FINANCE DIRECTOR'S OVERVIEW

$263.2 Million Total Budget
$47.1 Million Capital
$106.1 Million General Fund

$0.0 General Fund Capital - $2.7 Million General Fund Deficit

Building a Fiscal Bridge to FY 2023

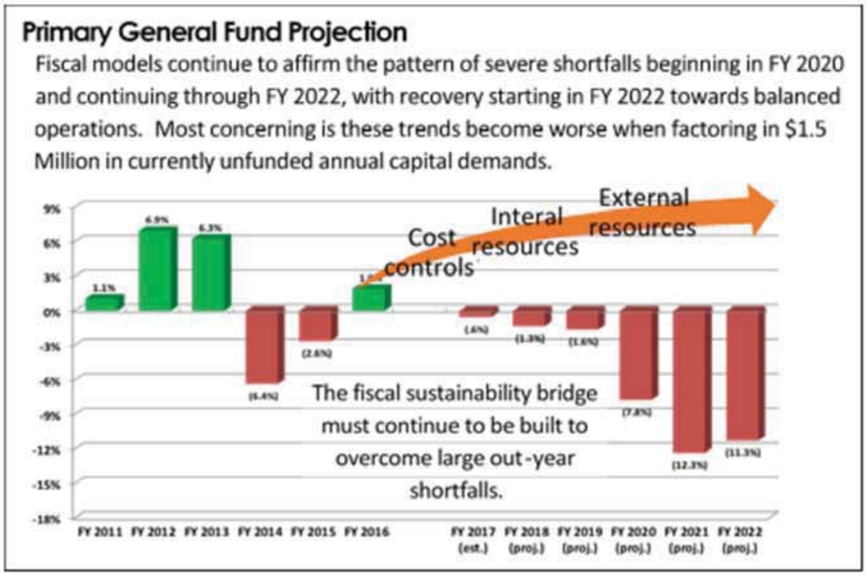
This FY 2018 Annual Budget represents another pillar of our five-year fiscal bridge build-out. By continuing to take purposeful, but measured incremental steps, we will continue to insulate our community against a credible, wide-spread governmental financial crisis.

But we are not there yet, as shown in the latest General Fund projection, which projects a FY 2022 shortfall of $15 million (or 11% of FY 2022 projected operations).

The last several General Fund budgets have been adopted with operating and capital appropriations exceeding annual projected revenue. And while the operating portions of the prior Adopted Budgets were balanced, the City must be able to commit to funding annual capital needs when they come due.

These past budgets relied on better-than-expected results and/or potential reserves, to plug any actual deficits that emerged. However, as was the case with FY 2015, the projected deficit became an actual deficit of 2.6 percent, which reduced the City's available fund balance.

The primary drivers in this new governmental economy are not new, but the lack of additional resources during times of a robust growth economy is a new, unwritten chapter in fiscal governmental management



As discussed later in this overview and within the City Manager's budget message, those key drivers to our General Fund's fiscal condition are: (1) the inability to keep up with investments to offset increasingly aging infrastructure, facilities, and equipment; (2) credible economic slowdown by FY 2020; (3) steep increases in pension and health care, and the need to retain and develop city staff; and (4) a slow but steady overall erosion of historically reliable revenue streams.

Adding to the General Fund's fiscal stress is that the City has used all remaining financial cushion, and therefore, any deficits that develop in FY 2017 and FY 2018 would dip into the current two-month stabilization reserve. In addition, we are ever closer to FY 2020 where our models indicate increasing annual gaps that, without any new resources or significant reduction in core cost increases, are credible and will require large future service changes or reductions. (See later sections of this overview for more information on reserves and resources).

Therefore, the City must aggressively continue down its fiscal sustainability path, as re-emphasized in the City Manager's budget message and will no longer be able to risk ending a fiscal year in a deficit position. Accordingly, during FY 2018, the City would need to provide a strategy to offset any potential General Fund FY 2018 deficit.

What is Changing in the FY 2018 Annual Budget?

While our FY 2018 Annual Budget is balanced in operational terms, after including required vehicle and equipment additions and replacements, the budget ends with a $2.4 million funding shortfall, which would be made up by dropping reserves below their minimum funding level.

Furthermore, the operating budget is again a status quo budget with little discretionary increases. In contrast, the 2018-2020 Capital Improvement Program is anything but status quo. It ranges from funding bold projects to move the City's enterprise and road programs forward, to projects with scarce resources far below the needed investment level. And, for the second year, the General Fund is unable to fund any core infrastructure, park and/or facility projects.

