CITY COUNCIL AGENDA ITEM

CITY OF SHORELINE, WASHINGTON

AGENDA TITLE:	2005 Budget and City Financial Long-Term Projection Update
DEPARTMENT:	Finance
PRESENTED BY:	Debbie Tarry, Finance Director

PROBLEM/ISSUE STATEMENT:

Staff is currently in the process of finalizing the 2005 Proposed Budget. The purpose of this discussion will be to provide the City Council with an update of the City's long-term financial projections and some of the primary policy issues that will need to be addressed during the 2005 budget deliberations. This report focuses on the City's operating budget which includes the General Fund, City Street Fund, and the Development Services Fund, as the Council recently completed a review of the capital budget through the 2005-2010 Capital Improvement Program (CIP) process.

FINANCIAL IMPACT:

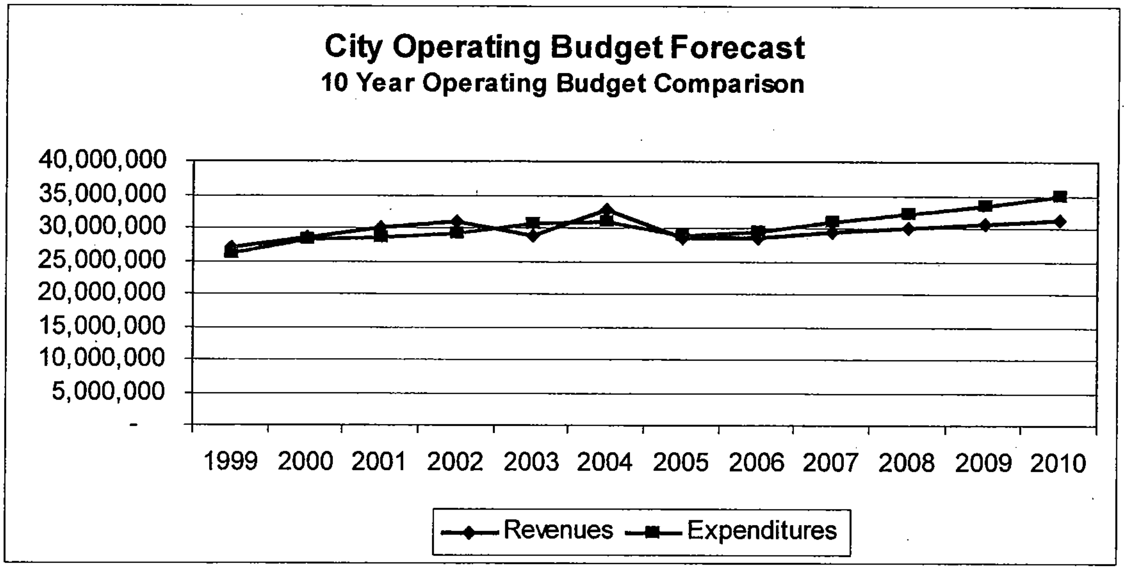
As of September 1, the City's 2005 proposed operating budget is still out of balance by approximately $50,000. This is still preliminary and subject to change as more revenue and expenditure information is gathered during the finalization of the proposed 2005 budget. It should be noted that at the current time the 2005 proposed budget includes approximately $163,000 of baseline expenditure reductions made by departments, but does not include any revenue from a surface water utility tax or fee changes in the City's recreation programs. As the Council may recall, the City Manager recommended in June 2004, as part of the City's long-term financial plan strategy, that the 2005 budget include up to $290,000 in expenditure reductions and $200,000 in revenue enhancements through the implementation of a surface water utility tax and recreation fee changes. The budget submitted to the City Council on October 25, 2004 will be balanced and will include components of the City Manager's recommended long-term financial plan strategy.

The Council last reviewed the City's long-term financial projections during the April City Council Retreat. At that time staff was projecting an operating budget gap of $600,000 for 2005, prior to any baseline expenditure reductions or revenue enhancements, and future budget gaps to grow to $3.4 million by 2010. Since that time we have been able to update some of our projections based on additional information. This includes gambling tax trends, lower than expected health insurance premium increases, a higher than expected Public Employee Retirement System (PERS) employer contribution rate increase, increased growth in sales tax, and tentative agreement on the City's agreement with Yakima County for jail services.

Although the City Council will be focused on review of the 2005 budget later this year, it is important that we continue to monitor our long-term financial position and consider policy decisions impacts on the City's long-term financial health.

The purpose of the long-term projections is to provide information so that staff and the City Council can make resource allocation decisions that provide sustainable public services to the Shoreline community.

The following chart shows the most recent projections of revenues and expenditures for 2005 through 2010.



Operating Fund Projections

Expenditure Assumption	**2005**	**100%**		**Others**	**99%**	
	Base Projections					
	2005	2006	2007	2008	2009	2010
Annual Revenues	28,625,163	28,535,416	29,521,345	30,084,372	30,650,382	31,227,963
Annual Expenditures	28,675,846	29,378,197	30,980,930	32,173,629	33,424,151	34,863,838
Annual (Deficit)/Surplus	(50,683)	(842,781)	(1,459,585)	(2,089,258)	(2,773,769)	(3,635,876)

RECOMMENDATION

No action is required by the City Council. This item is for informational purposes and to provide the City Council with preliminary 2005 budget information.

Approved By: City Manager ____ City Attorney N/A

INTRODUCTION

Staff is preparing the 2005 Proposed Budget and updating financial indicators and projections as part of the process. This workshop will provide an opportunity for staff to share with the City Council the latest financial projections, along with a discussion on some of the major policy issues that will need to be discussed during the 2005 budget workshop reviews. The Council 2005 budget schedule is as follows:

Preliminary 2005 Budget Update	September 20
Transmittal of Proposed 2005 Budget	October 25
Public Hearing & Department Budget Review	November 1
Public Hearing on Revenue Sources & 2004 Property Tax Levy	November 8
Budget Review Workshop	November 15
Adoption of 2004 Property Tax Levy	November 22
Adoption of 2004 Budget	November 22

BACKGROUND

During the April 2004 City Council retreat, staff provided Council with an update of the City's long-term financial projections. At that time, staff was projecting a $600,000 operating budget deficit in 2005. Since that time staff has continued to evaluate revenue and expenditure trends and updated the City's long-term financial model. Also departments have submitted their 2005 budget requests and 2005 revenue estimates. Some of the major changes that have occurred since the April projections include:

- **Public Employee Retirement System (PERS) Contribution Rates:** As was projected in the April forecast, PERS rates will be increasing in 2005, but the rate change will be more dramatic than originally expected. The long-term projections provided to Council in April projected rates to increase from the current 1.4% to 3.2% in 2005, 3.99% in 2006, and 5% in remaining years. The latest information from the Committee on Pension Policy, who makes recommendations to the State Legislature based on the State Actuary findings, is that the effective contribution rate for 2005 go to 3.3%, 5.21% for 2006, 6.5% for 2007-2009, and nearly 8% for 2009-2011. The major reason for these increases is that rates went down substantially from 1999-2002 because of extraordinary investment earnings from previous years. Unfortunately, during 2000-2002 the national recession resulted in significant investment losses although employer contribution rates remained low. In order to fund future pensions, the State Actuary has estimated that employer and employee contribution rates will need to increase in the future. The 2005 preliminary budget includes the expected rate increase for 2005, but in 2006 we anticipate that Shoreline will need to cover an additional $150,000 in PERS contribution. The long-term financial forecast has been updated to include the projected rate increases. The average contribution rate over the last 15 years has been 4.65%, which is substantially higher than the current 1.4%.
- **Health Benefits**: In 2003 the Council approved a new health benefit policy for the City, based on a recommendation from the City Manager. This new policy has helped to contain increases in health benefit costs to the City. The Association of Washington Cities (AWC) had projected that medical insurance premiums would

increase between 15% and 25% annually over the next five years. On September 1, 2004, the AWC committee that makes premium recommendations to the AWC Board of Directors recommended that medical premiums increase by approximately 8% for 2005. The Board will review this recommendation in October, but it appears that our health benefit cost increases may be slightly lower than previously anticipated.

- **Market Rate Adjustment**: The preliminary 2005 budget anticipates a salary market rate adjustment between 1.5% and 2.5%.
- **Lease Costs**: Recently staff has been in negotiations for the lease of the City Hall Annex. Our tentative agreement is for a 3 year lease, with 2005 lease rates increasing by 11%. This is lower than the 27% increase originally requested by the landlord. The lease for City Hall will need to renewed in February 2005. Based on the market conditions and results of the recent lease negotiations for the Annex, it is anticipated that lease cost increases may be greater than originally projected.
- **Jail Activity**: In 2002 and 2003 the City saw a dramatic decline in jail activity. This trend has continued in 2004, but there is a tentative agreement between the cities using the Yakima County jail and Yakima to pay for unused beds on a proportional basis. The City of Shoreline has guaranteed usage of 18 beds per day. The City's average bed usage in Yakima has been 9 beds per day. The tentative agreement will require that the City pay for a minimum of 13.3 bed days at the full daily rate ($57 for 2004) and 4.7 days at $27 per day, the rate required to fund the debt service for the Yakima jail. Given this, the anticipated jail cost for 2005 is approximately $870,000, a $70,000 increase from the 2004 budget. The City's long-term projections had anticipated that we would be required to pay for unused bed days, and therefore this amount is slightly less than was originally projected for 2005.
- **Gambling Tax Revenues:** The Hollywood Casino has now been in operation for seven months. Since the opening of Hollywood Casino we have not seen a decline in card room activity in other casinos. Even though this is the case we are still concerned with the financial status of a couple of the casinos, and therefore the 2005 gambling revenues are projected to increase by 19% compared to the 2004 budget. This is close to the baseline forecast that was provided to Council at the April retreat. If all casinos continue at the same revenue level as the first half of 2004, 2005 gambling revenues could increase by as much as 30%, $738,000, when compared to the 2004 budget.
- **Sales Tax Trends:** The growth in sales tax revenue has been encouraging in 2003 and 2004. In 2004 this growth has been spread across a variety of sectors, and therefore we believe the growth represents an expanding economy. During the first seven months of 2004 sales tax revenues are 5.8% ahead of 2003 collections for the same time period and nearly 10% greater than originally budgeted. Most economists are predicting both employment and income growth in the Puget Sound region for 2005. Based on current trends and the positive economic trends, we have raised our 2004 sales tax projections to $5.3 million and are projecting 2005 sales tax revenues to be approximately $5.5 million, a 3% growth rate. In 2003 the City collected $5.4 million in sales tax revenue.

