CITY OF STOCKTON

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City Council
City of Stockton, California

BUDGET MESSAGE

Summary
On behalf of the entire budget team I'm pleased to present this balanced, proposed budget for Fiscal Year 2015-16. It reflects the changes resulting from the bankruptcy court's approval of the City's Plan of Adjustment and, more importantly, reflects prudent financial practices that implement the lessons learned from the bankruptcy process. It also strengthens reserves while making incremental service-level enhancements consistent with the Council-adopted strategic priorities. The full return to pre-bankruptcy service and expenditure levels will be a long-term process that results from years of fiscal discipline, adherence to the Long-Range Financial Plan (L-RFP), and patience to stay the course despite calls to make immediate new expenditures that run contrary to the L-RFP and to the decisions that enabled the City to emerge from bankruptcy. I'm pleased that this proposed budget does all of these things.

Realistic revenue projections, risk reduction by restructuring obligations to create level debt service payments, and frugal spending have placed us in a stable financial position. Your fiscal prudence is paying off and we are also seeing the early signs of a recovering economy providing cautious optimism. Since most of the current expenditure opportunities are the result of one-time events, we are not in a position to widely restore services that depend on ongoing financial commitments like hiring permanent staff. Instead, in order to provide the highest possible level of service and maintain fidelity with the L-RFP, I'm primarily proposing a series of non-permanent service enhancements to catch up on specific service backlogs that align with your strategic priorities. This results in improvements in some long-neglected areas without compromising the City's structural financial integrity or ability to withstand future economic downturns. In essence, it allows the citizens to experience visible improvements while also maintaining our collective commitment to never return to insolvency.

A Look Back

Fresh from the cost, distraction and embarrassment of bankruptcy, the memories are a stark reminder of how far we've come. While the Great Recession played a large role in the City's financial plight, the problems were actually years in the making. Myopic decision-making, inadequate financial projections, and overreaching to deliver well-intentioned yet unaffordable products and services were what set Stockton apart from other cities. These short comings left us vulnerable and unable to weather the fiscal storm. When trouble was on the horizon we were late to react which only compounded the problem.

By the time the City recognized and was prepared to address the problem, the impacts were far more severe. By then, even tragic cuts to services, employees, and retirees couldn't stave off the need to file for bankruptcy on June 28, 2012. This set off a wave of negative impacts and portrayals of this great City largely because of our size (larger than 99.6% of American cities by population) making us the largest U.S. City, at that time, to ever file for bankruptcy protection. On February 25, 2015, after a long and expensive legal battle that forced major sacrifices on our citizens, active and former employees, we implemented our court-approved Plan of Adjustment which restructured our debt enough for us to be financially stable but not enough to immediately restore service and compensation levels. We are obligated to adhere to the terms of that plan for decades into the future and the court's continuing jurisdiction is intended to ensure that this occurs. Coupled with the active appeal of the court's decision by a creditor, it is clear that we are not completely free of the bankruptcy process or obligations. Full implementation of the exit plan will be a long-term process which is why the 'bankruptcy and sustainability fund' continues to play an important role in our budget. The 972 day period of suffering under the cloud of bankruptcy was the darkest in the City's history. It forced us to do some soul searching, identify the root causes that put us in that place, and vow to never repeat those mistakes.

Lessons Learned

The first major lesson is that every financial decision has an impact which far outlasts the useful life of any product we purchase or service we deliver. We now have a new tool to combat the myopic decision-making that comes from being unaware of those consequences. The L-RFP calculates, predicts, and offers a visual snapshot of the City's General Fund financial position for the next three decades. It is dynamic so that we can make adjustments as new revenue or expense data becomes available. More importantly, we can use it to evaluate the impact of hypothetical changes before we make a particular decision so we can now determine whether or not we can truly afford it or whether it will cause us short or long-term problems. By being better equipped to make decisions we can make them with certainty. It also takes away the excuse of ignorance for any financial decision that we can't afford. In other words, because of this tool, we know what we can afford and have no reasonable basis to accidentally make bad financial decisions.