Unlike prior years, when operations were facing changes related to drought, public safety or regulatory changes, the FY 2018 year is projected to be one of relative predictability as the City strategically narrows its focus to the City Council's work plan (see the City Manager's Budget Message for more details).

FY 2018 Appropriation Changes

The notable and modest budgetary changes included in this Annual Budget are:

For the 2nd straight year, no General Fund monies for Capital Projects.

New Measure D funding of $1.1 million for street maintenance and transportation.

Funding the implementation of Police body worn cameras, and 911 Center required system updates.

New Library Measure S funding of $2.2 million to renovate Branciforte and Garfield Park branches.

New $550,000 in State Gas tax resources for transportation projects.

Continuation of the road improvement strategies funded by the 2006 Measure H sales tax.

Continued development of Monterey Bay Sanctuary Scenic Trail Segment 7 and the SLR Trestle Widening projects.

Increasing City Council salary by 5% as allowed by Charter Section 6.03.

Net 23.22 Full Time Equivalent (FTE) positions added City-wide with 12.47 in Enterprise and other funds (including the Library) and 10.75 within the General Fund. These include

> Net 6.0 positions in Water to support capital projects, lab testing, San Lorenzo River coordination and customer service.
>
> Net 3.0 positions added within Public Works enterprise operations; 1.5 for parking maintenance; 1.0 for mandated food waste; and 0.5 for environmental capital improvements.
>
> Add 3.0 Community Service Officers to manage body worn camera implementation and ongoing support; and support increased public safety service requests.
>
> Addition of a Fire Prevention Technician to support prevention and inspection efforts.
>
> Add 0.5 administrative position for initial employee services in areas including workers compensation and health.
>
> Increase code compliance specialist by 0.5 from half to full time.
>
> Convert temporary staffing to two 0.5 regular positions for a recreation assistant and custodian at Louden Nelson and one 1.0 Ranger position to better serve the downtown.
>
> Add 1.0 Assistant Director of IT position and increase an IT programmer position by 0.25 from three-quarter to full time.
>
> Operational reorganizations touching only 8 positions to support strategic initiatives in Water, Planning, Parks & Recreation, IT, and Finance.

The General Plan Update Reserve Fund was reclassified as a distinct revenue and cost center within the General Fund.

Contractually increasing annual funding to the Library JPA by $70,000 (through FY 2021).

Implementation of the City Council approved unified fee schedule with increases for Planning division, Public Works Engineering division, Special Events, and Fire and Police departments.

Other notable items include:

Budget for potential 2018 ballot measures.

Updated internal service fund charges from cost plan update.

Increases to 911 Center and Animal Services Authority JPAs.

City Council translation services.

Large increases in the City's water consumption costs.

Relocation of software maintenance costs from applicable operations to IT.

Increasing Police communication & outreach programs.

Funding for District Attorney support of a one-stop interview center for victims.

Adding of Harvey West patrols.

In addition to these budgetary changes, this document was redesigned with the goal of allowing independent departments and schedules to stand alone as unique communication tools. More emphasis has been placed to highlight the FY 2018 operational objectives and prior year accomplishments.

FY 2018 New Resource Highlights

Over the next fiscal year, there are several resource changes that are expected and/or probable. These resources will be critical to offset known increases over the next five fiscal years.

It is imperative that new General Fund resources be restricted to offset these large cost increases and accordingly be limited to resorting reserves, for one-time debt reductions and/or one-time initiatives.

Water Resources

The Water Enterprise fund will be increasing financial resources with the issuance of debt to fund a new series of core Water system improvements. This will be a significant investment of staff resources but will contribute to restoring and replacing key water infrastructure systems.

Transportation Funding

With the 2016 passage of the Regional Transportation Commission's Measure D, the City is expected to receive $1.1 million in FY 2018 for bicycle, pedestrian, and street resurfacing projects. A public hearing to affirm the City's allocation of Measure D proceeds was held on May 25, 2017 at 10:00 a.m., as part of the budget study sessions. Distribution of Measure D is reflected in the FY 2018 Annual Budget.

With the Governor's approval of the Road Repair & Accountability Act, the City is expected to receive increased State transportation funding near $550,000 in FY 2018 for the first, partial year of the increases. Funding for FY 2019 could increase another $800,000. These funds will be used to support projects to increase the City's Pavement index to over 70, or a "C" grade.

Retail Cannabis

Starting in January 2018, the State will begin allowing for retail sales of cannabis. Should the City allow for retail outlets, each outlet could generate over $50,000 annually in sales tax. And, should the City consider and voters support a local excise tax, each site could generate conservatively $250,000 annually in local tax.

