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Gabriel A. Gonzalez
CITY ADMINISTRATOR

To: Honorable Mayor and City Council

From: Gabriel A. Gonzalez, City Administrator

Date: May 30, 2017

Subject: Fiscal Years 2018 and 2019 Proposed Budget

INTRODUCTION

The proposed Fiscal Year (FY) 2018 and 2019 budget is hereby presented to Council and is the culmination of several months of preparation by Council and City Staff which began with the Strategic Planning meeting on February 2nd, 2017. For Fiscal Year 2018 the Proposed City Budget for the General Fund is $51.7 million in expenditures with $52.7 million in revenues and the Fiscal Year 2019 Budget is $52.4 million in expenditures with $53.5 million in revenues. In non-General Funds, the accumulation of fund balance is necessary over time to fund capital projects – the operating margin in future years can/will shift towards an imbalance as accumulated funds are expended on large one-time capital projects and purchases.

The Budget is the single-most important policy document the Council adopts as it is the City's expenditure and service delivery plan for the next two years. The Proposed Budget is also an adoption of the City's goals and reflects discussions and presentations made to Council over the last several months. The budget serves as the financial plan, but just as importantly a communication tool for our community.

Gilroy is at a crossroads – the economy is doing well, but not well enough to overcome many of our future financial challenges – many that are out of our control. Years of conservative spending have left Gilroy in an enviable position as we have built up significant reserves – reserves that I am recommending we utilize for investing in our infrastructure which is aging and in need of significant updating. By doing so, we make our employees more efficient and thus able to provide better services to our community.

This is the first budget cycle that Gilroy has undertaken with the focus of a ten-year forecast which will enable us to better prepare for future economic challenges and allow us to make decisions today with the next decade in mind. The ten-year forecast will also aid us in seeing our financial challenges well before they are realized – giving the City the opportunity to identify and implement solutions well in advance.

Our City has several challenges ahead of us that we must start addressing in the near term: unfunded liabilities and California Public Employees' Retirement System (CalPERS) costs.

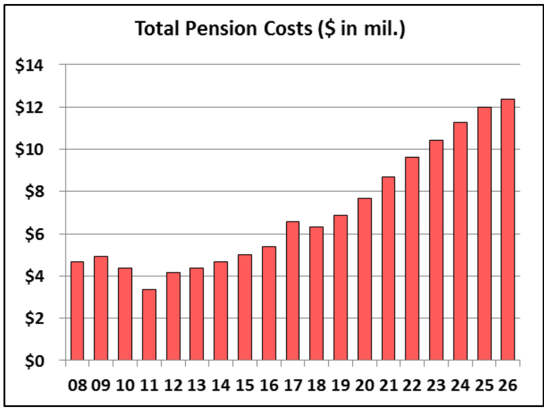
Unfunded Liability

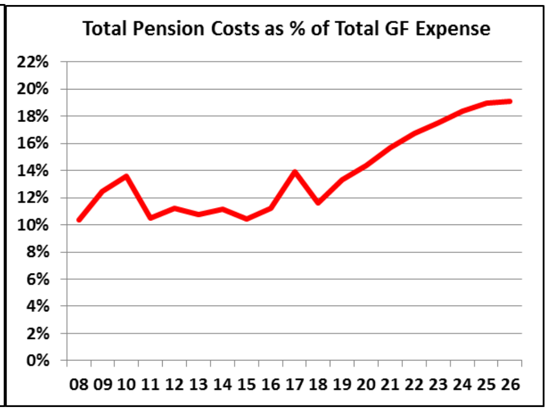
Today, Gilroy, like virtually all California cities, is faced with the ongoing challenge of how to provide a consistent level of service given rising costs and limited sources and types of revenue. Costs, including pension and medical contributions, continue to rise, often at faster rates than revenue growth. In addition to the foregoing factors, the City is also faced with a magnitude of unfunded liabilities that have accumulated over the past years and in some cases decades. As stated in the unfunded liability staff report previously shared with Council, the City needs at least $11 million annually to begin addressing the City's unfunded liabilities.

Other factors that have contributed to the City accumulating millions of dollars in unfunded liabilities was the decline of City revenues and at the same time the need to invest in infrastructure the City maintains to provide city services. As the City has developed and grown in population, so has the increase in service demand. This has resulted in a deliberate decision to focus revenues to maintain current City services while infrastructure maintenance and capital improvements investments were deferred. This budget submission intends to begin a re-investment in our infrastructure.