The second significant lesson is that stability not only mitigates the stress of economic challenges but it also allows more quick and adaptive adjustments which ultimately decrease the negative impacts on the organization. Stability is the result of thoughtful planning and strategic restraint. We now have the tools to do this and this proposed budget is an excellent opportunity to demonstrate the City's true intentions.

Fund Balance or Reserves are more than a measure of financial stability. They are a mechanism to provide adequate cash flow to offset the timing mismatch between when expenses are incurred and when revenues are received. They also serve as a buffer against the unknown. The reserve level directly correlates with the City's ability to weather an economic storm. For those reasons the Government Finance Officers Association (GFOA) recommendation of two months of operating expense reserves is only a starting point. A higher reserve level is a greater indication of financial stability and allows a City to mitigate a more significant economic event. This is particularly important because, historically, we've seen recessions every 7 years on average since 1928.

It is useful to have the knowledge provided by our forecasts but the real value lies in our ability to take early actions to address issues that will occur in the future. Based on our L-RFP we know the City will deficit spend for a short period beginning in a couple of years when the costs of structural improvements to CalPERS reach their peak right before we reap the next round of cost savings from the measures we have already implemented. During that time we will see a drop in our reserves. Given the importance of maintaining those reserves at or above the GFOA minimum, and knowing that the level will temporarily drop soon, I'm recommending the demonstration of fiscal restraint by seeking a higher reserve level in the near-term to minimize but not eliminate the impacts of the pending drop. This will delay the City's ability to fund new items in the near-term but will insure against the need to further reduce funding to those same items in the event of a negative economic event. This is consistent with prudent financial practices and, since the L-RFP didn't anticipate reaching the GFOA minimum reserve levels for several years, there was no inherent expectation to immediately fund those new items.

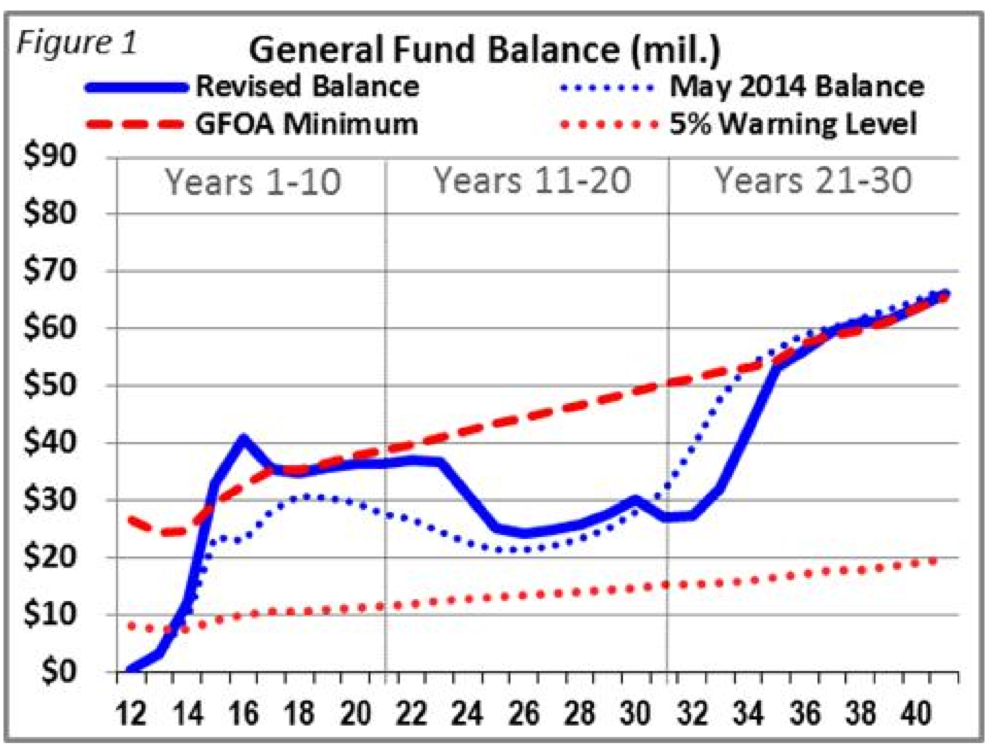
I'm proposing a reserve level of 20% which, compared to where we were a couple of years ago, is heroic. In the context of a healthy organization, however, it isn't as impressive and is only slightly above the minimum recommendation of the GFOA. For comparison, our auditing firm Pun & McGeady surveyed the Comprehensive Annual Financial Reports (CAFR) of more than 100 California cities with populations greater than 50,000. They found that the average reserve level in 2011 was 24%. A year later the 2012 percentage dropped to 15%. This provides two important insights. First, that 20% is on the low side for not being in the middle of a recession. Second, the 9% drop over one year demonstrates how quickly those reserves can be depleted during an economic downturn. Both points support the current 20% recommendation. Alternatively, the increase compared to the GFOA minimum is 3.33% or $6.6 million. With annual General Fund expenditures of $199 million we spend approximately $545,000 per day. This means the additional funding is the equivalent of less than two weeks' worth of General Fund expenditures. For each of these reasons I find this recommendation to be prudent and modest.

