $700,000 reduction will last for two fiscal years, after which time, we will purportedly receive our full allocation in the form of Property Taxes.

Up to this point, the City received our Sales Tax and VLF allocations on a monthly basis. However, as a result of the actions mentioned, the State has rescheduled these in lieu payments of Property Taxes for January and May. While the revenues will match those we would have received in Sales Tax and VLF (with the exception of the $700,000 takeaway) the timing of the payments affects cash flow and mid-year reporting, resulting in the skewed Sales Tax and VLF revenues through December.

Since the generation of the mid-year reports in early January, the Property Tax revenue in-lieu of Sales Tax and VLF has been received from the state. Based upon those receipts, we are pleased to report that we are on target for meeting our original General Fund estimates.

Property Tax (29% of General Fund revenues - $11.2 million) continue to outperform all other revenue sources. The active housing market, coupled with vigorous remodeling activity has created large gains for this revenue in each of the past four years. The City's assessed valuation has increased over 40% from five years ago, and Property Tax collections have increased 52%. The current year is continuing that trend. As it appears now, we are conservatively projected to exceed budget in this key source by 7% or $800,000. Recent data from the UCLA Anderson Economic Forecast indicates that housing values may be approaching their peak while others project another year of healthy increases. We continue to budget our largest revenue source conservatively.

Sales Tax makes up 19%, or $7.2 million of General Fund revenues. Through December, we have collected 43% of our yearly total as compared to 49% last year. Like Property Tax, the statistic for this revenue source has also been skewed by the State's shift of 25% of Sales Tax to Property Tax. Considering this impact, Sales Tax is trending relatively flat and expected to come in at, or slightly above, budget.

Sales Tax is seasonal with holiday shopping sales receipts from November-December arriving later in February, so the effects of this past holiday season will remain unknown for a few more weeks. While Sales Tax has been flat recently, positive developments that may add to our revenues include the addition of the Mercedes Benz auto sales location on the site of the former Champion Chevrolet, renovations and new retailers at the Manhattan Village Mall (with more improvements in the works), and the addition of South Bay Lincoln Mercury which now shares the Manhattan Beach Toyota location. Looking to the early part of next year, we are optimistic about the prospects for the new Metlox commercial development and the activity it will generate, not only on site, but throughout the downtown.

Sales Tax revenue remains locally sensitive as a significant percentage of our Sales Tax base is derived from a small number of businesses.

Transient Occupancy Tax (TOT or Hotel Bed Tax) (5% of revenues - $1.9 million) again appears to be making gains after two straight years of large declines following September 11th. While our collections are trending even with 1999 levels, well below the peak in FY 2001, there are signs that tourism is returning, and hotels are beginning to fill once again. This particular year one of our hotels, Barnabey's (renamed as Belamar), has been closed for renovation. With the remodeled facility poised to open in spring 2005, we anticipate additional revenues giving further credence to a recovery in this area. In December our TOT collections were 10% higher than one year earlier. We expect our revenue projections for the full year will be exceeded by $150,000 (8%). The opening of the new boutique style inn at the Metlox development will create a new TOT revenue source when it opens in 2005. On a related note, percentage rent from the Marriot hotel is tracking higher than last year by 8%, and is expected to come in over budget for the full year. We expect this trend to continue as travel and tourism expands.

Other Revenue Sources:

Vehicle License Fee revenues (5% or revenues - $2.2 million) are suffering from the elimination of the local government backfill at the State level. In the end, we will lose the backfill amount ($700,000) for a period of two years, at which time it will purportedly be reinstated in FY 2006-2007.

Parking Citations (5% of revenues - $1.9 million) are tracking 15% below budget estimates. This shortfall can be attributed to several factors. Staffing vacancies from existing positions have resulted in reduced activity. Further, two new positions added in the current year, for which revenue was added to the budget, have not been filled yet. These vacancies are being actively recruited, and should be filled shortly.

Interest Earnings (3% of revenues - $1 million) have fallen, as expected, by 63% given the use of over $28 million in reserves to fund the Police & Fire Facility project coupled with the lower interest rate environment. Given this change in fund balances and rates, the City will earn $900,000 less in interest compared to the prior year, although we will come close to meeting budget estimates.