DISCUSSION

Some of the primary factors affecting the 2005 proposed budget and the 2005-2010 long-range forecasts include:

GENERAL FUND

Revenues

General Fund operating revenues, excluding transfers from other City funds and the use of fund balance for one-time expenditures, are projected to increase by approximately 2.3% from the 2004 current budget to 2005. This is a $530,000 increase.

A description of the most significant revenue trends for 2005 is discussed below.

Property Tax Revenues: Property tax revenues are projected to grow by 1.9% in 2005. Approximately .9% of this growth is a result of projected new construction within the City, which results in increased valuation. In November 2001, Initiative 747 was passed by a vote of the people in Washington State. This initiative limited property tax levy increases, beginning in year 2002, to 1% plus new construction without voter approval. The 1% increase in levy accounts for the remaining increase in property tax for 2005. The 1.9% increase in property tax revenue equates to approximately $129,000.

Sales Tax Revenues: The current projection for 2005 is for sales tax to grow by 4.42% over the 2004 budget levels, or $233,000. Although this may seem like a large increase, we have increased our 2004 sales tax revenue projections to $5.3 million. Based on this level of sales tax revenue, the 2005 projected collections reflect a 3% growth for 2005. A recent release of the economic forecast for the Puget Sound Region projected taxable retail sales to grow by 6.5% in 2005.

The City also receives criminal justice sales tax, which is collected county-wide and then distributed on a per capita basis. County-wide sales tax revenues in 2003 increased by .61% compared to 2002 collections. This was a positive change, as sales tax on a county-wide basis had shown negative growth in the previous year. County – wide sales tax is projected to continue in the growth mode as the economic recovery continues in the Puget Sound region. For this reason 2005 collections are projected to increase slightly, 4%, to $1,040,000 in 2005.

Utility Taxes & Franchise Fees: Overall utility tax, franchise fees, and interlocal utility contract agreement revenues are projected to decrease by 6% from 2004 to 2005. The primary reason for this decrease is that Seattle City Light (SCL) plans to repeal the existing electric rate surcharges that have been in place since 2002 during the last quarter of 2004. This will reduce the overall revenue collected by SCL and the contract payment that we receive. This has been anticipated, as the City has been treating the revenue as a result of the surcharge as one-time revenue.

The City Manager's recommended long-term financial plan included the implementation of a utility tax on the City's surface water utility for 2005. This is expected to generate approximately $150,000 in general fund revenues. This revenue source has not been included in the City's long-term projections at this time and is not included in the preliminary 2005 budget numbers. It is anticipated that the 2005 budget submitted to

Council in October will include this revenue source. There are 47 cities in the State of Washington that charge a utility tax on their surface water utility at a rate that varies between 3% and 19%. The City Manager's recommendation is a 6% rate. The impact to a residential household, based on current SWM rates, is $6 per year.

Gambling Tax: Gambling tax revenues are projected to increase by 19% from 2004 to 2005. This is primarily a result of the operation of the Hollywood Casino.

State Shared Revenues: Liquor Board Profits and Liquor Excise taxes are two sources of revenue collected by the State of Washington and then distributed to cities on a per capita basis. It appears that liquor board profits are continuing to increase. Based on the revenue forecasts completed by the Municipal Research Services, the City is anticipating a $84,000 increase in revenues from these two sources in 2005. This is nearly a 16.5% increase from current levels.

The City will see a decrease in revenue from the state I-695 backfill monies in 2005. The State provided very minimal I-695 backfill monies (State assistance as a result of the elimination of the Motor Vehicle Excise Tax) for the 2004-2005 biennium. In 2005 the City will receive approximately $36,000. This is a significant drop from the $148,000 in 2003 and the $1,485,138 received in 2002. The City anticipated this drop and has been treating the I-695 backfill monies as one-time revenues since the State Legislature never identified an on-going revenue source to fund these payments.

Recreation Revenues: The City Manager has recommended that the Parks & Recreation Department review their rates and consider an increase or the implementation of a resident discount program along with enhancing the City's scholarship program for 2005. Any additional revenues that may be generated from this recommendation have not been included in the City's long-term financial forecast or the 2005 preliminary budget at this time. It is anticipated that these efforts may generate between $30,000 and $55,000 in revenue.

Based on current activity levels it is anticipated that Recreation revenues will generate approximately $833,000 in 2005. This is approximately $13,000 greater than projected revenues for 2004.

Investment Interest: Investment interest has dropped significantly since 2001, as a result of dramatic decline in investment rates. In 2001 the City's General Fund received $573,900 in investment interest. In 2004 investment interest is only expected to be approximately $150,000. It should be noted that the General Fund cash balance invested has remained fairly stable. It is unknown, at this time, if investment rates will significantly increase in 2005. For this reason investment interest is projected to remain flat in 2005.

Expenditures

Overall expenditures, excluding operating transfers between operating funds, are projected to increase by approximately .3% in 2005 as compared to the current 2004 budget. The current 2004 budget includes approximately $537,000 in carryovers from the 2003 budget. Excluding these carryovers from the current 2004 budget, the preliminary 2005 budget reflects a 2.8% increase, $600,000, from the 2004 budget.

A discussion of the most significant expenditure trends follows.

Personnel: Personnel expenditures represent approximately 28.6% of the General Fund budget. Excluding any new personnel positions, personnel costs are projected to increase by approximately 4.3%, $306,000. This is primarily based on anticipated step increases for employees who are not at the top of their salary range, an anticipated market adjustment of 2.5%, and a projected 5% increase in the City's health insurance benefit costs, and an increase in the current PERS contribution rate from 1.4% to 3.3% for 2005. The City's long-term financial forecast projects personnel costs to increase by approximately 5% annually.

Police Contract: The police contract with King County is projected to increase by approximately $300,000, 4%, in 2005. This is primarily a result of anticipated labor cost increases. This is a preliminary increase based on historical trends, as the City has not received the preliminary cost estimate for the 2005 contract at this time.

Jail: Jail costs are projected to increase by approximately 8.9%, $70,000, in 2005. This includes costs associated with the Yakima County agreement that fulfills the City's bed day commitment. Even with this growth rate, the 2005 costs are less than the City's jail costs in 2001. This is a result of decreased activity levels and the use of the Yakima jail.

Technology Plan: The 2005 anticipated expenditures for technology improvements is estimated at $300,000. The Council endorsed the 2004-2006 technology plan in 2003. The technology improvements scheduled for completion during 2005-2006 will focus on the ability to integrate and improve the ability to access information from the City's software systems for management and performance measurement purposes. Also the City will focus on emergency back up systems and maximizing the use of existing systems.

Capital Funding: The City currently allocates approximately $1.4 million of general fund revenues on an annual basis to fund capital projects and long-term road surface management. This allocation is included in the City's long-term projections and the preliminary 2005 budget.

<u>Fund Balance</u>

The General Fund currently has a healthy fund balance based on conservative budget planning by the City Council. The 2004 projected ending fund balance for the General and General Reserve Funds combined total $5.4 million, nearly 22% of General Fund revenues. This fund balance reflects the allocation of $4 million from general reserves for the City Hall project, as was adopted in the 2005-2010 CIP. The transfer of the $4 million will be included in a budget amendment being brought to Council in October. Although a fund balance of 22% of revenues is healthy, the City should not rely on the fund balance to balance it's operating budget over the long-term.

<u>Future Needs</u>

Evaluating future financing options will be key in determining any future service enhancements the City may consider. Given our financial projections the 2005 budget instructions to departments was to only submit service enhancement requests that were either funded by new on-going revenues or reductions in existing programs that are a lower priority or reductions that can be made as a result of efficiencies. Some enhancement requests that met this criteria that are being considered include:

- *Aurora/Interurban Planner*: This position would be funded through the existing project budgets. The primary purpose of this position would be to help with the development of the projects with a big-picture development perspective and to assist community members affected by the project. This could include responding to many questions that have developed as we have proceeded with Phase I of Aurora, such as property access questions, redevelopment opportunities, and coordination between property owners.
- *Associate Traffic Engineer*: This position would be funded by decreasing contract services related to the Neighborhood Traffic Safety program and services contracted with King County for traffic services. Staff believes that this is one of the City's top priorities and that we can respond to the needs of the community in a more effective and efficient manner with additional in-house staff in this area. This position would assume many of the services that are currently obtained with external contracts.
- *Police Administrative Sergeant*: This position would be funded with a 3 year grant and eliminating one contracted deputy position. Staff believes that this would enhance the ability of current officers to respond to community needs on the street as several programs that are currently spread between deputies and sergeants could be coordinated and supervised by a single individual.

One request that would require additional funding would be to create a funding stream for future major facility repair and maintenance. This need is being evaluated against other needs such as additional funding for road surface maintenance. Two major replacements that need to occur in 2005 are the Shoreline Pool roof replacement and the replacement of the Police Station Heating, Ventilation & Air Conditioning System, which are estimated to cost a total of $125,000. It is likely that the 2005 budget will recommend that we proceed with these using one-time revenue sources.