A Closer Look

Starting Position

The City is projected to end the Fiscal Year (FY) 2014-15 with a positive net annual activity of $23 million which is $12 million higher than budgeted. This unanticipated increase is primarily due to our continued struggles with vacancies and an earlier than expected property tax revenue restoration (see second quarter budget update report for details). Although, these causes are one-time in nature, they provide an ending fund balance that reaches the reserve level. Figure 1 shows this positive impact of the projected FY 2014-15 ending General Fund balance along with its impact on the long-term financial position.

FY 2014-15 Projections before FY 2015-16 budget changes



Long-Range Financial Plan

The L-RFP was created as part of the bankruptcy process to demonstrate the financial viability of the Plan of Adjustment over a 30-year period. This is significantly longer than most long-term forecasts, but was necessary because of significant changes of CalPERS pension rates over time and the long period over which debt costs were restructured. The L-RFP is updated periodically. It provides a framework for the budget process, labor negotiations, and the capacity of the City to invest in service and infrastructure improvements over time while maintaining sufficient reserves and contingencies to weather economic downturns and volatility in expenditure levels.

Figure 2 shows the projected ending fund balance for the General Fund, under the FY 2015-16 Proposed Budget, compared to a 20% reserve level and 5% warning level. The balance in the near-term meets the reserve objective. This has occurred sooner than expected due mainly to: (a) faster than expected recovery of assessed values which has boosted property tax revenues, (b) a stronger recovery of the sales tax, and (c) higher levels of employee turnover and vacancies than expected, which resulted in significant savings during the past three years. While the strength of the economic recovery is surprising given the extent to which Stockton and the Central Valley suffered during the Great Recession relative to other areas, it is a hopeful sign for the City's long-term fiscal stability. The rate of vacancies should return to pre-bankruptcy levels as the additional Marshall Plan police positions are filled.