Building permit revenue (2% of revenues - $850,000) is exceeding budget by 16%. There continues to be an abundance of remodeling activity. Demolition permits, a leading indicator of future building permits, remains consistent, at approximately 10-15 per month. **Plan Check** revenue (3% of revenues – $1 million), which typically indicate future building permit revenues, is exceeding budget by 10% or $100,000.

Real Estate Transfer Tax (1% of revenues - $550,000), which is collected each time a parcel changes hands, has increased and is expected to exceed budget. This is mainly due a change in ownership at the Raleigh Studios which generated an additional $50,000 in unexpected income.

General Fund Expenditures:

General Fund expenditures through December 2004 are 2% under budget in line with a five year mid-year average. At the end of this year, we project an overall savings of 3% to 4% ($1.2 million to $1.6 million). Although we remain within established budget levels, it is clear that rising costs are a key theme again this fiscal year. A similar pattern and message was noted for 2003-2004.

A review of expenditures at the fund level indicates that City departments remain within budgetary appropriation limits at mid-year overall with a combined 48% utilization rate. Two departments (Fire and Parks & Recreation) are tracking over budget at mid-year. For the Fire Department, this is caused by paid leave due to injuries and the need to fill those vacancies with overtime. For Parks & Recreation, expected cost patterns from the summer season (early in the FY) give the appearance of going over budget, but will even out as the year progresses.

The following General Fund expenditure highlights are worth noting:

- Employee salary and benefit expenditures are trending higher but are expected to settle into routine levels as we fill required minimum safety staffing levels. We expect overall City wide salary and benefit costs to run close to budget estimates this year.
- Personnel vacancies among all departments remain close to last year levels. The majority of vacancies are in our safety departments (12 of 21). As always, we carefully evaluate vacancies before recruiting to ensure the position is essential to our service levels.
- Several of the Recreation department revenue generating, fee based, programs are exceeding budget expenditure limits given seasonal trends in class activity, yet are expected to cover costs considering that overall revenue collections have nicely increased as has been the trend for the past four years. In 2004 this group covered direct costs by 110%.

As we summarize General Fund expenditures at mid-year we project being within budget at year end; however, it is clear that rising costs have narrowed our budget-to-actual margins. Having said this, expense control becomes ever more important given the current fiscal trends affecting all California cities.

Capital Project Fund:
The Capital Improvement Fund (CIP) revenue is expected to meet, or slightly exceed, budget estimates. While parking citation revenues are trailing budget levels, parking meter revenues are performing near estimates and hotel bed tax revenue is above budget by 8%, exceeding prior year collections. This fund does reflect one-time revenue of $1.2 million in bond reserve proceeds resulting from the sale of the Police & Fire Facility certificates of participation. These funds are held in trust and dedicated for future

use in satisfying fiduciary debt requirements. Excluding the impact of these bond dollars, this fund is projected to realize $1 million in revenue by the end of the year. These revenues are important because they will pay debt service on the Police & Fire facility beginning in FY 2006-2007 (the facility is scheduled to be completed by December 2005). Expenditures in the Capital Improvement Fund at mid-year are at 11% of budget. These costs include completing the design of the Strand Walkway, installing new Marine Avenue Sports Fields batting cages, and contributing to the Mira Costa all weather track. Mid-year expenditures also reflect bond delivery costs of $166,000 - a one time issuance cost which precedes annual debt service scheduled to begin after the completion of the Police & Fire facility.

With CIP fund revenues dedicated to paying debt service on the Police & Fire facility, and the funding of Strand reserves, the funding of future new capital projects is largely subject to our ability to generate General Fund surpluses. Reserves for our major capital projects have been provided for and are maintained with the full funding of the Police & Fire facility and $4 million of earmarked reserves for the Strand.