CITY STREET FUND

The City Street Fund receives approximately 54% of it's resources from Gas Tax and Right-of-Way fees and the remaining 46% from General Fund Revenues. More General Fund monies have been shifted towards maintenance of City streets over the last two years as a result of the elimination of the local vehicle license fees in 2002. The elimination of license fees resulted in a revenue loss to the City of nearly $500,000 annually. Of this amount, street related operating maintenance services were reduced by $180,000 in 2003. Fuel taxes are projected to increase by approximately 1.4% in 2005. This is primarily a result of decreased gas sales throughout the state. The Street Fund maintenance does not include the long-term pavement management program.

The long-term projections for this fund indicate that either the City will need to allocate additional general fund revenues for street operations or develop alternative revenues to maintain service levels, especially as some of the capital projects are completed and increased service levels are required to adequately maintain the improvements. In the absence of these options it is likely that service levels will need to be reduced. For the short-term the fund has adequate reserves.

DEVELOPMENT SERVICES FUND

Although the permit activity of the Planning & Development Services Department has been accounted for in a separate fund, the Development Services Fund, it is likely that the 2005 budget will move these activities to the General Fund. Most cities account for these activities within the General Fund, as it is unlikely that permit fees will ever fully recapture all direct and indirect costs of providing land use, building inspection, and permitting services. During the last couple of years, permitting fees have offset 100% of the direct costs of providing the related services. Fees have not recaptured the indirect costs, such as facility, accounting, and administrative costs.

The preliminary 2005 revenue projections for permit activity is that revenues will remain flat between 2004 and 2005.

2005 AND BEYOND

Staff will be finalizing the proposed 2005 budget during the next month and the City Manager will present a balanced budget to the Council in October that is in alignment with the City Manager's long-term financial plan presented in June of 2004. Although this is the case, the City's long-term financial projections continue to show operating budget deficits throughout the remaining five years of the forecast.

In order to continue to provide current services to the community in the future, based on our current revenue and expenditure projections, it will be necessary to follow through with the City Manager's long-term financial planning recommendations made to Council on June 21, 2004 (Attachment B). These recommendations are summarized in the following table:

	Revenue Effective Year		
Action	**2005**	**2006**	**2007**
Reduce department base budgets by 1% and review low priority services for elimination (Up to $290,000)			
Implement a utility tax on our surface water utility ($150,000)			
Increase recreation fees by approximately 10% and enhance the City's scholarship program ($30,000 to $55,000)			
Implement a revenue generating regulatory business license program (Net Revenue $50,000)			
Seattle City Light franchise fee (6%) on the distribution portion of the electric utility fees ($0 to $600,000)			
Property tax levy lid lift ($0 to $2 Million)			

These recommendations may need to be modified if there are future revenue reducing initiatives, such as ones like I-864, passed by voters.

The following table is the updated operating projections for the City for 2005 through 2010.

Operating Fund Projections

Expenditure Assumption	**2005 Base Projections**	**100%**		**Others**	**99%**	
	2005	2006	2007	2008	2009	2010
Annual Revenues	28,625,163	28,535,416	29,521,345	30,084,372	30,650,382	31,227,963
Annual Expenditures	28,675,846	29,378,197	30,980,930	32,173,629	33,424,151	34,863,838
Annual (Deficit)/Surplus	(50,683)	(842,781)	(1,459,585)	(2,089,258)	(2,773,769)	(3,635,876)

The long-term projections assume 100% expenditure levels in 2005 and 99% expenditure levels in future years. Traditionally the City has had an expenditure level of 96 to 97% of budgeted expenditures. A more in depth discussion of the City's long-term operating budget financial forecast and assumptions is included as Attachment A.

SUMMARY

As Council has continued to monitor future financial projections, it has followed conservative financial planning. This has allowed the City to carefully plan service enhancements, and weather the recent recession in good shape. During the last two years staff has focused on reducing expenditure growth through efficiencies and modification of policies such as the City's health benefit policy. Even though this has been the case, if current trends and assumptions hold true, with no changes in expense or revenue levels, the City's operating budget will have annual operating budget gaps in each of the next five years. The purpose of the long-term projections is to provide information so that staff and the City Council can make resource allocation decisions that provide sustainable public services to the Shoreline community. As the Council continues to plan for 2005 and beyond, it will be a necessary to monitor financial trends and follow a plan that will allow for the long-term provision of public services.

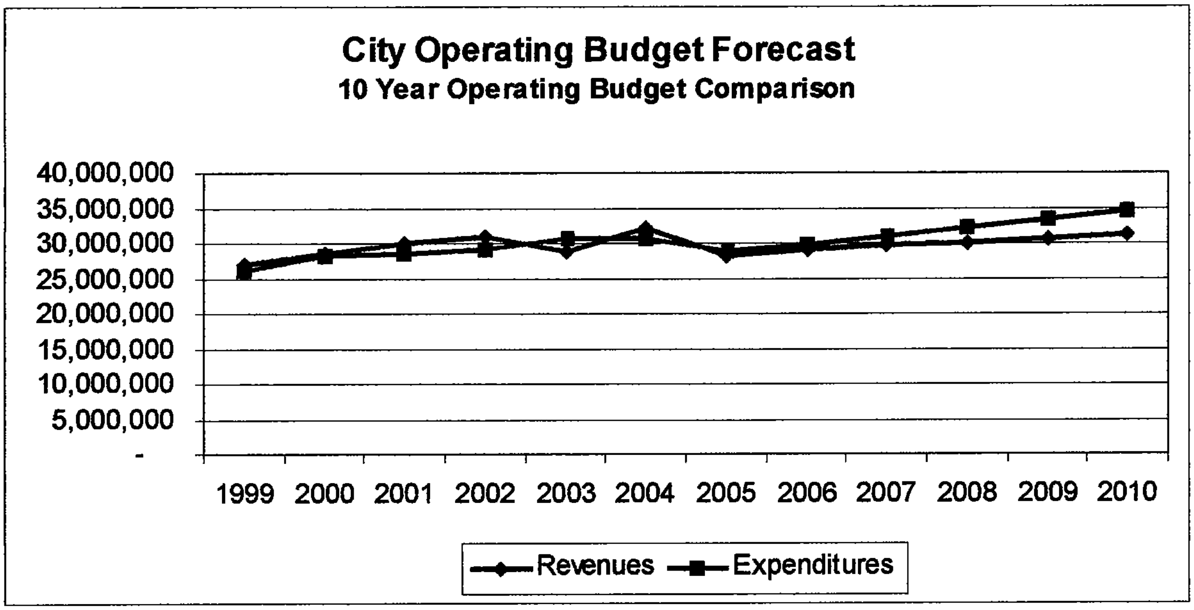
RECOMMENDATION

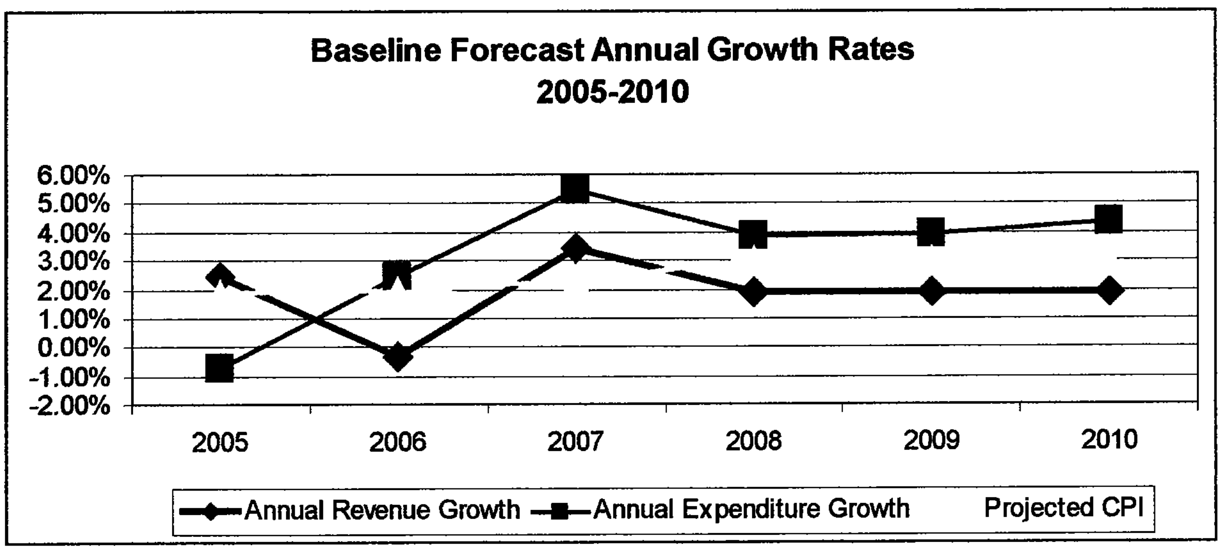
No action is required by the City Council. This item is for informational purposes and to provide the City Council with preliminary 2005 budget information.

ATTACHMENTS

Attachment A – 2005-2010 Operating Budget Financial Forecast
Attachment B – Staff Report: 2005 Budget Strategy & I-864 Options - June 21, 2004

City of Shoreline, Washington
2005-2010 Operating Budget Financial Forecast





	2005	2006	2007	2008	2009	2010	Average
Annual Revenue Growth	2.47%	-0.31%	3.46%	1.91%	1.88%	1.88%	1.88%
Annual Expenditure Growth	-0.73%	2.45%	5.46%	3.85%	3.89%	4.31%	3.20%
Projected CPI	1.90%	2.00%	2.30%	3.00%	3.00%	3.00%	2.53%

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Background & Purpose

The National Advisory Council on State and Local Budgeting (NACSLB) has endorsed the forecasting of revenues and the forecasting of expenditures in their Recommended Budget Practices. The Government Finance Officers Association (GFOA) recognizes the importance of combining the forecasting of revenues and the forecasting of expenditures into a single financial forecast. GFOA recommends that each government entity have a financial planning process that assesses long-term financial implications of current and proposed policies, programs, and assumptions that develop appropriate strategies to achieve its goals. The forecast should extend at least three to five years beyond the budget period and should be regularly monitored and periodically updated. The forecast, along with its underlying assumptions and methodology, should be clearly stated and made available to participants in the budget process.