FY 2015-16 Proposed Budget

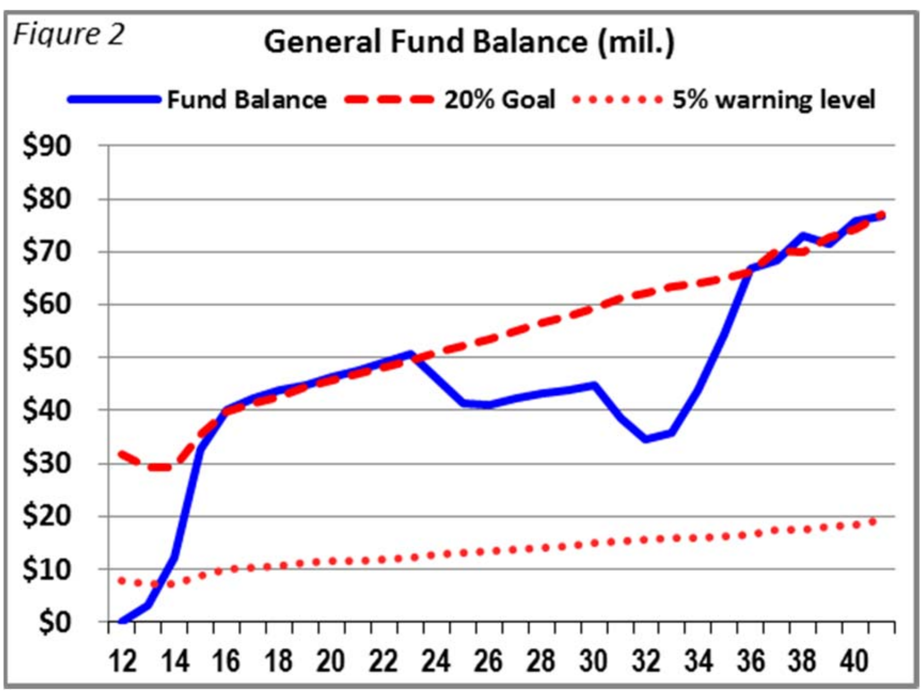
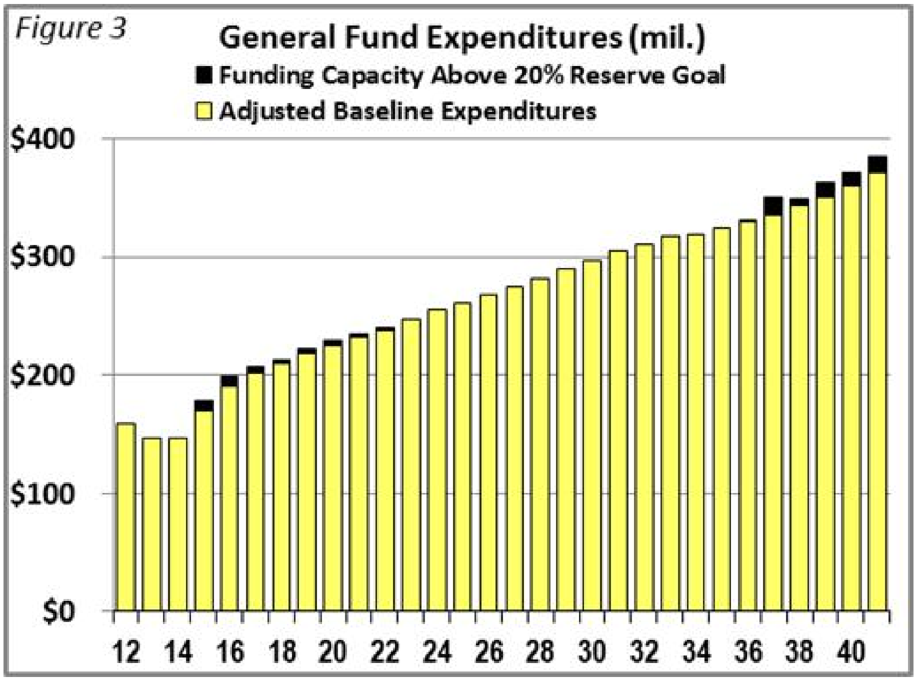


Figure 3 shows the baseline expenditures including public safety spending of Measure A revenues, and the additional funding capacity in excess of the 20% reserve level. In the context of overall spending levels, this additional funding capacity is small, but it will allow the City to make future investments in services and infrastructure that address currently unmet needs.