Police/Fire Construction Fund:
The Police & Fire facility project is now budgeted and expenditures are being processed through the newly created Police & Fire Construction Fund. In November 2004, $12.9 million in bonds were sold completing the final element of the City's financing plan for this major facility. At the time of sale, the City transferred accumulated reserves of $16 million into established construction trust accounts. These bond and reserve dollars, approximating $28 million, cover the full estimated cost of construction when one considers that $13 million of internal City reserve dollars were expended up to that point. Through mid-year, we have spent $14.3 million of the $41 million total project budget which brings us to 35% of project cost. The project remains within budget.

Other Funds:
All other City fund revenues are at expected rates at mid-year. Citywide expenditures for all other operating funds are pacing well below budget levels on a combined basis. The City's Special Revenue, Enterprise and Internal Service Funds, with the exception of the Insurance Reserve Fund, are also operating as expected and remain in line with budget expectations.

With respect to the City's Insurance Fund, workers compensation costs are again rising. Our mid-year activity reports show that we have experienced 17 claims with 398 lost work days through December 2004, compared with full-year history of 25 claims and 266 lost days in 2003-2004 (although this is a slower pace than the 54 claims and 1,109 lost days in FY 2002-2003). As a result, **the Insurance Fund expenditures are tracking significantly above budgetary estimates which will most likely require an equity transfer from the General Fund to maintain the policy reserves within this fund**. It is important to note that under the newly adopted Governmental Accounting Standards Board Statement #34, we are now required to recognize such internal fund transfers as expenses in the General Fund which will negatively impact any reported budget surpluses that may exist at year end. Staff continues to promote improvement in workplace safety with our new safety awareness program. The program's goal is to raise employee safety awareness in an effort to reduce both lost time accidents and workers compensation costs, and maintain a safe work environment for all employees. The program encourages a competitive spirit by posting the number of consecutive days without lost time due to injury. It also includes a rewards program and recognition for achieving safety.

Exhibit C attached presents a high-level summary of expenditure performance by fund.

Fiscal Policy Compliance:

As of December 31, 2004 the City remains in compliance with all aspects of the established financial and investment policies for all funds. In particular, the City remains in compliance in the following key areas:

- The General Fund is projected to be balanced.
- General Fund working capital reserves, as set by policy, have been maintained.
- Reserves for approved capital projects have been recorded and maintained.
- Budget control at the fund level has been maintained citywide.
- We remain in compliance with the City's investment policy.
- Restricted cash balances in Special Revenue, Enterprise and Internal Service Funds continue to be safeguarded and monitored for appropriate use.

Current & Near Term Challenges:

In reviewing our mid-year financial status, the City clearly remains in sound financial health as a result of years of prudent fiscal management as set by City Council. Additionally, we recognize the efforts of all department staff in closely adhering to and enforcing budget policies throughout the year on a continued basis.

It should be noted that we are faced with several significant financial challenges as we look to the near term and next budget year. These challenges include:

- **The economy remains stable but sluggish**, and is expected to continue as such in the coming months. This state of the economy has affected our Sales Tax, which has been flat for a couple of years.
- **California's budget deficit will continue for several years**. Although we are comforted by the passage of Proposition 1A, the State budget has resulted in a loss of vehicle license fees of $700,000. This loss will also be experienced in FY 2005-2006.
- **Increased PERS Pension Costs** are a certainty given increased levels of safety benefits and the poor performance of the equity markets in past years. Pension rates for both Police & Fire will be as high as 44% next year, an increase of more than 65% over FY 2004 levels. This increase, combined with the loss of super funding status for the miscellaneous group of employees, is costing the City an additional $2 million in this current year, and will add as much as $300,000 more to the FY 2005-2006 budget. This expense category exists as the single largest cost increase item which will continue for several years.
- **An upward trend in employee medical benefit costs** is a national pattern that will increase City labor costs by as much as $150,000 per year. Recent changes in the PERS medical plan costing (use of regional pricing which favors southern California members) may mitigate some of the impacts of these increases, but the overall trend of higher medical expenses is expected to continue.
- **A material impact on Interest Income** now that cash reserves have been expended towards the construction of a new Police & Fire facility. Interest earnings will decrease by approximately $1 million this year, a decrease that is further aggravated by the historic low interest rate yield environment.