A key component in determining future options, potential problems, and opportunities is the forecast of revenues and expenditures. Revenue and expenditure forecasting does the following:

- Provides an understanding of available funding;
- Evaluates financial risk;
- Assesses the level at which capital investment can be made;
- Identifies future commitments and resource demands; and
- Identifies the key variables that cause change in the level of revenue.

As with any forecasting process, assumptions are made based on historical experience, current trends, and known future changes. Forecasts are usually based on conservative assumptions in that revenues should not be forecast based on maximum growth potential and expenditures should not be forecast based on the minimum growth in expenditures.

The City's financial policies and state law require that the City adopt a balanced budget. This being the case, even though forecasts may project budget deficits, the City would not be able to operate in a budget deficit position on an on-going basis. This is one of the reasons for long-term forecasts, to plan for changes that must occur in order to maintain a balanced budget.

Forecast Scenarios

The September 2004 Operating Budget Forecast includes three different scenarios: a baseline forecast, an optimistic forecast, and a pessimistic forecast. The main differences between the forecasts are described below:

Issue	Baseline Forecast	Optimistic Forecast	Pessimistic Forecast
An Initiative Similar to Initiative 864	No Impact	No Impact	25% Reduction in Annual Property Tax Revenue starting in 2006 based on Tim Eyman's intent to bring a property tax reduction initiative to the voters in 2005
Gambling	Hideaway & Golden	Hideaway, Golden	Same as baseline.

ATTACHMENT A
2005-2010 Operating Budget Financial Forecast

Issue	Baseline Forecast	Optimistic Forecast	Pessimistic Forecast
Establishments	Nugget discontinue business. Hollywood Casino gambling tax revenue is annualized based on 8 months of operation. Results in a 25% increase in card room gambling tax revenue.	Nugget and Parker's continue to generate gambling tax based on historical collections. Hollywood Casino gambling tax revenue is annualized based on 8 months of operations. Results in a 32% increase in card room gambling tax revenue.	
Gambling Tax Allocated to Capital Fund	Maintains current Council policy of 36% of gambling tax revenue allocated to capital fund.	Maintains current Council policy of 36% of gambling tax revenue allocated to capital fund.	Maintains current Council policy of 36% of gambling tax revenue allocated to capital fund.
Annual Sales Tax Trends	2005 – 4%; 2006-2.5%; 2007 & beyond – 3%	4% annual growth in all years.	Same as baseline

ATTACHMENT A
2005-2010 Operating Budget Financial Forecast

Issue	Baseline Forecast	Optimistic Forecast	Pessimistic Forecast
PERS Contribution	Rates increase from the current 1.4% to 3.3% in 2005, 5.21% in 2006, 5.86 in 2007, 6.5% in 2008, 7.15% in 2009, and 7.8% in remaining years.	Rates increase from the current 1.4% to 2.5% in 2005, 3.99% in 2006, and 5% in remaining years.	Same as baseline
Health Benefits	Assume 9% increase in medical premiums for 2005; 15% in remaining years. Results in benefit cost increases of 5% in 2005 and 7.5% in remaining years.	Same as baseline for 2005. Assume 15-20% increase in medical premiums in all remaining years. Results in benefit cost increases of 6.5% in all years.	Same as baseline for 2005. Assume 25% increase in medical premiums for 2006-2007; 20% in remaining years. Results in average benefit cost increases of 8.5% in 2006-2007 and 7.5% in remaining years.
Jail	Required to pay Yakima for unused beds based on tentative agreement of 13.3 days at full rate and 4.7 at $27 per day.	Not required to pay Yakima for unused bed capacity at full rate or ability to fully shift prisoners to use full capacity at Yakima.	Same as baseline.
Police Contract	5% Annual Increase	Same as baseline	7% Annual Increase

Other assumptions remain constant between the three scenarios. Further discussion of these assumptions will be found in the assumption section of this document.

Baseline Forecast Overview

The baseline operating forecast is the scenario in which staff is focusing it budget planning efforts. It should be noted that the impact of any future property reduction initiative, similar to Initiative 864 (I-864), would have the most serious impact on the City's long-term financial health and this impact is contained in the pessimistic forecast.

Based on current trends and if there are no changes in revenue and expenditure forecasts, the City's baseline forecast projects annual operating budget gaps starting in 2006 and continuing for each of the next five years. The most significant gaps are projected to begin in 2007 ($1.5 million) and grow to $3.6 million by 2010. It should be noted that the later years of any forecast are less certain than the earlier years.

The current projected operating gap for 2005 is approximately $50,000. This is prior to any revenue enhancements that have been discussed as part of the City's long-term annual financial plan. Although the 2005 preliminary budget is not balanced, the City Manager will submit a balanced a budget to the City Council in October. The projected deficit for 2006 grows slightly to approximately $843,000, but nearly doubles for 2007 to approximately $1.5 million.

The 2004 projected ending fund balance for the General and General Reserve Funds combined total $5.4 million, nearly 22% of General Fund revenues. This fund balance reflects the allocation of $4 million from general reserves for the City Hall project, as was adopted in the 2005-2010 CIP. Although reserves can be used to help ease "short-term" economic changes, they cannot be used to balance the City's operating budget for the "long-term". In fact, the City's financial policies state that the budget needs to balance on-going expenditures with on-going resources. Reserves are not considered "on-going resources".

The following table and graph demonstrates the City's operating budget baseline financial forecast for 2005-2010.

Operating Fund Projections

Expenditure Assumption		**2005**	**100%**		**Others**	**99%**

Base Projections

	2005	2006	2007	2008	2009	2010
Annual Revenues	28,625,163	28,535,416	29,521,345	30,084,372	30,650,382	31,227,963
Annual Expenditures	28,675,846	29,378,197	30,980,930	32,173,629	33,424,151	34,863,838
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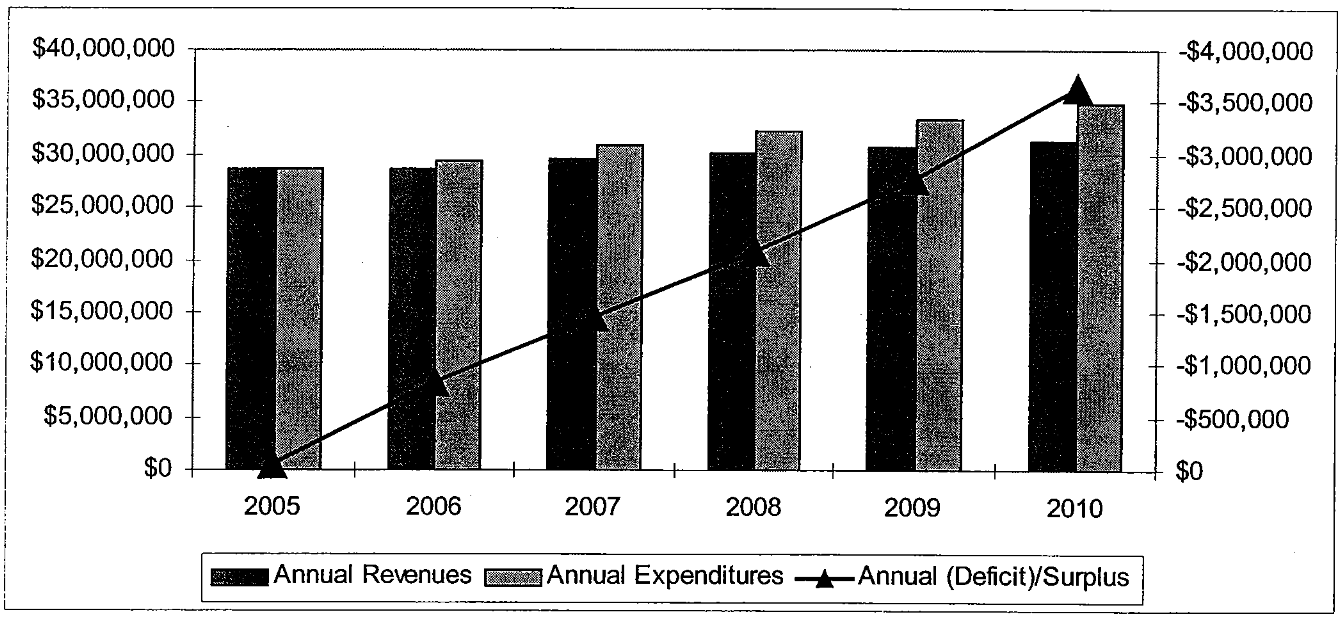