The L-RFP shows an improved position in the lean years compared to prior projections. As we move forward with the FY 2015-16 Proposed Budget and build on the L-RFP an additional $7.4 million net annual activity is projected that will bring the General Fund ending available fund balance to the level of 20% of expenditures. Taking a look at the impact of this proposed budget on the L-RFP, as shown above, provides for a more stable position in the lean years of the mid 2020's through the mid 2030's.

Revenues

General Fund revenues proposed in the FY 2015-16 budget are $206.6 million which is an increase from the prior year by $8.6 million or 4% due to the following estimations:

Property tax revenues continue to recover at a rate greater than anticipated in the L-RFP primarily due to recapture of property values reduced below Proposition 13 values during the housing market downturn as authorized by Proposition 8. Propositions 13 and 8, coupled with a more rapid than expected increase in property values, resulted in an increased revenue sooner, but not greater, than expected. As property values recover from the drastic recession drop, the growth in revenues temporarily bypasses the 2% Proposition 13 cap and equals the growth rate of the property value until the

Proposition 13 value has been reached. This means that the majority of the increased revenue should be treated as a one-time source. More than half of the 5% estimated increase in property values is the result of these value adjustments on Proposition 8 parcels. Other drivers of the improved property tax revenues include a 1.998% CPI adjustment on Proposition 13 property values and double-digit increases in the median home sales prices in 2013 and 2014.

Sales tax revenues are projected to increase $6.1 million (8.7%) in FY 2015-16 from the $69.5 million projected in FY 2014-15. Actual point-of-sale revenues are projected to increase 3%. FY 2015-16 includes an additional $3.8 million in backfill payments from the State due to the close out of the Triple Flip. Revenues from the Sales Tax Incentive Program approved by Council in 2014 will add $472,000 to the City's sales tax revenues; all of which has been earmarked for Economic Development programs. Measure A revenues are projected to increase 2.4% for a total of $28.1 million, slightly below the $28.8 million projected in the Measure A Implementation Plan.

Utility Users Tax (UUT) revenues are projected to increase 3% or $877,000 overall. Water revenues have been budgeted flat as water conservation efforts are expected to reduce usage. Gas and electric revenues are budgeted to increase 2% and video revenues are budgeted to increase 1% as projected by the City's UUT consultants. The FY 2015-16 budget incorporates State law AB1717 which enables local governments to charge UUT on prepaid wireless and goes into effect in January 2016. Expanding the base of the telecommunications UUT is expected to generate an additional $534,000 in the first 6 months. The City will continue to receive prepaid wireless revenues for the next few years until the State law sunsets in 2020. Each sector of UUT revenues continues to be vulnerable to market conditions and industry advancements such as conservation efforts, solar energy usage, cable video alternatives, and federal laws regulating taxation of internet usage.

Other City tax revenues including Franchise, business license, hotel/motel, and document transfer are expected to remain stable or experience modest growth in FY 2015-16.

Program Revenues are down $950,000 or 8% from the FY 2014-15 year end projection. Significant fluctuations in the Fines & Forfeiture category compared to FY 2014-15 budgeted revenues are due to the elimination of a contract with RedFlex for red light camera monitoring ($577,000) and the transfer of parking enforcement activities in the downtown area to the newly created Parking Authority ($600,000). A corresponding cost reduction in the Police Department budget for the RedFlex contract makes the contract termination cost neutral to the General Fund. Fire Department dispatch contract revenues are up $635,000 from the FY 2014-15 budget in the Charges for Services category as a result of contracts with additional agencies and rate adjustments. These revenues will be used to pay for dispatch center operations and implementation costs associated with expanded services. The dispatch revenue increase is offset by a $565,000 reduction from the elimination of a charge to the MUD Stormwater Utility Fund for storm drain maintenance due to the concerns about the utility's fiscal condition. Revenues from other agencies include $500,000 from the disbursement of Redevelopment Property Tax Trust Fund (RPTTF) revenues in excess of the Successor Agency's Recognized Obligation Payment Schedule (ROPS). The increase in property tax revenues also impacted the Successor Agency resulting in a distribution of funds to various taxing agencies including the City. The amount received in future years will vary depending on the Successor Agency's debt obligations, so these funds have been set aside for Economic Development programs rather than used for ongoing operations. FY 2014-15 projected revenues include $497,000 in one-time reimbursements from the State for wildfire mutual aid assistance.