As we prepare the FY 2005-2006 budget for Council consideration we will need to address the dynamic nature of our finances during the coming months. This includes:

- Reducing or eliminating the level of new year budget requests and holding the line to only our most dire needs.
- Setting realistic expectations as it relates to anticipated salary growth patterns where controllable.
- Evaluating the status of employee vacancies existing at the current time.
- If necessary, revisiting the contingency budgets we prepared in prior years that reflect proposed levels of reductions in departmental controllable expenditures. It should be noted that from year to year, staff in all departments have managed costs under their direct control with great diligence and have displayed the ability to realistically budget such costs in line with existing service levels. Going after these expenses is a worthy exercise and will produce benefits but is not likely to result in material cost savings.

It is important to note that the City's primary product is service. As a result, 70% or more of the City's General Fund budget is labor and related costs. When economic times are challenging, it is difficult to significantly reduce expenses without cutbacks in service.

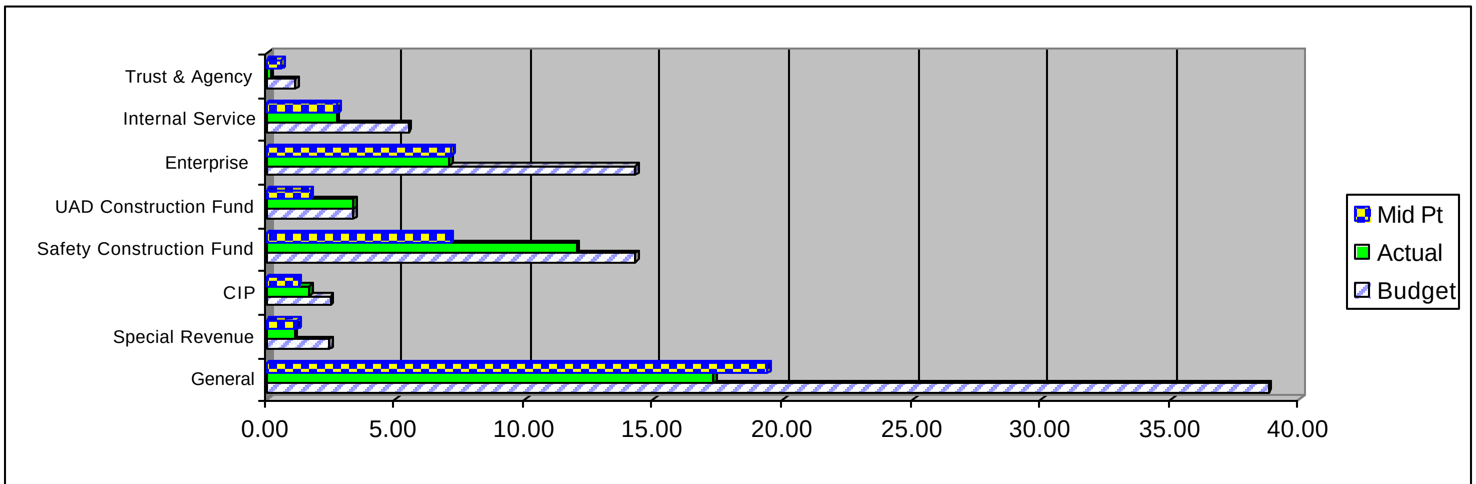
CONCLUSION:
The City remains in a sound financial position and current trends indicate that we will meet budget estimates for the 2004-2005 year. Current economic trends and rising costs require that we aggressively plan to address the many financial challenges we face. In short, cost control is critical in a stagnant revenue environment. Significant labor cost increases, which are a certainty in the coming years, demand that we develop action plans at this time given our tradition of maintaining a proactive financial plan. We will approach the budget in the same comprehensive and conservative manner we are accustomed to. In doing so we will present a budget to City Council that will address the issues at hand.