California Public Employees Retirement System (CalPERS) Liability Changes

Of the City's unfunded liabilities, CalPERS is the largest. In addition to having a large unfunded liability, the annual payments required by CalPERS to fund the City's pension plan is one of the larger costs the City must budget for each year. CalPERS has recently lowered its discount rate which is the assumed rate of return on investments and is used to calculate the amount of contributions cities must pay CalPERS for their plans. This reduction will result in the cost of CalPERS payments to increase approximately $1.5 million over each of the next 5 years, and an increase the City's CalPERS unfunded liability by approximately $22 million over the next 3 years. The City's 10-year forecast shows that annual CalPERS payments will grow from their current $6 million in FY 17 to almost $12 million by FY 22. There are already discussions about another potential discount rate reduction, which would magnify this fiscal impact.





These significant cost increases threaten the ability of the City to continue services at their current level. As revenues adjust incrementally at a much slower rate (typically 2-3% annually), CalPERS payments will consume a greater portion of the City's budget, limiting investment in personnel, technology, equipment, capital projects, and other elements that provide critical services to the community.

Gilroy is a financially healthy City, but like most communities it is unable to provide all services at an enhanced or optimum level. We will continue to operate within our means and will continue to cultivate an environment that practices sound financial judgment, however, Council will be asked to consider recommendations that balance the need to invest today while understanding our future cost challenges.

Fiscal Year 2018 and 2019 Highlights

As part of the budget process, the City conducted an organizational review and held departmental meetings to identify areas that the City should focus on in the biennial budget. As a result of this input, the Fiscal Year 2018 and 2019 budgets were developed with three key priorities – operational capacity, infrastructure investment and efficiency improvements.

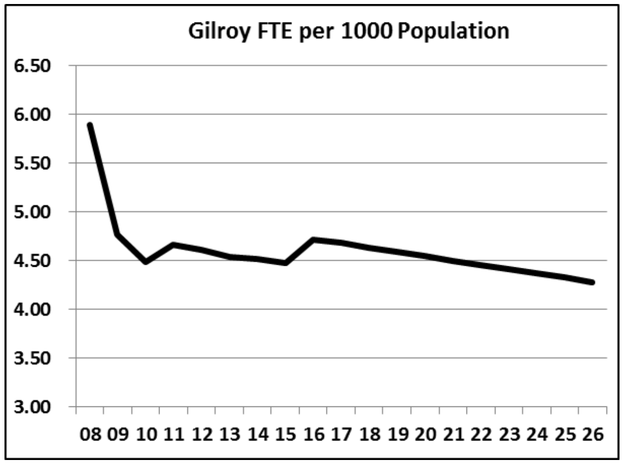
1. Operational Capacity

The City's operational capacity was significantly reduced during the recession in 2009 and 2010. The City, during the recession, went into self-preservation mode resulting in severe layoffs and sustained non-investment in technology, equipment, staff development, nor did the City review its business models, which increased the gap between what the community demands for services, and what the City can provide.

Staff downsizing, cuts in investments for information technology, equipment, and training lowered the amount of workload that was possible for the City to execute. Although there has been some recovery, the City's staff, technology, equipment, and training has not yet returned to the levels that were present before the recession.

Despite this, the City's population has increased, resulting in higher workload demand for services. Delivery of services is constrained, and future additions are restricted, unless this workload imbalance is addressed. Below are some points of consideration regarding the City's operational capacity.

Fiscal Year (FY) 2017 budgeted staffing levels have decreased City-wide by 11% when compared to FY 2008. This represents 33 full-time positions that have still not been replenished after nearly a decade post-recession. The major losses were in Police, Fire, and Community Development. Over the same period the population in Gilroy increased by approximately 16%, increasing the ratio of residents to staff by 30%.



The City's technology is outdated and inadequate to ensure that a maximized workload capacity can be met with current staffing. Improvements in both hardware and software are needed to free up capacity and create efficiency that could offset lower staffing levels.

The "Silver Tsunami" – that is the wave of retirements that were projected several years ago is upon us and significant turnover is expected within the next five years. Not only are retirements a significant loss of institutional knowledge, they further limit the capacity of staff as new employees require resources to train and develop their skills and acclimate to a new work environment.