Interfund Reimbursements revenues are down 4% compared to the FY 2014-15 projection due to one-time reimbursements from the State and Federal governments received in FY 2014-15.

Expenditures

General Fund expenditures in the FY 2015-16 Proposed Budget are anticipated to be $199.3 million which is an increase from the prior year budget by $13.7 million. The expenditure increases are made up of a combination of one-time and on-going items and are listed below in order of their application to the Council strategic priorities.

Public Safety

Ongoing	*One-time*	
$4,323,000		Addition of 40 Police Officers and 5 public safety staff funded by Measure A Transaction and Use Tax revenue in support of the Marshall Plan on Crime (Marshall Plan)
	$ 175,000	Body Camera equipment for Police Officers
$ 255,000		Body Cameras for Police Officers ongoing support
$ 100,000		Shotspotter ongoing support
	$ 175,000	Simulator system equipment
$ 115,000	$ 150,000	Training including simulation, investigations, fire academy
	$1,998,000	Technology equipment for CAD/RMS, body camera, network encryption, and dispatch
	$1,800,000	Radios for public safety
$ 40,000		Office of Violence Prevention Ceasefire costs
	$1,500,000	Building improvements at SEB for additional PD staff

Fiscal Sustainability

Ongoing	*One-time*	
$ 76,000		Addition of Treasury Assistant and ASD support staff
	$ 170,000	Procurement study implementation
$ 15,000		Software for financial reporting

Organizational Development

Ongoing	*One-time*	
$ 273,000	$ 162,000	Employee training / recognition
$ 37,000		Partial funding for new Human Resources staff
$ 214,000		Animal Shelter new support staff position, supplies, services

Economic Development

Ongoing	*One-time*	
	$ 1,504,000	Economic incentive and development plan
	$ 100,000	Marketing plan implementation
$ 19,000		Vacant properties maintenance

Youth

Ongoing	*One-time*	
	$ 130,000	Community Center fitness equipment
$ 215,000	$ 109,000	Community Center and special event materials and support
$ 131,000		Swimming pool maintenance, repair, supplies
$ 35,000		Weber Point water feature maintenance, supplies
$ 10,000	$ 15,000	Bookmobile support

Infrastructure

Ongoing	*One-time*	
	$ 150,000	Animal Shelter electrical upgrade
	$ 35,000	Civic Auditorium canopy replacement
	$ 500,000	Street resurfacing materials and supplies
	$ 300,000	Sidewalk repair and maintenance
	$ 200,000	Tree trimming
	$ 100,000	ULI implementation
$ 64,000		Library repairs and maintenance
	$ 25,000	Fire station improvements
	$ 295,000	Entertainment venue safety and other improvements
	$ 588,000	Irrigation controller upgrade for water conservation efforts
	$1,576,000	LED street light conversion Phase 3

Public Relations/Image

Ongoing	*One-time*	
	$ 100,000	Mobile City Hall equipment
$ 115,000	$ 107,000	Litter abatement and clean-up project(s)
$ 23,000		Legislative advocacy and U.S. Conference of Mayors' membership

In summary, the ongoing increases include Marshall Plan staffing and operations for the second full year of the plan, normal staff costs from labor negotiations net of 5% vacancy savings, and operational improvements of $1.7 million shown above. The funding for these ongoing costs is supplied through the planned use of Measure A Transaction and Use Tax revenues and increases from property and sales tax revenue. One-time expenditures listed above include planned mission critical spending from the Measure A revenues and other costs from available one-time property tax revenues. These one-time projects are budgeted at $12 million. Overall, proposed increased spending primarily addresses the Council's strategic priority of public safety ($10.6 million) with some efforts in all of the strategic priorities in an effort to enhance service to the citizens and/or improve operational efficiencies.