Attachments: A. Revenues by Fund Type
B. General Fund Revenue by Type
C. Expenditures by Fund Type

City of Manhattan Beach
Revenues By Fund Type
As of December 31, 2004

% of Year **50.00%**

							YE Projection	
	Budgeted	YTD		5 yr Avg	Prior	Prior	Year End	YE
Fund Title	**Revenue**	**Revenues**	**Realized**	**Realized**	**Year %**	**Year $**	**Projection***	**Realized**
General Fund	38,763,857	17,279,265	45%	49%	47%	16,905,530	39,755,130	1.03
Special Revenue	2,433,392	1,081,448	44%					
Capital Improvement Fund	2,464,112	1,682,457	68%					
Safety Construction Fund	14,250,000	12,000,000	84%					
UAD Construction Fund	3,372,889	3,383,993	100%					
Enterprise Funds	14,276,189	7,064,428	49%					
Internal Service	5,494,020	2,708,531	49%					
Trust & Agency	1,136,368	139,181	12%					
	82,190,827	45,339,303	55%					



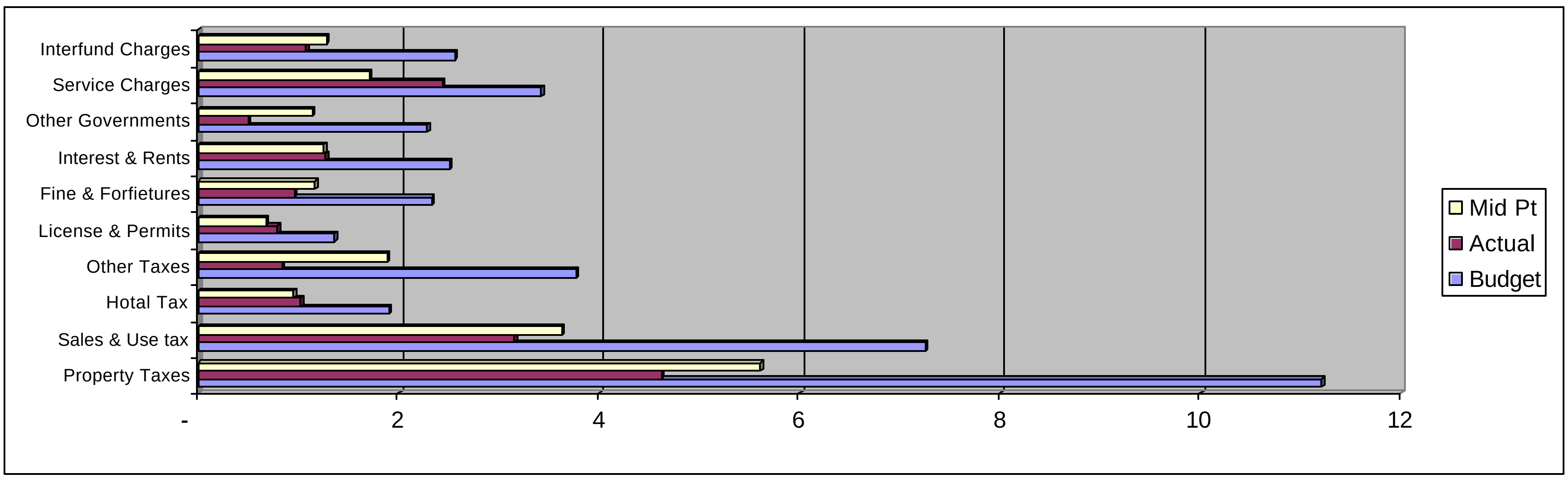
43,426,970 28,060,038 65%

Exhibit A

City of Manhattan Beach
General Fund Revenue By Type
At Decemeber 31, 2004

		% of Year	50.00%					
		Mid Year Status					YE Projection	
	Budgeted	YTD		5 yr Avg	Prior	Prior	Year End	YE
Fund Title	**Revenue**	**Revenues**	**Realized**	**Realized**	**Year %**	**Year $**	**Projection***	**Realized**
Property Taxes	11,210,329	4,625,538	41%	46%	45%	4,557,972	11,998,594	1.07
Sales & Use tax	7,254,000	3,154,743	43%	51%	49%	3,668,697	7,254,000	1.00
Hotel Tax	1,900,400	1,027,207	54%	51%	58%	930,663	2,054,414	1.08
Other Taxes	3,772,724	836,714	22%				3,852,718	1.02
License & Permits	1,360,999	790,676	58%				1,533,688	1.13
Fine & Forfietures	2,331,700	961,173	41%				1,922,346	0.82
Interest & Rents	2,507,990	1,275,313	51%				2,339,811	0.93
Other Governments	2,283,833	502,044	22%				1,774,844	0.78
Service Charges	3,418,200	2,434,340	71%				3,897,951	1.14
Interfund Charges	2,562,210	1,074,382	42%				2,529,630	0.99
Miscellaneous	161,472	597,134	370%				597,134	3.70
	38,763,857	17,279,264	45%	50%	46%		39,755,130	1.03

