

To: City Council
From: City Manager
Finance Director
Date: November 20, 2008
Subject: First Quarter Financial Review

RECOMMENDATION

That Council review this financial report for information purposes, and that Council adopt the nine budget policy measures detailed in the discussion section below and direct staff to implement them.

POLICY IMPLICATIONS

It has been our policy, and is a good business practice, to review the status of the City's revenues, expenditures, reserves and overall financial condition for the current budget year as of its mid-point. Given current difficulties in the financial markets recently however, an update to Council on the City's financial status as of the first quarter was deemed appropriate this year. In addition, staff believes the severity of the economic times warrant the implementation of additional budget control measures and policies as outlined below.

FISCAL IMPLICATIONS

Downward adjustments to the City's revenue estimates in the net amount of \$1.7 million due to the faltering economy will generate an estimated \$1.6 million operating shortfall for FY09, and an estimated ending balance deficit of \$962,000. Furthermore, the early estimate of the FY10 General Fund operating shortfall is now \$2.9 million.

DISCUSSION

Summary of FY 2007-08 General Fund Finances

The financial beginning point for any new fiscal year is dependent upon activity in the prior year. In the General Fund, all four of the largest tax revenues came in almost exactly on target in FY08 (within 1% or less of the estimated amount). This includes TOT, sales tax, property tax, and business license, representing 56% of all General Fund revenue. Other General Fund revenues, on the other hand, came in about \$700,000 higher than estimated. The main drivers for this additional revenue were construction permits, Sports Center, conference center room rentals, and utility users tax.

General Fund expenditures came in under budget in FY08 and within less than 1% of what was expected. Given these factors, as the chart below shows, FY08 ended up with a net operating deficit of \$595,000. However, a deficit was expected and in fact, because of the additional revenues described above, turned out to be significantly less than the \$1.2 million deficit originally projected for FY08. In addition, as the chart also shows, the FY08 ending General Fund balance was \$1.46 million, which is about \$700,000 higher than revised estimates last year. The good news, however, stops there.

General Fund Financial Report and Projections

	2007-08	2008-09	2009-10
	Actual	Revised Budget	Preliminary estimate
Operations			
Revenues	53,214,240	54,065,342	56,396,749
Expenditures	(55,447,417)	(57,839,556)	(60,751,884)
Net transfers	1,637,408	2,149,341	1,441,210
Net operating surplus (deficit)	(595,769)	(1,624,873)	(2,913,925)
Beginning Fund Balance	34,978,771	33,319,972	32,166,098
Redevelopment Agency loan payback	4,431,321	4,443,617	2,684,642
Net non-operating transfers	548,278	(1,063,012)	799,208
CIP	(4,899,897)	(1,790,000)	(1,250,000)
Debt Service	(1,142,732)	(1,119,606)	(1,102,373)
Ending Fund Balance	33,319,972	32,166,098	30,383,650
Reserves	31,855,636	33,128,220	34,599,508
Available General Fund ending balance	1,464,336	(962,122)	(4,215,858)

FY 2008-09 General Fund Financial Projection

As the above chart shows, there is now a projected net operating deficit of just over \$1.6 million in the General Fund for current fiscal year (FY09). During the budget presentation last June, staff indicated that the worsening economy and the State's fiscal situation were serious fiscal "storm clouds" and that "a little rain" had begun to fall. This made balancing the budget very difficult at that time. However, staff also explained that if the situation got any worse we would very likely have to revisit our budget projections even before the traditional mid-year review.

Though there were signs that the economy was in trouble early last summer, no one envisioned the magnitude of the simultaneous stock, credit and real estate market collapses the nation has witnessed over the last couple of months. The financial impact of these historic events is already being felt by the City of Monterey in the form of reduced economic activity in our area.

Because of the timing of reporting by the State on certain key financial data (like sales tax receipts), it is still too early to predict with certainty how these events will effect the City's bottom line. First quarter sales tax data for example will not arrive from the State Board of Equalization until mid-December. Though reliable, hard data is difficult to come by at this time of the year, discussions with our sales tax auditors, the county assessor's office, early TOT information from major hotels and other sources give us some indication of where we are headed financially at this point.

Under normal circumstances it has not been our practice to review revenue projections until the mid-year review. However, given the unprecedented events of recent weeks, adjustments are being made to projections for TOT, sales tax, interest income and vehicle license fees.