Fee Study

Implementation of the Council approved Unified Fee Schedule will generate over $500,000 for the General Fund in this first fiscal year.

Investments

After implementation of Council-approved investment trusts for pensions and other retiree obligations, these trusts have the potential to generate an additional $200,000 annually in General Fund resources towards reducing future pension costs and obligations.

While these new resources are welcomed, they are far from supporting the over $300 million in unfunded core and community enhancement capital projects, and insufficient to offset the looming General Fund funding gaps.

Therefore, staff will follow the City Council's lead in the development of the new two-year work plan that could include evaluation of new revenue sources.

Leading Over a Credible Crisis

These are unique times in the City's 150 year history where despite strong revenue growth, the City's General Fund continues to be unable to meet its core operating and capital needs. However, the City is poised to be a leader in what it's done already and what it plans to do to maintain service levels through the coming fiscal crisis.

Models continue to indicate that the General Fund could face a growing, annual funding gap through FY 2022, peaking during FY 2021.

These gaps are driven by: the recurring need to repair significant infrastructure and/or facility issues due to lack of funding for adequate maintenance, a credible slowdown in the economy in the coming years, State changes in pension funding and the related pressures from the level of unfunded obligations, continued increases in health insurance costs, providing adequate compensation to maintain a skilled and effective work force, and a continued, methodical erosion of our tax base (See the section later in this report on future pressures and the City Council work plan).

Fortunately, the City has been well informed and Management, along with the City Council, has taken repeated strategic steps in the past four years to brace for these changes. For example, some of the strategic measures have included:

Adopting strong reserve and surplus policies;

Working with the community to expand and diversify revenue from voter-approved increases to Transient Occupancy Tax and medical cannabis business tax;

Implementing funding strategies for core equipment replacement, and for future pension and health care costs;

Operational reductions to support strategic and prioritized Council goals;

Updating certain fees to gradually return to full cost recovery;

Approving new investment trusts to fund future pension increases;

Working with employees for sustainable compensation packages balanced with employee training and development; and

Supporting business development and tourism industries.

In the coming years, the City will continue to: evaluate other fiscal strategies from more in-depth operational analysis, consider cannabis changes to allow for retail sales and/or manufacturing, continue reduction of higher cost debt, and will evaluate possible 2018 ballot measures focusing on the City Council's work plan.

What is Special About FY 2023?

By FY 2023, the City may be the beneficiary of several major fiscal milestones. First, the 2010 bonds issued to lower pension costs will be retired, providing $3.3 million of annual General Fund resources.

Second, a possible completion of a new La Bahia hotel property could also generate significant property tax, sales tax, and transient occupancy tax gains for our community.

Third, by the mid-2020's, it is possible that pension rate increases will flatten out, reducing upward pressure on operations.

Finally, if current models hold up, the regional economy could be emerging from a short economic slowdown that may start by FY 2020.

Together, these events could provide between $5 million and $9 million annually in resources for our General Fund. Unfortunately, even if all this materializes, it would not be enough for the General Fund to offset the credible $15+ million shortfall in FY 2021.

General Fund Reserves and Trusts

The General Fund's 2-month operating reserve is likely to fall short of its required funding level when FY 2017 audit is complete. Although the reserve is currently funded just above the minimum level required by the FY 2017 adopted operating budget at $14.8 million, if FY 2017 ends in a deficit, the reserve would fall below the minimum funding level.

In addition, with the January 2017 authorization to utilize 40% of the reserve to establish critical revenue generating investment trusts, the General Fund's available reserve would be reduced to 10% or $9.9 million with the adoption of the FY 2018 budget. This level is far short of the 25% recommended level based on the City's reserve stress tests.

In addition to this reserve, the City maintains two Council created trusts: the City Public Trust and the Economic Development Trust.

The Public Trust is expected to start FY 2018 with a balance of over $3 million. Amounts, per policy, are intended to be used to leverage or provide matching funds to complete a high priority, unfunded project. This fund has been used in the recent past as the funding source for the Warriors arena project and accumulates proceeds from one-time sales of city properties.

The Economic Development Trust, after considering approved capital projects, is fully committed for FY 2018. Any available amounts, per policy, would have been limited to the purpose of supporting city top priority economic development projects. This fund is being used to support the critical I-Net broadband project for City facilities and accumulates amounts from the former Redevelopment Agency tax distributions and from the 1% increase in 2012 to the Transient Occupancy Tax (from 10% to 11%).