* adjusted for State "Triple Flip" allocations



City of Manhattan Beach
Expenditures by Fund Type
As of December 31, 2004

% of Year **50.00%**

Fund Title	Budgeted Expenditures	YTD Expenses	Realized	5 yr Avg Realized	Prior Year %	Prior Year $
General Fund	39,230,484	18,923,790	48%	48%	49%	17,501,364
Special Revenue	6,224,217	1,884,216	30%			
Capital Improvement Fund	4,293,257	462,732	11%			
Safety Construction Fund	18,765,882	6,312,361	34%			
UAD Construction Fund	5,150,000	3,665,982	71%			
Enterprise Funds	21,215,406	6,344,055	30%			
Internal Service	5,646,306	3,276,878	58%			
Trust & Agency	731,398	40,133	5%			
	101,256,950	40,910,147	40%	43%	46%	

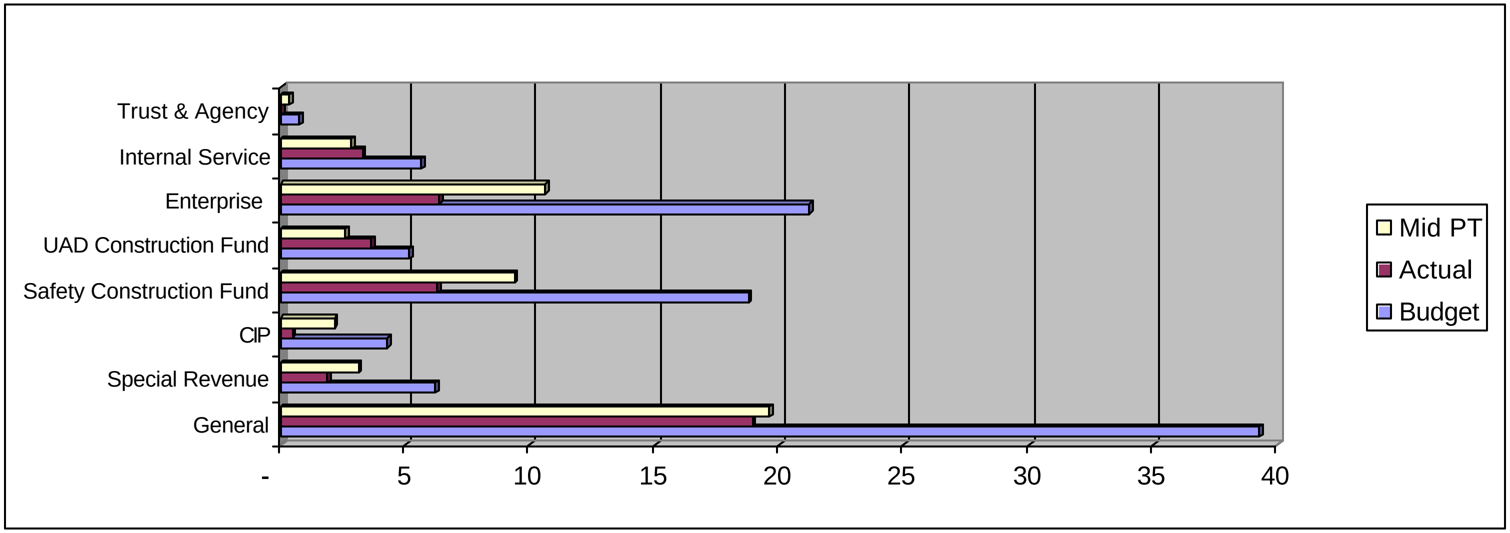


Exhibit C