The chart shown on page two shows a General Fund "net operating deficit" of a little over \$1.6 million for the current fiscal year, and a deficit ending balance of \$962,000. This ending balance deficit would have been worse had not the FY08 ending balance come in stronger than expected. Note that this deficit includes the set-aside of \$750,000 into the Reserve for Economic Uncertainty according to the budget plan. The goal has been to restore this reserve to 15% of net General Fund expenditures by FY14. This goal may have to be revisited at mid-year to help bring the current year's budget into balance.

Discussion of Key General Fund Revenues through First Quarter

Transient Occupancy Tax

TOT is collected 30 days after the close of every bi-monthly reporting period. So as of the date of this writing, only the July/August period has been collected. In that reporting period TOT increased over the same period in the prior year by 8.7%. At first glance this looks very positive. However, this includes the impact of a major new hotel (the Intercontinental Clement Monterey) and two other hotels coming off of major remodels. If these effects are discounted, full-service hotels for this period were actually down 2.5% (the eight full-service hotels account for 61% of all TOT). In other words, despite 8.7% growth, this fell short of projections.

Though official TOT returns for the September/October reporting period are not in yet, informal discussions with many of the larger hotels indicate that this period will be down even further, in the double digit range. Room rates are weakening, companies are canceling conferences sometimes due to their own financial predicament, and in some cases just because they are concerned that the expenditure will not be received well by their stockholders.

In light of the above information, the TOT growth estimate has been reduced from 13.7% (which includes the new hotel) to 7.7% for FY09. This equates to essentially flat growth for TOT except for the additional revenues from the Intercontinental Clement Monterey. The dollar effect of this change in the General Fund is approximately

\$794,000. It will not immediately effect the NIP program, though this change will be factored into the available NIP funds in the FY10 budget. Because of the unstable and speculative nature of all financial projections at this time, it is possible that staff will return at mid-year to report additional revenue estimate adjustments.

Sales Tax

Information about quarterly sales tax receipts (collected by the State Board of Equalization) are reported typically about 2 ½ months after the end of each quarter. So as of this writing we do not have actual data for the first quarter regarding sales taxes. The state does send monthly estimated payments for cash flow purposes. But this does not help us understand what is happening in that quarter.

That said, discussions with our sales tax auditor and other anecdotal information gathered from local retailers have created enough concern that sales tax revenue projections are being reduced as well. Original estimates were for an increase of 4.6%, partly due to several new stores opening up in town (such as those at Del Monte Center). However, it now looks likely that sales tax revenues overall may actually decrease by 3% or more. This results in a reduction to estimated revenues of \$617,000. As with TOT, staff will continue to monitor as we get in hard data from the state and return at mid-year if additional adjustments need to be made.

Interest Income

The recent lowering of the federal funds rate by the Federal Reserve will pull down earnings for short term investments, which will have an impact on the liquid portion of the City's portfolio. In addition, rates on mid and longer term securities are expected to dip in the months ahead, also pulling down overall investment earnings. These factors, along with simply having a smaller cash balance due to reduced revenues, have contributed to a downward revision of our General Fund interest earnings estimate of \$200,000.

Vehicle License Fees

Motor vehicle license fees received by the State are allocated first to county health and welfare programs (75%). Then administrative charges to help fund the Department of Motor Vehicles and other programs are deducted. After that, cities may receive an allocation based on population. However, because the sale of automobiles has been dropping recently, the State notified us recently that cities would not be getting a VLF allocation in November. Staff believes this trend will continue for some time and we have therefore lowered the VLF revenue estimate by \$120,000 to approximately \$101,000.

Additional Fees from Contractual Services

On the plus side, two recent developments have created additional revenues that help offset, albeit modestly, the revenue reductions noted above. The contract for fire service with Pacific Grove and the new contract with Ovation for catering services at the conference service are together expected to generate an additional \$162,000 in FY09. In the case of the fire contract we are "contracting in" and in the case of catering services "contracting out", but these are both good examples of the kind of creative

thinking we will need to continue to do as an organization to weather this latest financial storm.