Other Scenarios

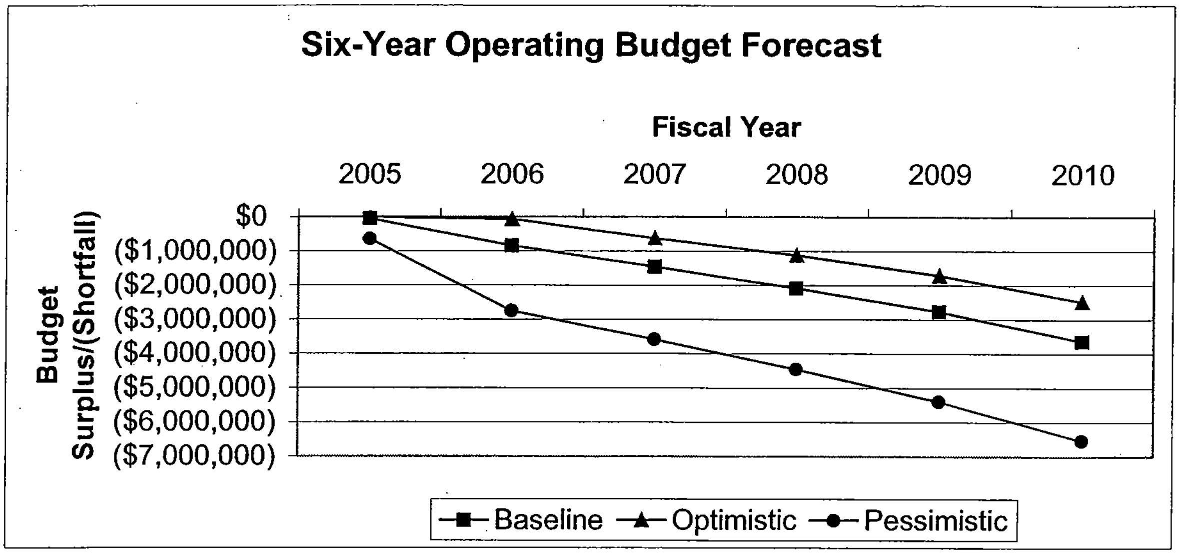
Besides the baseline forecast, pessimistic and optimistic forecasts have also been developed.

The following table and graph displays the three different long-term forecasts. As you can see in 2005, the difference between the optimistic and pessimistic forecasts is nearly equal to a $635,000 dollar swing. By 2010, the range between the optimistic and pessimistic forecasts grows to nearly $4.1 million. The majority of this difference is due the assumption of a property tax reduction measure, such as Initiative 864, included in the pessimistic forecast.

ATTACHMENT A
2005-2010 Operating Budget Financial Forecast

Annual Budget Surplus/(Shortfall) Forecast

Scenario	2005	2006	2007	2008	2009	2010
Baseline	(50,683)	(842,781)	(1,459,585)	(2,089,258)	(2,773,769)	(3,635,876)
Optimistic	(3,691)	(68,240)	(623,012)	(1,115,268)	(1,711,926)	(2,479,031)
Pessimistic	(640,559)	(2,755,734)	(3,588,863)	(4,455,033)	(5,392,910)	(6,532,635)



Other Supporting Data

The Budget Division has begun using the International City Managers Association's (ICMA) Financial Indicators as another tool to use in assessing the City's financial condition. The study and reporting of a City's financial condition is a recommended practice of ICMA. This study follows the guidelines set forth by ICMA and includes thirteen of their recommended indicators. The ultimate end of this analysis is that it will be used as a tool to help the organization identify existing and emerging financial trends, areas of concern and/or area's of strength. Information on the thirteen indicators was provided to the Council during the April 2004 retreat. This information will be updated on an annual basis.

Operating Budget Description

The City's operating budget is defined as the combination of the City's General Fund, Street Fund, Development Services Fund, and Surface Water Management Fund (SWM). Together, these four funds support the general operations that the City provides to its residents and business operators on a daily basis. These include public safety, enforcement of local codes, park and facility maintenance, recreation and cultural activities, street and right-of-way maintenance, planning and community development, development plan review and building construction inspection, community communications, and support services.

Since the operating budget includes multiple funds, there may be questions as to the reasoning for combining the General, Street, and Development Services Funds. The primary reason for combining these funds is that they are all dependent on general tax support. For example, the Street and Development Services Fund each are charged for General Fund overhead support (facility space, support services, utilities, etc.) and at the same time the General Fund allocates a portion of general revenues to these funds to maintain a positive operating position. To balance the Street Fund, approximately $1.4 million a year in general revenue sources is required. In the Development Services Fund, direct costs are generally supported by permit revenues, while the overhead charged to the Development Services Fund is offset by the contribution of general fund resources. Although from an accounting perspective we are required to maintain the three separate funds, in order to simplify the long-term financial analysis of City operations, we have consolidated the three funds and eliminated the interfund transfer of monies.

Although the Surface Water Fund is supported entirely by SWM fees, it is considered an operating service to our community. For long-term forecast purposes it is assumed that SWM revenues and expenditures offset each other as any surplus on the operating side will be used for capital purposes. Currently the City is in the process of developing its first Surface Water Master Plan. This plan will include a full analysis of operating, capital, and system replacement needs along with impacts these may have on future rates. The City Council will be reviewing this plan later in 2004 and will have an opportunity to make policy decisions that will influence the future financial needs of this operation.

Outstanding Items

Capital Planning: This forecast focuses on the City's operating budget. Although this is the focus there is some interrelationship. Completion of capital projects many times lead to additional operating costs. For those projects within the current Capital Improvement Program we have included operational impacts into our forecasts. The City is currently in the process of developing several master plans (Surface Water, Transportation, Capital Facilities, Parks) that will include capital needs for the next 20 years. The current drafts of those plans show capital needs in excess of $370 million for this time period. Current funding sources for capital fall well below this amount at $125 million for the same period. As the City Council reviews those plans part of the challenge will be to determine which projects should be priorities and if alternative funding sources, such as capital bonds should be sought to fund the projects. These capital projects and their operational impacts are not included in the current 2005-2010 operating budget forecast.

Long-Term Repair & Replacement of Facilities: The City currently sets aside monies on an on-going basis for the replacement of its equipment, but it has not identified an on-going funding source for the long-term replacement of its facilities. The CIP currently includes projects as they become critical to complete. Projects of this nature include roof replacement, HVAC replacement, etc. The Public Works department is currently doing an analysis of the funding requirements to maintain the existing facilities at acceptable levels. Preliminary information indicates that on average the City should be setting aside between $50,000 and $70,000 annually to meet the needs of the City's three largest facilities: Police Building, Swimming Pool, and Highlands Recreation Center. It may be necessary to have a larger amount of money in the early years to improve the current condition of the facility and then lower the amount in later years as long-term maintenance is performed. These costs are not currently included in the City's operating forecast, but should be considered as part the 2005 operating and capital budget development process.

Price of Government: The City of Shoreline is only one taxing entity in which residents support through a variety of taxes. Current estimations are that the median household in Shoreline spends 8.8% of their income for State and local taxes. Since we only receive much of the information specific to Shoreline that is used to determine the price of government during each census cycle, it is difficult to develop trend analysis information. Although this is the case, it is a factor we need to be aware of as we review the City's long-term financial health.

Forecast Assumptions

The City's budget policies require that on-going expenditures be balanced with on-going revenues. For this reason the six-year financial projections show either a budget surplus or a gap by comparing the annual projected revenues against the annual projected expenditures. There is no consideration given for available reserves, as reserves are not considered on-going resources.

Revenue Assumptions

Baseline: Overall revenues are projected to grow by an average of 1.9% annually over the next six years.
Optimistic: Overall revenues are projected to grow by an average of 2.3% annually over the next six years.
Pessimistic: Overall revenues are projected to grow by an average of 0.9% annually over the next six years. The following is more specific information on the most significant operating revenue sources.

Property Tax

Baseline: This assumption does not include any impact of the possible passage of a future property tax reduction initiative such as Initiative 864 (I-864) which would reduce local property tax levies by 25%. Property tax growth is limited to an annual 1% levy increase (I-747 limitation) and an annual average of $35 million in new construction. This results in average annual real property tax revenue growth of 1.6%.
Optimistic: No change from baseline forecast.
Pessimistic: Assumes an initiative such as Initiative 864 passes in 2005 and therefore, the property tax levy has been lowered by 25% beginning in 2006.

Sales Tax

Baseline: Sales tax for the Puget Sound Region is forecast to grow by 5.5% in 2005, 4% in 2006 through 2008, then 3% in 2009 and 2010. There is nothing to indicate, at this time, that Shoreline's sales tax growth will be this strong; therefore our long-term forecasts for sales tax are somewhat lower than the rest of the region. We expect growth in 2005 to be approximately 4% compared to the 2004 budget, decreasing to 2.5% in 2006 and 3% for 2007 through 2010.
Optimistic: Sales tax growth in 2005 and 2006 is expected to be 3.5% and 4% for 2007 through 2010.
Pessimistic: No change from baseline forecast.

Gambling Tax

Baseline: This forecast assumes that Hideaway and Golden Nugget discontinue business and that Parker's continues to operate. It also assumes that the annual tax that will be generated from Hollywood Casino's is based on its first 8 months of operation. This results in an 25% growth in card room gambling tax revenue in 2005 and then flat growth in future years.

Optimistic: This forecast assumes that no casinos cease operations and that Hollywood Casino's annual tax collections revenue continues to equal their first 8 months of operation. This results in a 32% growth in card room gambling tax revenue in 2005 and then flat growth in future years.
Pessimistic: This assumes that Hideaway, Golden Nugget and Parker's discontinue business. Hollywood Casino's annual revenue continues to be based on their first 8 months of operation. This results in flat gambling tax revenue growth for 2005-2010.

All forecast scenarios assume the continuation of the Council's policy to allocate gambling tax revenues generated over a 7% tax rate towards capital. The City's current tax rate is 11%. This results in approximately 36% of the City's gambling tax being allocated for capital purposes.

Utility Tax and Franchise Fees
Baseline: Utility tax and franchise revenue increases have been linked to projected inflationary increases. Usually utilities structure their rates to recapture inflation related increases. These increases average approximately 2% annually over the next six years. The long-term financial forecast also takes into account the new provisions of the franchise agreement with Ronald Wastewater District.
Optimistic: No change from baseline forecast.
Pessimistic: No change from baseline forecast.