The solution to staffing and service challenges is not simply to increase staffing. There has not been a comprehensive review at the service provision level conducted to identify alternative means to deliver services currently offered by the City. There are many opportunities within the organization to achieve efficiency, and the proposed budget asks that Council approve investments in technologies that will ultimately change the way we do business, making it a better experience for the customer and more efficient for the employee. We can no longer "do more with less"; we need to do "more with more."

There are significant challenges and limitations to the City's operational capacity – just to maintain the current service level. Based upon the City's financial forecast, it is evident that the City cannot, in a way that is fiscally responsible, hire its way out of the capacity shortage. It will need a combination and balance of:

- Hiring essential additional staff that are related to the provision of mandated or critical core services or maximize the capacity of other staff;
- Improving and implementing technology solutions to maximize productivity of the existing staff;
- Providing training to help maximize use of time and resources to increase efficiencies in executing the work of the City; and
- Conducting a thorough exploration of alternative business models to provide the same or similar services, while reducing the workload demands where possible.

The City will not be able to restore capacity immediately to meet all service demand needs. However, by progressing in the above four areas, it will be possible to reduce the gap between service demand and service level.

2. Infrastructure, Maintenance and Efficiency Investments

   Gilroy faces significant challenges due to aging facility and information technology assets. The City successfully weathered the challenges of the economic recession, however, in order to maintain services, the City made a conscientious decision to defer investments into infrastructure – a decision that was made out of necessity. The results of such decisions solidified Gilroy's position as a conservative, fiscally-responsible organization, however those decision were made with the knowledge that one day the City would have to make efforts to catch up on deferred maintenance and spend funds to secure our infrastructure. These investments are absolutely necessary to ensure that we have the most practical facilities and systems to provide our employees and residents. These investments are a one-time use of our reserves. In the biennial budget for all funds, we are recommending that the City Council authorize in FY 18 the use of approximately $6 million and in FY 19 approximately $1 million in one-time funds to essentially "catch-up" the organization. The monies would be used on projects that are absolutely essential in ensuring that we maintain an organization that invests in the most basic of infrastructure needs including:

   a. Investment in a new Enterprise Resource Planning system ($2M) that would replace the current Sungard system that Gilroy has utilized since 1998. The Sungard system is at the end of its' useful life and is coupled with the CityVision budgeting software that has been surpassed by numerous products in the industry, it is time for the City to make the investment in this product that will serve us well into the next decade.

   b. Investment in Community Development Land Management System software ($1M) to expedite the development process and make information more accessible to our customers and developers.

   c. Investment in Facilities – the one-time use of funds include various investments in City Hall, Wheeler Auditorium, the Senior Center, Willey, the Gilroy Arts Center, and various parks that have deferred maintenance needs that need to be addressed. Also, replacement of city hall HVAC systems, flooring, painting, and basic maintenance needs that have been deferred since the recession.

   d. Information Technology ($800,000) – the City is proposing to upgrade all desktops, laptops, cyber-security, improvements from 100MB to 1GB in network performance speed, display panels in conference rooms and City Council chambers, and department-specific upgrades to create efficiency in maintenance operations and point of sale terminals.

   e. Ongoing General Fund investment in personnel in FY 18 of $.9 million and in FY 19 and thereafter $1.1 million – the City's reduction in workforce of almost 25% in 2008-09 has resulted in significant deficiencies in our ability to meet our customers' basic needs. We have proposed to add staffing in Community Development, Police, Fire, City Clerk's Office, and Public Works.