Discussion of General Fund Expenditures through 1st Quarter

General Fund expenditures through the first quarter came in at about 28% expended. This is a little higher than the 25% that might be expected if all expenditures were evenly distributed throughout the year. However, there are two large expenditures that take place in the first quarter that somewhat skew the numbers. They are the visitor marketing payments to the Monterey County Convention and Visitors Bureau (\$967,000) and the County emergency 911 communication charges (\$604,000). If the effects of these early lump payments are factored out, expenditures run closer to 25.5% through September, which is just about on target.

Budget Outlook for FY10

Projecting with any confidence what this economy will look like in several months or a year from now is not possible. However, our best information at this early point tells us that the \$1.2 million FY10 shortfall that was projected last June was optimistic. Our best estimate now is that the FY10 General Fund operating shortfall will be closer to \$2.9 million, largely due to the weaker revenue numbers discussed earlier.

Note that this shortfall number still does not fully fund appropriate facility and infrastructure reserves as we discussed during the budget process last spring and summer. It is also important to note that one of the major factors driving the FY10 shortfall, even before the recent economic problems emerged, is the fact that the Cannery Row redevelopment project area is projected to hit its property tax increment cap next year. This alone will reduce the repayment to the General Fund by about \$1.8 million.

One major unknown for FY10 is what action the State may take to balance their budget that will impact cities. The Legislative Analysts Office just published a report saying the State is facing a staggering \$28 billion deficit through FY10. And beyond that, if nothing changes, they face an ongoing annual gap of \$22 billion. These numbers are breathtaking and almost guarantee that the State will have to use every tool they have to bring their budget into balance.


One of those tools of course they are implementing even this year is a take away of redevelopment funding that impacts the General Fund (not housing funds however) in the amount of \$448,000. This may well become a permanent takeaway given the State's troubles and unwillingness to deal with them. In addition, the State has the ability to "borrow" from cities if they declare a fiscal emergency, which clearly they are in. This would amount to several hundred thousand more dollars taken away. State takeaways from the County could then have a ripple effect causing the loss of Prop. 172 money (\$200-\$300,000) the County currently uses to offset in part the cost of operating the emergency 911 communications center. Needless to say, there are countless potential budget hits we are tracking related to the States budget woes.

Recommended Budget Measures


In order to address these unprecedented economic realities and the impacts on the City budget, staff recommends that the City Council direct staff to implement the following action items:

1. **Develop scenarios for 5%, 10% and 15% in net budget reductions.** These targets can be met through recommending service cuts or creation of new revenue. Obviously, new revenues cannot be new taxes in the short term. I anticipate that we would not apply these scenarios across the board for each department.
2. **Review all currently vacant positions** and require written justification for recruitment of each position. This should include a description of service impacts should the position not be filled and opportunities to alter our approach to service delivery in ways that make us more efficient and effective.
3. **Evaluate CIP and NIP projects that have been previously approved,** to identify essential vs. non-essential projects for further Council evaluation and consideration of freezing for the time being. I would define essential as those projects that are necessary for public health and safety or critical renewal of current facilities as opposed to projects for new capacity or capabilities that are not essential.
4. **Request that the NIP consider funding only essential maintenance and public safety projects in the next fiscal year.**
5. **Explore additional service consolidation opportunities** with other organizations and within our own organization.
6. **Work with labor organizations to consider financial strategies that would allow us to minimize potential layoffs so we can preserve services.**
7. **Continue making investments that will enhance the long-term capacity of our organization.** This will be particularly important if we find ourselves with a substantially smaller staff at some future point.
8. **Be prepared to absorb and execute economic stimulus projects that may come from the State or Federal governments.**
9. **Develop and execute a public information strategy** that informs the general community, all Boards and Commissions, Neighborhood Associations, Business Associations, City employees, and other groups of interest as to the serious nature of the financial situation and the approaches we are taking to deal with the situation. This will help ensure the community's expectations are realistic and that they fully understand the scope of what we are attempting to accomplish.

Staff realizes that this report will cause concern throughout our organization, but we want everyone to understand how important and serious this situation is. While we remain a nearly \$100 million/per year enterprise, and are in a better financial posture than most of our neighbors because of difficult decisions made in the past, this situation will require our complete and focused attention. While we may have to cut some programs and services, we will have to set new expectations of ourselves and the public. To that end, staff will be hosting meetings with Boards and Commissions, Neighborhood and Business Associations and the public to re-calibrate their expectations for services in the next 12-24 months.



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