Permit Revenue
Baseline: The long-term financial forecast does not account for any activity level increases (increased number of permits), but does project increases in revenue related to valuation increases. The valuation increases average 2.7% annually over the next six years.
Optimistic: No change from baseline forecast.
Pessimistic: No change from baseline forecast.

Expenditure Assumptions:
Baseline: Overall expenditures are projected to increase an average of 3.2% annually over the next six years. The six-year forecast assumes that we will maintain our current services and service levels.
Optimistic: Overall expenditures are projected to increase an average of 3.0% annually over the next six years.
Pessimistic: Overall expenditures are projected to increase an average of 3.7% annually over the next six years. The following is more specific information about the major expenditure categories.

Expenditure Rate:
Baseline: As has been the City's experience, it is highly unlikely that 100% of the City's operating budget will be expended in a given year. In 2003 the General Fund expenditure rate was 95.5% of projected expenditures. The long-term forecast assumes a 100% expenditure rate for 2005 and 99% for the remaining years.
Optimistic: No change from baseline forecast.
Pessimistic: No change from baseline forecast.

Inflation
Baseline: Inflation is projected to average 2.5% annually over the next six years. Inflation is used to project expenditure increases related to salaries, professional service contracts, and intergovernmental contract increases.
Optimistic: No change from baseline forecast.
Pessimistic: No change from baseline forecast.

Salaries
Baseline: Market rate adjustments are forecasted at 90% of inflation. It is assumed that 25% of staff positions will be eligible for merit increases (4% annually) over the next six years, as currently one-third of our regular employees are at the top of their salary range. This also assumes that there will be some turn-over in current staffing and replacement staff may start lower in the salary range than long-term employees.
Optimistic: No change from baseline forecast.
Pessimistic: No change from baseline forecast.

Benefits
Baseline: The major changes in benefits are expected to occur in health and retirement benefits. This forecast accounts for a 9% increase in medical premiums in 2005 and assumes that medical premiums will increase by 20% in the early years of the forecast. Under the City's new benefit policy, this will result in an overall increase in health benefit costs of 5% in 2005 and 7.5% annual increases for the remaining years. The City participates in the State of Washington retirement system. Over the last couple of years we have seen both the employer and employee contribution rates drop significantly as a result of significant investment earnings during the late 90's. As we are all aware, the market has changed and retirement systems are no longer able to make the same level of investment earnings. As a result, we fully expect employer contribution rates to gradually increase over the six-year period to the historical averages of 5%. The current employer contribution rate is 1.4%. This forecast assumes that the PERS rate for 2005 will be 3.3%, rising to 5.21% in 2006, 5.86% in 2007, 6.5% in 2008 and 7.15% for 2009 and 7.8% in 2010.
Optimistic: This forecast assumes that medical premiums will increase by 20%, resulting in an overall increase in health benefit costs of 6.5% annually. This forecast assumes that the State Legislature will delay the increase in the PERS rates until the economy is more stable and the State budget is better able to absorb the increases. Therefore for 2005, we anticipate that the PERS rate will only rise slightly to 2.5%, then increase to 3.99% in 2006, 4.99% in 2007, and 5% for 2008 through 2010.
Pessimistic: This forecast assumes that medical premiums will increase by 25% for the next few years, resulting in an overall increase in health benefit costs of 8.5% annually, and then medical premium growth will drop to 20% in the later years of the forecast. This forecast assumes PERS rate increases at the same level as the baseline projection.

Public Safety
Baseline: The police contract is projected to increase by an average of 5% annually over the next six years. Jail costs have been projected based on a four-year average of the usage of bed days.

This forecast also assumes that once negotiations with Yakima County have been completed, we will pay for a portion of unused bed days as outlined in the contract.
Optimistic: The police contract is projected to increase by an average of 5% annually over the next six years. Jail costs have been projected based on a four-year average of the usage of bed days. This forecast assumes we will not be required to pay for any unused bed days at the Yakima Jail or that we will be able to fully transfer the current unused bed usage from King County to the Yakima jail.
Pessimistic: The police contract is projected to increase by an average of 7% annually over the next six years. Jail costs have been projected based on a four-year average of the usage of bed days. This forecast also assumes that once negotiations with Yakima County have been completed, we will pay for a portion of unused bed days as outlined in the contract.

Capital
City Hall: All forecast scenarios assume that the City will construct a new City Hall and that debt service payments will begin in 2007. Currently we are estimating annual occupancy costs (debt service/maintenance & operations) to total between $1 and $1.1 million dollars. As approved by the City Council, with the adoption of the 2004-2009 CIP, $400,000 of Real Estate Excise Tax will be dedicated towards the debt service costs for City Hall in 2007.

Construction costs for City Hall are still being developed. It is anticipated that the project could cost in the neighborhood of $20 million. Based on the adoption of the 2005-2010 CIP, the City has $10 million in cash allocated towards this project. The remaining cost of the project would be generated by the issuance of non-voted general obligation bonds. It is anticipated that this combination of financing, and current interest rate environment, should help the City meet its occupancy cost goals. It should be noted that the 2004 budget includes approximately $600,000 in expenditures related to occupancy of City Hall and the annex.

The long-term forecast continues the current policy of the City Council to allocate an amount equal to the gambling tax that is collected in excess of a 7% tax rate. Given the different gambling tax assumptions for each forecast scenario, this amount ranges from $970,000 to $1.25 million annually.

General Reserve Fund
Baseline: The General Reserve Fund was established to accumulate monies to be used for emergencies or to moderate economic changes. The amount of reserves that can be accumulated in this fund are limited by state law to $0.375 per $1,000 of assessed valuation. Since the City's assessed valuation has continued to increase, and this trend is projected to continue, the amount of the reserve has continued to increase. The reserve increases by transferring general fund revenues to the reserve fund. The long-term forecast continues this policy and an annual average of $134,000 of operating resources are transferred from the operating budget to the General Reserve Fund.
Optimistic: No change from baseline forecast.
Pessimistic: No change from baseline forecast.

General Fund Reserve Levels:
The City's financial policies state that we must maintain a minimum General Fund reserve level of 10% of our general fund revenues. The General Fund reserve is defined as the combination of the General Fund ending fund balance and the General Reserve Fund ending fund balance. The City's General Fund reserve level was approximately $9.7 million as of January 1, 2004, or 38% of 2004 General Fund revenues.

As was stated earlier, the long-term forecast does not assume the use of reserves to close operating budget gaps. If reserves were used to close the projected gaps, the City would have nearly enough to balance the operating budget for the next six years. Since reserves are not considered recurring revenues, the City would be in a very precarious financial situation beginning in 2011 with a budget gap projected at nearly $4 million and no reserves. The real purpose of the reserves is to help address declines in economically sensitive revenues, shifts in revenue sources that are out of the City's control, or to cover cash flow needs which alleviates the need for short-term borrowing. Reserves are available to provide the City with more operating flexibility.

The level of reserves is not mandated by law, but rather is a decision that each jurisdiction makes based on the elasticity of their revenue sources, their cash flows, and their local economy. Moody's Investors Service, who provide bond ratings to many cities and counties throughout the State of Washington, have reported that their clients have reserve levels that range from the teens to close to 50%. Bond issuers outside of the State of Washington often have reserves at significantly higher levels. Although the City's policy is to have a minimum General Fund reserve level of 10%, it is recommended that we always maintain at least a 20% reserve level. This would equate to approximately 2.5 months of our operating expenditures or $5.5 million dollars.

The use of an additional $4 million in reserves for City Hall will bring the City's combination of General and General Reserve fund balances to approximately $5.5 million or approximately 22% of its operating revenues. The use of reserves for this purpose will bring the reserves to the minimum recommended level and would eliminate the ability to use reserves to close long-term budget gaps.

Conclusion
Based on the assumptions described above, the City's operating budget is projected to have annual budget gaps during the next five years. The deficit for 2006 is approximately $842,000, and beginning in 2007 the annual deficit increases significantly to $1.4 million and grows to $3.6 million in 2010.

Although the City's long-term projections reflect annual operating gaps, this does not mean that the City will actually operate in a deficit position. Rather the long-term projections help staff and the City Council anticipate the need to develop long-term solutions to bring the annual operating budget into balance. Although reserves can be used to help ease short-term budget deficits, our projections show that the operating budget has long-term issues that need to be addressed in order to balance the budget on an on-going basis.

The reason for the deficits is basically a result of the long-term expenditure growth outpacing long-term revenue growth. The following graph summarizes the expected operating revenue and expenditure growth rates for 2005-2010 under the baseline scenario.

	2005	2006	2007	2008	2009	2010	Average
Annual Revenue Growth	2.47%	-0.31%	3.46%	1.91%	1.88%	1.88%	1.88%
Annual Expenditure Growth	-0.73%	2.45%	5.46%	3.85%	3.89%	4.31%	3.20%
Projected CPI	1.90%	2.00%	2.30%	3.00%	3.00%	3.00%	2.53%

Although operating expenditures are projected to increase modestly over the next six years, the growth is slightly greater than projected inflation and greater than projected revenue growth. Revenue growth is not projected to keep pace with inflation and in fact will average less than 2% annually over the next six years.

ATTACHMENT B

Council Meeting Date: June 21, 2004 **Agenda Item:**

CITY COUNCIL AGENDA ITEM

CITY OF SHORELINE, WASHINGTON

AGENDA TITLE:	2005 Budget Strategy & I-864 Options
DEPARTMENT:	City Manager's Office
PRESENTED BY:	Steve Burkett, City Manager

PROBLEM/ISSUE STATEMENT:
The City's preliminary 2005 budget forecast projects an operating budget gap of $600,000. The City's long-term financial projections indicate that the operating budget gap will grow in future years with a gap of $800,000 projected in 2006 and $1.4 million in 2007. This operating gap is primarily due to the continued slow growth in sales tax revenues and the impact of previous initiatives limiting property tax revenue growth to 1% or less. In addition to the projected budget gaps, Tim Eyman has developed a new initiative (I-864) that would reduce local government property tax levies by 25% starting in 2005. This equates to an additional $1.7 million loss of revenue for the City of Shoreline. The combination of the operating budget gap and the possible passage of I-864 would amount to a 8.5% ($2.3 million) Operating Budget shortfall in 2005.