Forecast Inputs

In order to arrive at forecasted results, like those in our General Fund forecast, we rely on complex forecast models that have improved the level of projections considerably.

The models are built with the primary goal of projecting credible, expected results, as opposed to goal of the Adopted Budget, which sets the maximum spending authority for the City.

While this practice is sound and supports providing transparent and credible financial information to the public, it is a diversion from how things used to be done, and can result in a budget with little "budgetary cushion." For example, it was not uncommon a decade ago to project large deficits but in actuality, end the year with a strong surplus. Now, budget projections continue to be credible, and ultimately translate to actual results in line with budgeted deficits or surpluses.

The table to the right discloses our model's key revenue assumptions within the General Fund's top revenue categories (that account for 85% of all General Fund revenue).

Revenue Type	FY 2018-FY2020 Growth
Property Tax	3.0% - 6.6%
Sales Tax	1.0% - 5.10%
Transient Occupancy Tax	3.0% - 18.0%
Utility Users Tax	3.5% - 4.0%
General fees	-1.0% - 9.6%
Franchise fees	2.5% - 3.3%

The risk in these models is the same with any prediction of future results; many things can change in the 18 months between when the model was created and when the actual year ends. Some recent examples of unexpected events that impacted our models have included the recent damage from the January and February storms (that may result in $15 million of city-wide damages); positive impact from a prolonged drought (that created a longer than normal vacation season); and the Scott Kennedy Field Restoration costs.

Future Pressures and the City Council Work Plan

As detailed in the City Manager's budget message, the City is focusing resources in the three priority areas that threaten the City's immediate ability to produce balanced General Fund budgets. They include focused efforts on Housing, Infrastructure, and Community Safety and Well-Being.

In addition, the City continues to experience a common pattern felt across the nation from an evolving governmental funding model (loss of infrastructure funding, increases in mandatory employment costs, and erosion of tax base) and the looming timetable of an economic slowdown.

Infrastructure and Facility

The City's level of unfunded infrastructure and facilities has exceeded a milestone marker of over $300 million. While there are large future community investment projects whose timing is uncertain (such as the Wharf Master Plan, possible new sports arena, possible new or remodeled Civic Auditorium), there are many others that represent current, degrading infrastructure that has either exceeded its useful life, or is near critical replacement stage.

The development of this level of unfunded capital has been well chronicled as an outcome of the Great Recession, reduction in Federal and State funding, and elimination of once strong resources like Redevelopment Agency tax increment, gas taxes, and Community Development Block Grant funds.

Economic Slowdown

While the City of Santa Cruz has projected an economic slowdown near FY 2020 for several years now, it is becoming more commonly accepted that our nation's economy is facing a slowdown within the next 18 to 24 months and already the Governor is bracing his California FY 2018 budget for a slowdown.

As of the date of this letter, this economic expansion period has secured its position as the third longest period of recovery in the nation's documented history (we stand now at 7.8 years). And, if our models hold up, this recovery period would last through FY 2019 and emerge as the longest period in our history (at 10.1 years). And, while there are not any near-term data indicating an immediate slowdown, some of the optimism within early 2017 is starting to fade quickly in a stronger 2017 economy.

Pension, Health Insurance, and Compensation Challenges

As a key pillar to the City's future financial success, the City Council has wisely embraced measures over many years to reduce future pension rate increases, investigate options to mitigate the extent of large health insurance increases, and adopt strategies to bridge large compensation gaps to help the City retain its strong talent and be attractive to a skilled workforce.

But, for pensions, the steep, annual California Public Employees Retirement System (CalPERS) pension increases of nearly $2.7 million for just the FY 2018 General Fund will require more efforts.

The pension increases stem from a combination of CalPERS factors including substandard investment rate returns (2.4% and 0.6% for the last two years), changes in CalPERS assumptions (lowering the discount rate and demographic changes), and delayed increases from Great Recession losses. These changes are certain and built into the CalPERS formulas for the next ten-year operating cycle. There is also a credible potential for CalPERS to make another assumption change that could increase rates even more by FY 2020.

To prepare the City, staff will be presenting new options that could significantly lower the City's interest rates on unfunded pension obligations and preserve cash flow by paying down certain pension debt.

Further compounding the General Fund are the continued increases in employee health insurance costs passed down from the CalPERS Health Program.

For just the General Fund, FY 2018 increases of nearly $800,000 are expected. The City has less control and options around the costs of health insurance. The City has no influence with CalPERS on the benefits or plans offered. Cost can only be reduced through negotiations with employees for greater participation in sharing the cost of health care premiums.