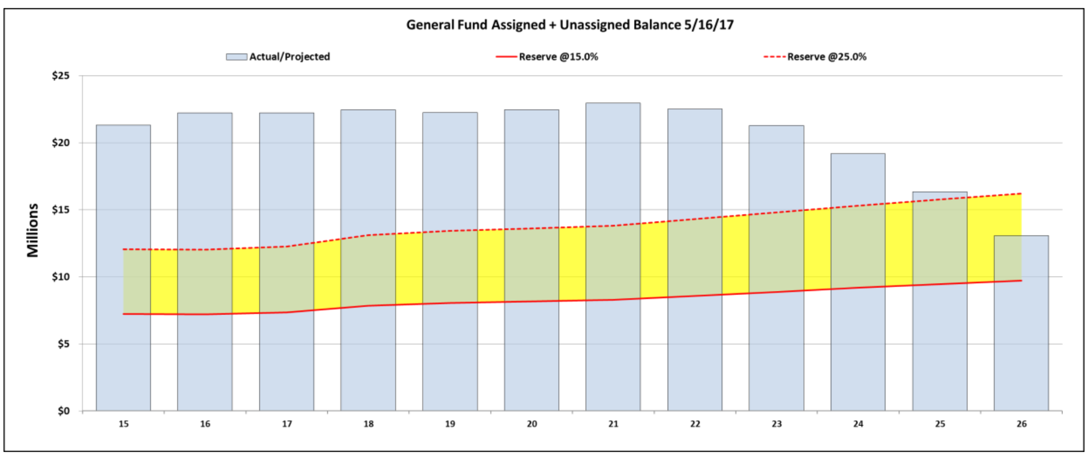
The proposed action is sustainable for the next few years but will require the City to evaluate service levels, staffing, and revenue options as the aforementioned cost increases, which will arrive in the next 3-4 years will have significant budgetary impacts.

<u>Health of General Fund – Financial Overview</u>

a. Fund Balance/Reserves – the City maintains a General Fund reserve level of 25% of annual expenditures for general operating needs and an additional 15% for economic uncertainties. This was a prudent fiscal decision made by previous Councils and continued through both good and bad economic cycles. That being said, it is prudent for Council to ensure that those figures are based on solid, analytical history that truly reflects Gilroy's unique community and economy. The City will be conducting an extensive analysis by partnering with the Government Finance Officers Association (GFOA) to determine best practices for Gilroy's fund balance/reserve policy.

In the two-year Budget FY 18 & 19, a reserve drawdown of approximately $6 million and $1.1 million ongoing is required for the City to "catch-up" on deferred maintenance and services.

The chart below shows that the FY 18 and FY 19 budget can absorb an increased level of service, however once CalPERS rates increase in FY 20, the City can no longer sustain the service level we propose to have in this biennial budget.



b. Revenues

The City's General Fund has five main revenue sources: sales tax, property tax, transient occupancy tax, utility user tax, and business license fees. In total, General Fund revenues are expected to be $52.6 million in FY 18 and $53.5 million in FY 19 – growth of about 4% and 1% respectively from FY 17 budget amounts primarily due to reduced development-related revenues.

Sales tax has performed remarkably well over the last few years and is expected to continue its' upward trend during the biennial budget. Sales tax is an extremely volatile revenue as it is greatly tied to the ability of our residents/customers to purchase non-essential items. The budget includes growth of 3.4% and 2.7% in the next two years from $17.6 million in FY 17 to $18.2 million and $18.7 million in FY 18 and FY 19, respectively. This growth assumes that the transportation (car sales) sector will continue to perform well and that our retail establishments will continue their transaction level at a slightly higher rate.

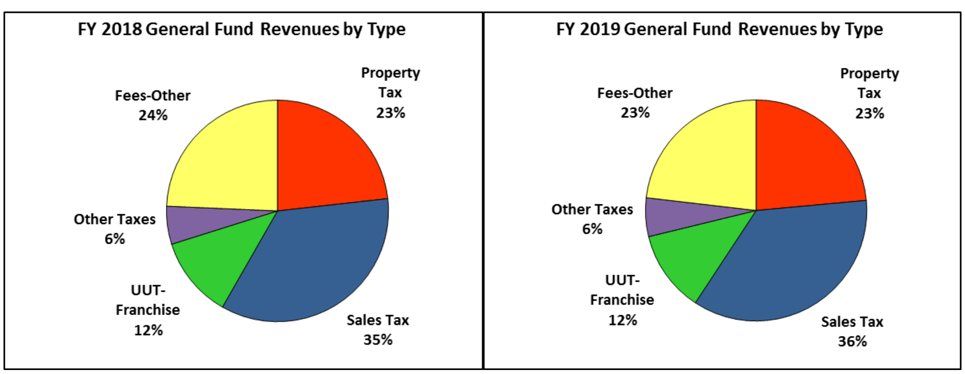
Property tax is a stable revenue and has historically been easier to accurately predict. In FY 17, the general fund received $11.4 million and is expected to grow by 5.3% in to $12.0 million and 2.5% to $12.3 million in FY 18 and FY 19, respectively. Gilroy continues to see residential development and with it growth in the assessor's property tax roll.