DISCUSSION:
During the April City Council retreat I made the following recommendations:

- Pursue a levy lid lift on the November 2004 general election ballot if I-864 is certified to appear on the same ballot.
- Continue to monitor expenditures and reduce dependence on the operating budget for those services that are a lower priority to our community.
- Place a bond issue for capital projects on the election ballot in 2005; and,
- Begin negotiations with Seattle City Light (SCL) to extend the franchise fee to the distribution portion of the SCL rates.

Since that time I have had additional time to evaluate our financial position and refine my recommendations for our 2005 budget strategy and the City's options related to I-864. I am now recommending that the following actions be taken to balance the 2005 budget:

- The City Council authorize a 6% utility tax on our Surface Water utility;
- Evaluate recreation fees and increase them up to 10% while at the same time providing some enhancements to the scholarship program;
- Reduce 2005 base budget targets for departments by 1%; and,
- Pursue a revenue-generating regulatory business license program.

I am also recommending that if I-864 is certified for the November General Election ballot and passes, that we authorize a levy lid lift election during the spring of 2005.

FINANCIAL IMPACT:
The previous recommendations would be used to close the projected 2005 operating budget gap of $600,000. A levy lid lift could restore any lost revenue from the passage of I-864 ($1.7 million). Additionally, we have capacity within the legal property tax levy rate of generating an additional $2 million in property tax revenues through a voted levy lid lift.

RECOMMENDATION
No Council action is required for this item, but staff would like feedback from the Council on the City Manager recommendations.

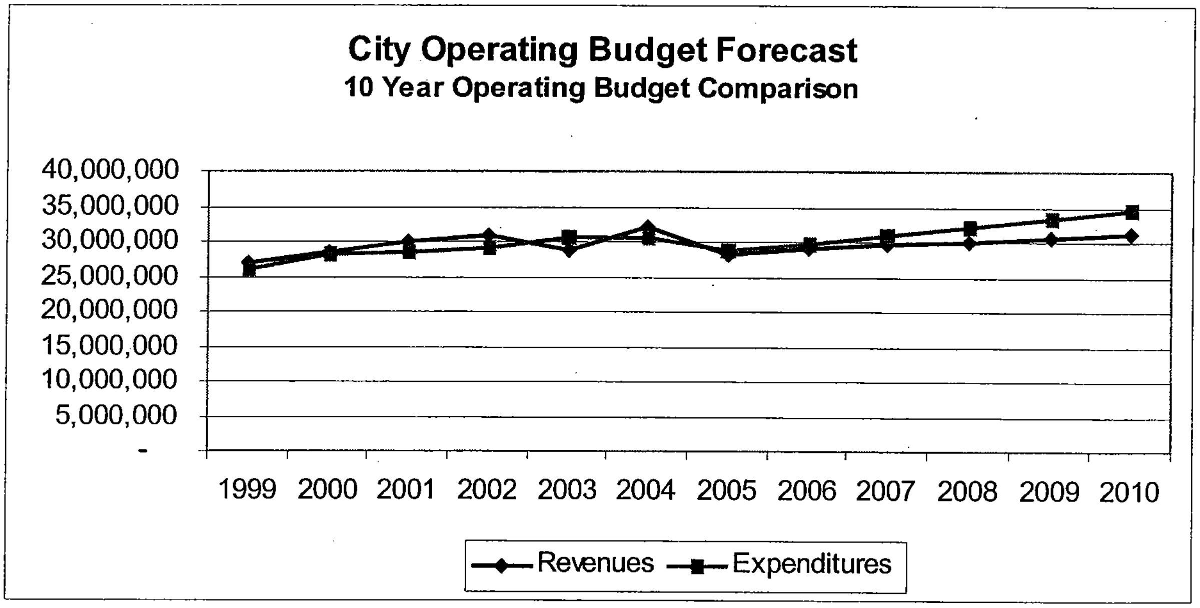
Approved By: City Manager ____ City Attorney ___

INTRODUCTION

City staff will be preparing the 2005 budget during the next several months and I will be presenting the 2005 proposed budget to the City Council on October 18, 2004. Prior to fully developing the budget I would appreciate Council's feedback on the following preliminary budget recommendations. This report also presents some options that the City can take if I-864 passes.

BACKGROUND

During the April City Council retreat, the Finance Director provided the latest long-range financial update. Based on current assumptions, those projections anticipate a $600,000 budget gap for the 2005 operating budget and nearly a $800,000 gap in 2006. The budget gaps are projected to continue to grow through 2010. The following graph depicts the City's baseline operating budget projections for 2005-2010.



These budget gaps are projected to occur because the City's revenue base is growing at a slower rate than expenditures. Through increased efficiencies and continuing budget growth constraint efforts we have been able to maintain expenditure growth at or below the rate of inflation. However, two of our primary revenue sources, property and sales taxes, have grown at an even slower rate. As you are aware we are required to adopt a balanced budget, and therefore will be submitting a "balanced" 2005 proposed budget in October. The "Discussion" section of this staff report contains our current proposal for how to develop this balanced budget.

In addition to anticipating operating budget gaps, we must be prepared to address the latest Tim Eyman initiative. We will know in early July if the required number of signatures (over 192,000) are gathered for the initiative to appear on the November ballot. As we have discussed previously, I-864 would reduce local government property tax levies by 25% starting in 2005. This would reduce our operating revenues by $1.7 million starting in 2005.

In order to address both the projected operating budget gaps and to prepare for the possible impacts of I-864 it is important that the City Council continue to discuss options. I am recommending that we concurrently pursue two courses of action. The first is to develop a plan to address the projected operating gap, while the second is to develop a contingency plan to address the impacts of I-864 in addition to the projected operating shortfall.

DISCUSSION

Addressing Operating Budget Gaps

As we discussed at the April retreat, the City will be challenged to continue providing our current level of services to the community in the future. As was explained at the retreat there are only four general options for the City to consider:

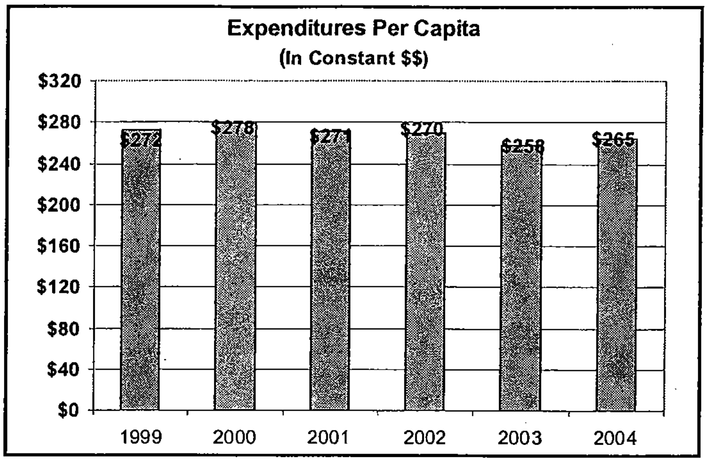
- Reduce expenditures
- Reduction in operating funds allocated for capital purposes
- Increase revenues
- Combination of expenditure reductions and revenue enhancements

Since we know that the operating budget forecast is a long-term structural issue I am proposing a phased combination of expenditure reductions and revenue enhancements as indicated in the following table.

	Revenue Effective Year		
Action	**2005**	**2006**	**2007**
Reduce department base budgets by 1% and review low priority services for elimination			
Implement a utility tax on our surface water utility			
Increase recreation fees by approximately 10% and enhance the City's scholarship program			
Implement a revenue generating regulatory business license program			
Seattle City Light franchise fee (6%) on the distribution portion of the electric utility fees			
Property tax levy lid lift			

Reduce Department Base Budgets by 1% and review low priority services for reduction or elimination ($290,000, Effective 2005): Each year the Finance Department establishes a base budget for departments in which their budget proposals must fit. The base budget usually includes any known contract increases, new services required as a result of the completion of capital projects, and impacts of anticipated personnel cost changes related to salary and benefit cost changes. Other than these changes departments have not been given any inflationary increases in their base budgets since 2001. This has put staff in the position of looking for ways to become more efficient in providing their services and finding alternative revenue sources to provide any enhanced services. It has also resulted in the City's operating expenditures per capita, when adjusted for inflation, being less in 2004 than they were in 1999. For 2005 the Finance Department will once again establish base budget levels for departments, but will reduce the base budget target by 1% for departments. Departments will need to identify any service impacts this will create.

In addition to the base budget reductions we will utilize the budget prioritization results from the City Council, results from the Citizen Survey, and feedback from our public process to identify lower priority services and/or programs that can be eliminated.



Utility tax on surface water utility ($150,000, Effective 2005): I am recommending that we include our surface water utility (SWM) as a utility subject to the City's utility tax. Currently we receive either a utility tax or franchise/contract fee of 6% on the following utilities: cable, water, sewer, garbage, telephone, and electricity (power portion). Collection of a utility tax on our surface water fees will impact both residential and commercial customers. Single family residential customers currently pay $102 annually for their SWM fees. A 6% utility tax on a single-family customer will increase their annual bill by slightly more than $6 annually. Commercial customers pay their SWM fee based on the percentage of their property that is impervious surface, and therefore their fees are determined on a per acre rate. The City's SWM program already provides exemptions for fees for low-income seniors.