In addition, the City has invested resources into studying the compensation gaps and opportunities to develop initiatives to grow and retain talented employees within the City. The goal is to mitigate the cost of losing staff, of onboarding new employees, and the challenges with attracting new talent to this area with the challenge of our extremely high housing costs.

During FY 2017, the City has completed implementation of compensation changes targeted at the positions with the biggest compensation disparities from a 2015 Classification and Compensation Study. In addition, new programs and initiatives will continue to be rolled out from the City, led by the Human Resources department, to retain and grow talent and invest in more succession development programs.

Erosion of Our Tax Base

The City has also well documented the erosion of core governance revenues, that only recently have we seen restoration in one category (Gas Tax).

While property tax is the City's largest single resource and continues to be very stable, the intention of Prop 13's changes have resulted in unexpected consequences, where California's historic level in property values have not resulted in like increases in property tax bases due to provisions that limit increases in commercial property and transfer of large estates amongst family members.

Sales tax has clearly been the most commonly acknowledged impact, from the massive growth of online sales and consolidation of taxable online transactions to limited distribution centers, and the move away from a consumer economy of goods, to an economy of services. Gone is a large segment of taxable sales related to books, music, games, and software. And, higher portions of limited consumer spending is, on the whole, now being redirected to non-taxable services (from items related to health care to discretionary experienced-based services).

In addition, both of these impacts are changing the face of retail malls and downtown centers where landlords are removing valuable taxable floor space from retail businesses into more reliable and/or lucrative service-based businesses (like health centers moving into former retail sales locations).

And although Gas Tax was just recently bolstered up by the Governor with the passage of the Road Repair and Accountability Act of 2017, some of the underlying concern within this tax base remains, as more and more cars become more fuel efficient, as well as the improvement in electric vehicle production. While these changes are long overdue and a net gain for the communities we live in, the need to fund transportation and road improvements still, remains albeit with a smaller taxable base.

Other key revenues are also now starting to be eroded, such as franchise fees and utility taxes, as customers are moving into cloud-based communication and entertainment that currently is outside the realm of municipal government franchise and utility user tax. In addition, the City faces a higher risk of Federal funding reductions, due to public policy changes in areas of health and immigration.

With Respect and Appreciation

It is with sincere appreciation that I thank all those who share in the passion of serving our community and delivering pragmatic and best practice fiscal reporting and policies.

This City has a rich history of partnership between our community, our Elected Officials, City Leadership, and City staff in adopting long-term, sound fiscal policies, as evidenced by the on-time adoption of award winning annual budgets.

Much of this budget's development started in January 2017. Since that time, City staff throughout all departments worked tirelessly on preparing a budget that minimizes new resource requests, while remaining dynamic to adapt to new programs and initiatives.

It is widely accepted, and proved these past many years, that budget preparation in times of optimism and growth are more challenging than times of declines. While the consequences of the budget during a reduction period are different and likely more impactful, preparing a budget plan in times of limited growth and real net loss in resource power is stressful for an organization that cherishes service as a primary value.

Therefore, it is with sincere gratitude that I thank our City Leadership, City Department heads, and their management and budget staff, for their efforts to work together and voluntarily withdraw certain requests or allow other priorities to take precedent.

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Finally, I want to personally thank the members of our region's strongest Finance Department, who have worked for many months planning for and producing and finalizing the materials in this document.

In particular, I must acknowledge the outstanding work of our budget team who took on additional duties beyond their full-time job in the development of the budget style guide, financial review and input, modeling, and ultimate compilation of the FY 2018 Budget and FY 2018-2020 CIP.

The team included Cheryl Fyfe, Assistant Finance Director; Tracy Cole, Accountant II; Raymond Chin, Finance Manager; Lisa Saldana, Senior Accountant; Jessie Soto, Administrative Assistant III; Michael Manno and Nick Gong, Accountants; and Natalia Duarte, Accounting Technician. It was their energy, creativity, desire for improvement, and many, many extra hours that has led to us raising the bar yet again with improvements to the format and readability of this document, such as the redesigned narratives and evolution of department sections that can stand alone as individual communication pieces.

Because of their efforts, along with the support of fellow Finance key team members, we are confident that the City will again be recognized with receipt of the Distinguished Budget Presentation Award from the national Government Finance Officers Association.

I am very proud of what we have accomplished so far and look forward to continued successes in the decades ahead.

Marcus Pimentel, Finance Director