Transient Occupancy Tax is expected to grow by 3% from $1.7 million to $1.8 million and $1.8 million in FY 18 and FY 19 respectively. The City expects to see some growth in hotel facilities in the next few years which will add to the transient housing inventory, however, neighboring communities have also added hotels to their communities thus competition continues to increase.

Utility Users Tax – at one time, this was a relatively stable revenue source but the industry has changed dramatically over the last few years and the redefining of telephone and media have brought significant changes and challenges to what the City can and cannot collect. That being said, the City only expects a 1% increase in UUT revenues from $4.5 million to $4.6 million in FY 18 and FY 19, respectively. The courts are still determining whether City's should be able to collect UUT on over the top (OOT) media which is film and TV content delivered via Internet.

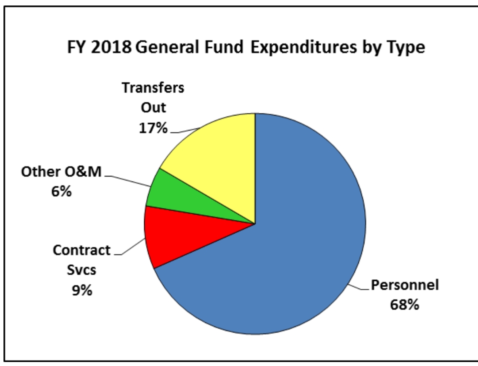
Business License – these fees are paid by businesses for the use of City services and the costs associated with business regulation. Based on a business' gross receipts, the City expects growth of 2% in the next budget period with revenues in the $600,000 range.

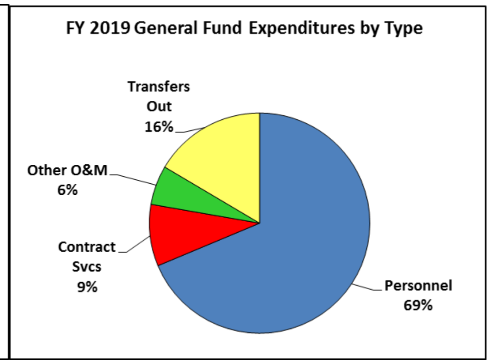
Development Revenues – the City receives significant revenues from development including planning, permitting and building inspections. These revenues are volatile as well and once the full effect of Measure H (the City's growth limit law) in the FY 22-23 timeframe is realized we expect to see development revenues to significantly drop. FY 17 is expected to generate approximately $4.1 million and flattens to $4.0 million in both FY 18 and FY 19. In the long term, these revenues are forecasted to lower to approximately $3.6 million in FY 22.



Given what we know about our existing revenues, new revenues need to be identified to offset the increasing operating and maintenance costs which hinder the City's ability to maintain current service levels, let alone the ability to meet future service demands. Common revenue measures include an increase to a city's sales tax, utility user tax or transient occupancy tax. While an increase in local taxes is never a popular path, often times if the measure is restricted to a specific purpose, for example a public safety tax, the voters can be supportive. However, careful and deliberate discussions will need to be held before any revenue proposals are actually presented. The reason to raise this issue now is simply to bring awareness to the long-term revenue challenges we will encounter in coming years.

c. Expenditures – the reality of past budget cycles has meant that City departments have operated with resources and expenditures that have remained at basic service levels. Service levels are proposed to be maintained with only known costs incorporated into departmental budgets which include known labor costs increases (salary adjustments included in labor agreements, benefit costs increases, etc.) and increased costs associated with existing contracts. In FY 17, the City expects that expenditures will be approximately $1 million below the amended budget amount of $51.2 million. Fiscal Year 18 expenditures are proposed at $51.7 million and Fiscal Year 19 expenditures at $52.4 million. Adopting a budget at this level maintains a "status-quo" budget with no service enhancements or investments in technology or infrastructure.





<u>Proposed Decision Packages</u>

A significant part of the budget process was the submission of decision packages to the City Administrator that reflected basic needs of City Departments. In total, departments submitted almost $28 million in requests, however, after numerous departmental meetings, it is recommend that the City Council consider in FY 18 a total of $4.5 million in General Fund one-time money and $.9 million in ongoing costs and an additional $200,000 in ongoing costs for FY 19. Reducing reserves and committing the City to further on-going costs is not something that is taken lightly. Current resources can absorb the ongoing costs but the City must consider the one-time use of reserves for technology and infrastructure investment is prudent. Detailed justification and Strategic Plan linkage is included in the budget document.