Enterprise Funds

Most notably, the Municipal Utilities Department (MUD) funds of water, wastewater, and storm water present unique challenges for the future. Storm water fund deficits are so severe that many important capital projects have been delayed for years. The City attempted to address this issue in 2010 with a Proposition 218 vote; however, the solution was rejected by voters. This leaves us with an ongoing issue that will require additional analysis in order to maintain the safety and efficiency of the flood control system as well as maintain compliance with our regulatory agencies.

The wastewater Fund has a projected ending fund balance at 6/30/15 of $30 million which is a sign of strength; however, in context of the Capital Improvement and Energy Management Plan (CIEMP), the balance is already spoken for. The CIEMP represents a major overhaul of the Regional Wastewater Control Facility which will modernize the plant while also making improvements to safety and efficiency. It is a multi-year process that is well underway with construction beginning reasonably soon on the Headworks component. In addition, improvements are planned for other pump station and pipeline projects in the City's collection system. The cost of the upcoming design and construction phases dwarfs the current fund balance and will require debt financing in order to complete the project.

Water revenues have a direct correlation to the amount of customer water usage. Since we are in the midst of an extreme drought, the mandated water conservation measures have dramatically reduced water usage and, consequently, reduced revenues. With this situation, the fund is in a position of decreasing revenues for the foreseeable future based on current rate levels or if the drought continues.

Each of these funds will require close observation and careful analysis going forward in order to maintain the appropriate level of fiscal health and meet debt coverage ratio requirements. In the interim any new burdens to these funds should not be taken lightly. We will continue to monitor and plan with the idea of returning to Council as needed for further direction.

Capital Improvement Program

The FY 2015-16 budget for the Proposed Capital Improvement Program is $51.8 million which is $29.7 million less than the prior year due primarily to FY 2014-15 projects which obtained funding from Measure K renewal and the General Fund to cover the following projects: Thornton Road widening, Phase B of Hammer Lane widening, Lower Sacramento Road and Bear Creek bridge replacement, French Camp Road and I-5 interchange landscaping and Citywide arterial roadway Light Emitting Diode (LED) street lights conversion. Converting the existing arterial roadway street light luminaires from 200-watt high pressure sodium (HPS) to LED continues to provide long term energy cost savings and reduced maintenance. The third phase of the LED street light project budgeted at $1.6 million has been identified as a mission critical project and funding is provided from Measure A revenues. This investment in energy saving equipment will reduce the City's future electric cost by as much as $367,000 annually.

Other important projects include General Fund projects that address the Council's strategic priorities relative to infrastructure such as an irrigation controller upgrade to improve water conservation efforts, SEB improvements ($1.5 million) to accommodate additional police positions in support of Marshall Plan, electrical upgrade at the Animal Shelter and City Hall Relocation project ($4.5 million), Roof Maintenance and Leak Repairs, HVAC Upgrades/Replacements due to failure of existing equipment, Hazardous Material Abatement, Fire Station repairs (engine bay, burn room and kitchen repairs), Leaking Underground Fuel Tank Program, Bin Enclosures, Irrigation Controller Upgrades, Chavez Library Upgrades and Maintenance, Stockton Soccer Complex Upgrades and Maintenance, Play Equipment Replacement at several Park locations, and Swimming Pool Evaluations and Repairs.