A list of all recommended decision packages is included below:

FY 18 & 19 Decision Packages Department	Fund	Recommended	FY 18 One-Time	FY 18 GF One-Time	FY 18 On-Going	FY 18 GF On-Going	FY 19 One-Time	FY 19 GF One-Time	FY 19 On-Going	FY 19 GF On-Going
CAO	100-0102	Downtown Revitalization Projects, etc.	50,000	50,000						
CAO	100-0102	Reclassify Management Analyst to Senior Analyst			20,000	20,000				
CAO	100-0103	Admin-City Clerk Reorg-Add Deputy City Clerk			132,000	132,000				
Finance	100-0410	Consultant Funding - Cost Allocation Plan/Studies	50,000	50,000			50,000	50,000		
Finance	100-0410	GFOA Reserve Study	25,000	25,000						
HR	100-0420	Applicant Tracking System-Neogov	5,000	5,000	10,000	10,000				
HR	100-0420	Reclassify HR Analyst to Senior Analyst			20,000	20,000				
HR	100-0420	Add New HR Summer Intern			5,000	5,000				
HR	100-0420	Convert PT HR Analyst to Create New Two-Year Full-Time HR Analyst	86,000	86,000			86,000	86,000		
Police	100-1400	GF Pickup of Youth Gang Prevention Manager			75,000	75,000			75,000	75,000
Police	100-1402	Police Report Speak/Write Dictation			45,000	45,000				
Fire	100-1500	Add New Management Analyst Position			150,000	150,000				
Public Works	100-2400	Convert Two PT Engineers to One FT Engineer			25,000	25,000				
Public Works	100-2430	Tree and Street Maintenance	250,000	250,000						
Public Works	100-2430	5-Year Tree Re-planting Program			20,000	20,000				
CD	100-2600	Accela Online Permitting - Cloud	1,000,000	800,000					150,000	120,000
CD	100-2600	Development Center Counter/Space Needs Assessment	25,000	25,000						
CD	100-2602	Citywide Historic Resources Survey	100,000	100,000						
CD	100-2602	Add New Senior Planner Position			180,000	180,000				
CD	100-2602	Add New Deputy Director of CD			210,000	210,000				
Recreation	440	Gilroy Arts Center Phase 1 - Design Plans	35,000							
Parks	600	Turf Grass Equip- Tractor Attachments	37,000	37,000						
Public Works - Rec	605	Tennis Fence Repairs	35,000	35,000						
CAO	605	AM 1610 Upgrade	10,000	10,000						
Fire	605	SVRIA Radios	80,000	80,000						
Fire	605	Respiratory Protection (SCBAs)	40,000	40,000						
Facilities	651	Installation of New Exterior City Hall Safety Lighting/CC Safety Measures	75,000	48,000						
Facilities	651	City Corporation Yard Needs Assessment	35,000	17,500						
Facilities	651	City Hall HVAC Assessment	25,000	25,000						
Facilities	651	City Hall HVAC Replacement					1,000,000	800,000		
Facilities	651	Facilities Needs Assessment	100,000	64,000						
Facilities	651	Museum/Wheeler/Willey/Senior Center Deferred Maintenance Repairs	237,000	237,000						
Facilities	651	Gilroy Arts Center HVAC Replacement	42,000	42,000						
CAO	690	City Website Update (assessment)	25,000	20,000						
Finance	690	Enterprise Resource Planning Software	2,000,000	1,600,000	25,000	20,000				
IT	690	IT Master Plan Implementation	100,000	80,000						
IT	690	Council Chambers AV Upgrades	70,000	56,000						
IT	690	IT Technology Equipment Modernization	885,000	708,000						
Public Works	700	Root Control Contractual			25,000					
Public Works	700	CCTV Mainline Sewer Inspection Unit	215,000							
Public Works	720	Large Water Meter Replacement/Repair	330,000		125,000					
Public Works	720	Large Meter Testing			40,000					
Public Works	720	Hydrant Painting/ID/Landscaping	140,000						50,000	
Public Works	720	Water Well Emergency Repairs			125,000					
Public Works	720	Sensus Analytics Software	45,000							
		Grand Total	**$6,152,000**	**$4,490,500**	**$1,232,000**	**$ 912,000**	**$1,136,000**	**$ 936,000**	**$ 275,000**	**$195,000**

Non-General Funds

The City's major non-General Funds are Sewer, Water, Impact Funds, and the budget for the South County Regional Wastewater Authority (SCRWA).

- The Sewer Fund (700) is also a "status-quo" budget with several decision packages proposed to increase technology and efficiency and reduce the dependence on outside contractors. FY 18 budget of $16.7 million includes a transfer of $3.7 million to SCRWA for capital improvements and design work related to the upcoming plant expansion. The FY 19 budget is at 13.3 million and only includes a modest amount of $150,000 for SCRWA capital projects. Revenues are projected at $13.5 million and $13.7 million respectively which are adequate to balance the operating budget. The one-time use of $3 million in fund balance is prudent and consistent uses of accumulated Sewer Fund balance.

- The Water Fund (720) continues its' current service level, but does include a decision package to enhance Well System Maintenance, a program that is only now considered due to rate adjustments that have provided resources to restore needed maintenance programs. The water fund proposes to expend $12.9 million in FY 18 and $11.9 million in FY 19 while generating revenues of $10.1 million and $11.5 million. As with most enterprise funds, investments in maintenance and/or capital projects will reduce accumulated fund balances – other than the issuance of debt, this is typically the only funding method of these large-scale projects.

- SCRWA (839 & 840) is the operation and maintenance of the City's wastewater treatment facility shared with the City of Morgan Hill. Gilroy's share of capital and operations is $9.7 million in FY 18 and $6.2 million in FY 19. The operations and maintenance costs have risen 5% as is included with the plant operator – CH2M to $5.8 million in FY 18 and $6.1 million in FY 19. The plant continues to complete projects including the aeration and secondary clarifier system and has begun the design phase of the upcoming plant expansion. The actual budget for the SCRWA is reviewed and approved by the SCRWA Board. Council is asked to appropriate the Gilroy share of costs.

5-Year Capital Improvement/Maintenance Program

The City's five-year program includes the investment of over $31 million in projects, purchases, and major maintenance. The chart bellows illustrates the distribution of $5.8 million for CIP and $25.3 million for major maintenance. A more detailed analysis is included in the budget document.

FY 18 - 22 CIP	
Aquatics Center Shade Structure	152,267
Replacement Fire Truck	700,000
Corp Yard Storm Water Compliance Imp.	1,000,000
Dowdy Street Demo	100,000
Ronan Channel Trail	1,315,609
Ranch Site Demo	100,000
CCTV Mainline Sewer Inspection Unit	215,000
Wren/Welburn (R9) Roundabout	503,739
Design of 10th Street Bridge at Uvas Creek	687,329
Sidewalk Gap Closure Project - Murray Street	294,900
Wayfinding Signs	257,094
Hydro Excavator	397,000
	$ 5,722,938

Conclusion

After surviving the economic struggles of the Great Recession, the City is now poised to capitalize on new opportunities that eventually will improve operational capacity to meet the City's growing service demand. During the economic recovery, the City was effective in meeting operational service demands with limited service levels in the "new norm" environment – doing more with less. The FY 18 and 19 proposed budget includes one-time investments to increase organizational efficiency to maintain and increase service levels in mission-critical operational areas. For example, a one-time investment in the Community Development Department to acquire a Land Management Software will improve the internal development review process while increasing access to external customers via online permitting.

A careful and methodical approach was taken in preparing the budget as to keep consistent with Council's past practice to exercise fiscal prudence with funding requests and preservation of the General Fund reserves. Departmental budget requests that had ongoing costs were scrutinized in light of essential operational needs, limiting the ongoing demand on the City's finances.

Development of the new long-term financial forecast model has proven to be an effective tool to identify future financial challenges – one-time or long-term. Having the ability to forecast these challenges provides the organization the opportunity to plan and troubleshoot these budgetary challenges. To this end the proposed budget does not attempt to fix the long term issues facing the City, but it begins to transition the City from financial stability to financial sustainability.

The City Council has a clear vision with strategic goals to continue to build a community that provides its residents a safe, charming and thriving quality of life. I would like to thank the entire Finance team, particularly Finance Director Jimmy Forbis and Budget Analyst Rosemary Guerrero, as well as the entire Budget Team, for their efforts in developing this budget proposal.

Respectfully,

Gabriel A. Gonzalez
City Administrator