Internal Service Funds

There are 12 Internal Service Funds (ISF): Three of the funds are managed by the Information Technology Department (Computer Equipment, Radio Equipment, Telephone Equipment), one by the Public Works Department (Fleet), and one by Administrative Services Department (Office Equipment). Seven ISFs are managed by the Human Resources Department (General Liability, Workers Compensation, Health Insurance, Unemployment, Long-Term Disability/Life Insurance, Retirement Benefits and Compensated Absences). These ISFs can be categorized as Equipment or Benefits. During the course of developing each fund's allocation rates, an evaluation was done and modifications have been made to the methodology used to determine and distribute rates, in addition to evaluation of the costs associated with each fund. Over the last few years, the methodologies for the equipment category of ISFs were improved to follow consistent and logical calculations while eliminating duplications. In FY 2015-16 further refinements to specific equipment categories have been made primarily in the Fleet ISF to standardize equipment classifications and set replacement lives at industry standards. Refinements will be examined next year to incorporate the City's experience and may be further adjusted. Some fluctuations have been created by the Fleet ISF refinements, most notably in the Police and Fire Departments; however, these improvements did not significantly impact the overall costs being allocated.

At a high level, the equipment-related ISFs of the FY 2015-16 Proposed Budget reflect increases consistent with the L-RFP and include public safety expansion and equipment made possible partly by mission critical funding obtained through Measure A revenues. The benefit-related ISFs also reflect comparable increases to the forecast except for the Retirement Fund which applies current CalPERS rates lower than originally forecast by an average of 17% lower than forecast and 11% higher than prior year.

Looking Forward

Although constrained, this proposed budget is strong and fiscally prudent. It allows the City to implement the lessons learned through the bankruptcy process, protect and sustain our ability to maintain the current spending levels, and makes incremental progress toward addressing the backlog of service requests from citizens. The financial discipline shown by the City in the aftermath of bankruptcy must continue as the new baseline for fiscal decision-making. At our current pace, and as more of our economic development initiatives come to fruition, I do anticipate additional opportunities to make modest enhancements to staffing levels and other ongoing expenditure items in the near future. I caution, however, that there will continue to be many competing priorities for each funding opportunity. The list changes rapidly but a few examples of those priorities include:

Libraries – After being hard hit during the downturn, activists are anxious to increase library hours or open/reopen a branch. In addition to capital costs, this will require a new and ongoing General Fund contribution and should begin with some in-depth analysis to identify and prioritize shortfalls in the system based on the Council's strategic priorities.

Body Cameras – As the City nears the full-scale implementation of body worn cameras for police officers we will need to plan for the new and ongoing General Fund impacts of storage and staffing to support the program.

Fire Inspection – In an effort to increase public safety, we will have some opportunities to enhance our ability to conduct the fire inspections that save lives. This will require a new and ongoing General Fund contribution.

Permit Center Fee Reductions – There is an ongoing interest in lowering building permit fees. There may be valid reasons for this request but implementing such a change will require additional ongoing support from the General Fund.

State Mandates – Cities continue to be burdened by new obligations from the State. One example is the recent changes to the implementation of prevailing wage rules as they relate to vendors. After some analysis it is likely that we will need to allocate staffing resources to address the additional workload placed on the City because of these changes.

Police Officers – While Measure A has allowed for a robust increase in the number of police officers, the research upon which the justification was made actually called for more than 100 officers on top of the 120 funded by Measure A. In the coming years Measure A hiring will be complete and a policy decision will have to be made about whether to stop expanding or continue in accordance with the Braga report.

Enterprise Fund Obligations - Enterprise Funds are segregated from the General Fund. This limits Enterprise Funds from being raided to benefit the General Fund and limits them to a narrow scope of eligible expenditures. While Enterprise Funds can't be used for General Fund supplementation, the General Fund has no such restriction for funding expenditures that fall within the Enterprise Fund scope. In the case of stormwater, for example, the current structural imbalance could be exacerbated by pending regulatory changes imposed by the State. If the Enterprise Fund were unable to afford these mandatory items, the General Fund would likely be called upon to bridge the funding gap with a new ongoing expenditure.

Each of these items and the others not listed here will be the subject of robust policy discussions going forward. While we won't be able to afford every item in the near-term, it is likely that we will have some capacity to address one or more of these items soon. I look forward to a fiscal year that maintains the current fiscal policies and places us in an even better financial position for next year.

Respectfully submitted,

KURT WILSON
CITY MANAGER