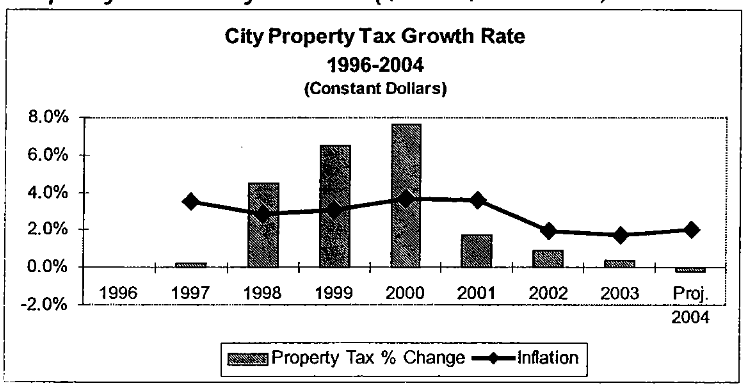
Increase recreation fees and enhance the City's scholarship program ($55,000, Effective 2005): The City's operating budget has continued to provide recreational programs that are supported by a combination of fees and general tax subsidy. Many programs will still be funded in this way, but I am requesting that our Parks & Recreation Department begin to look at our fees and identify programs in which we can reduce or eliminate the tax subsidy to provide the program. In order to remain competitive we will continue to monitor how our fees compare to neighboring jurisdictions. We will also continue to provide a scholarship program to assure that everyone who wants to participate will be able to, regardless of financial means.

Revenue Generating Regulatory Business License Program (Net Revenue of $50,000, Effective 2005/2006): The City does not currently have a business license program. We have discussed both the advantages and disadvantages of this program and I believe a program can benefit our ability to track commercial activity within the City and would provide beneficial information for our public safety providers. This is also a way to distribute impacts to both the commercial community and our residential community. Currently property tax is the City's largest source of operating revenue and approximately 86% of that revenue is generated from residential properties.

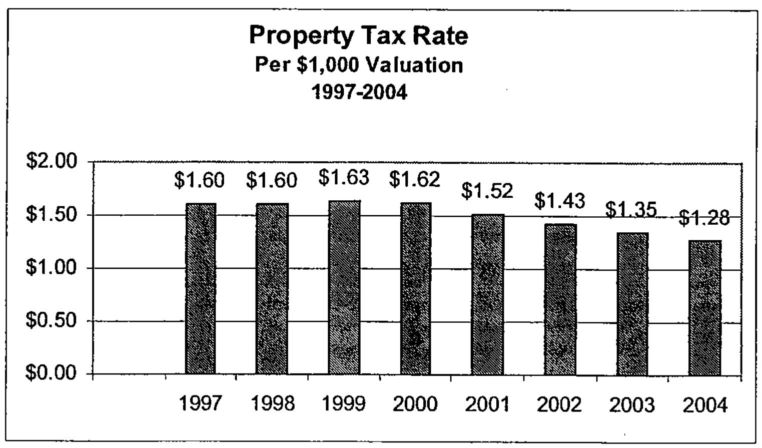
Franchise/Contract payment on the distribution portion of the SCL electricity rates ($0 to $600,000, Effective 2005/2006): Currently the City collects a franchise fee (6%) on the power portion of electricity rates billed and collected by SCL within Shoreline. The franchise contract allows the City to place a franchise fee on the distribution portion (approximately 50% of the overall charge) with a 12 month notice provision to SCL. Placing a franchise fee on the distribution portion of the electric rates will have an impact to City rates, as SCL is allowed to recoup this cost from Shoreline's rate payers. SCL is currently in a rate review process and will be submitting a recommendation to the Seattle City Council in late 2004. Since 2001 SCL's rates have included power surcharges to cover the excessive power costs that were a result of the power crisis of 2001. These surcharges are scheduled to be removed during the later part of 2004. The removal of the surcharges should result in fee decreases, but the current rate review process may result in a recommendation that includes other costs being incorporated into future rates that may or may not result into a net rate reduction. Since our franchise agreement requires a 12 month notification period, if the Council agrees with this option, we should proceed with the notification to SCL.

This again is an option that distributes impact to both the residential and commercial community.

Property Tax Levy Lid Lift ($0 to $2 Million, Effective 2007): Since the passage of I-747, November 2001, property tax levy increases have been limited to 1% annually plus any new construction. The net impact has been that property tax levy increases have not kept pace with inflation and the City's property tax levy rate has continued to decline.



If I-864 does not appear on the November 2004 ballot or does not pass, then I am recommending that the City authorize a levy lid lift vote in 2006 that would be effective for 2007 property tax revenues. The City's 2004 property tax rate is $1.28 and this rate is projected to fall to $1.18 by 2006. By 2007 the City will have maintained its property tax levy increases to 1% for five years, and it seems reasonable to ask Shoreline voters if they are willing to pay additional property taxes to maintain and/or increase City services. Each 10 cent increase in levy rate is projected to generate approximately $500,000 of revenue.



Outstanding Items: The City's financial forecast is based on assumptions that we have adequate information to analyze at any given time. Two specific items that may have additional impact on the projections are the City's gambling tax collections and the City's lease cost for facilities. At this time we have only received two quarters of gambling tax revenue from Hollywood Casino. Our baseline financial forecast is conservative in that it provides for increases in gambling tax from the Hollywood Casino to be partially offset by decreases in others. If we continue to see the current level of gambling tax collections from Hollywood Casino with no decrease in gambling tax collections from other casinos, we may be able to increase our revenue projections.

The long-term projections also provide for some level of inflationary increases in our facility lease costs, but both of our major lease agreements (City Hall and the Annex) are open for negotiations this year. Depending on the outcome of those negotiations we may see lease costs increase beyond the level provided for in our long-term projections.

Summary of Operating Budget Recommendations: By 2008 the City's operating budget gap is projected to be approximately $2 million. The options presented in this report will allow the City to close these gaps and continue to provide critical services to our community. By determining a draft plan of action now, it will allow time to interact with the community to further understand their priorities and how those priorities will be funded.

Addressing I-864

Initiative 864 would add to the City's financial challenges if it were to pass in November 2004. This initiative would reduce the City's property tax levy by approximately $1.7 million starting in 2005. The previous plan did not take into consideration impacts from I-864.

As we have discussed, a $1.7 million decrease on the City's operating revenues would result in decreased services to our community. This loss of revenue could be equivalent to any of the following groupings:

- The net cost of our Recreation and Park Maintenance operations; or,
- The City's cost to provide support to human service agencies, the City's 24 hour customer response team, police storefront operations, the School Resource Officer program, teen programs, museum and arts council funding, and a 10% reduction in our park maintenance funding; or,
- 42% of our support service (City Manager, City Clerk, Finance, City Attorney, Human Resources, Communications & Intergovernmental Relations) costs; or,
- The contract cost for 14 police officers; or,
- A 17% reduction in our non-police personnel (approximately 23 of our 139 regular positions)

If I-864 does pass in November I would recommend that we follow the plan that was outlined in the previous section of this report, with the exception of moving the levy lid lift vote to the Spring of 2005. The Department of Revenue has interpreted I-864 to exempt voter approved levies, therefore a voter approved levy lid lift would exempt the City from I-864.

Many cities are debating whether to pursue a levy lid lift in 2004 or 2005 in anticipation of the passage of I-864. As mentioned previously we will not know until July whether sufficient signatures will be gathered for I-864 to appear on the November ballot, although most initiative experts are predicting that sufficient signatures will be gathered.

The two remaining election dates in 2004 are September 14 (primary election) and November 2 (general election). In order for Shoreline to place a levy lid lift on the September ballot, the City Council would need to adopt an ordinance of intent by July 30th. There is not adequate time for the City Council to fully discuss this issue and make this decision by that deadline. In order for the issue to appear on the November ballot the City Council must adopt an ordinance no later than September 17, 2004. In either case a campaign committee would need to be identified, as the City is prohibited from campaigning for such a levy.

Passage of a levy lid lift on the November ballot is the only way to exempt the City from the affects of I-864 for 2005. At the same time there are certain risks in pursuing a levy lid lift in November, including the limited amount of time for the City Council to make the decision, the limited amount of time for a campaign committee to form and campaign, the limited amount of time for the City to provide educational information to the public, the number of items that will appear on the November ballot, and probably most significantly is that the outcome of I-864 would not be known until after the November election.

For these reasons I am recommending that we wait until the spring of 2005 to place a levy lid lift on a ballot measure. The major risk in waiting until this time is that if I-864 does pass in November, the City's property tax levy will be reduced by $1.7 million in 2005. Fortunately the City is in good financial position and has reserves that could be used to cover this gap. As the Council is aware it is recommended that the City use approximately $10 million in cash as a down payment for a new City Hall. Given this, our General and General Reserve fund balances will be approximately $5.5 million or approximately 21% of our operating revenue at the end of 2004. If the City were in a position to use an additional $1.7 million in reserves to cover the loss of property tax in 2005, our general reserves would still be approximately 15% of our operating revenues. The City's financial policies require that our general reserves be equal to at least 10% of our operating revenues.

Although the use of reserves may not be ideal, this is a case in which it makes sense to use reserves on a one-time basis. The real purpose of the reserves is to help address declines in economically sensitive revenues, shifts in revenue sources that are out of the City's control, or to cover cash flow needs which alleviates the need for short-term borrowing.

The use of the reserves in 2005 would only be on a one-time basis. If our community does not approve a levy lid lift, then we must be prepared to make expenditure reductions to live within our revenue stream. This would mean that we would have a reduction in current service levels. In order to prepare for this possibility staff will be working, as part of the 2005 budget process, to identify what services would be eliminated and/or reduced if we were to lose $1.7 million in operating revenue. This should be a realistic list of reductions that we can share with the community as the impacts of I-864 are discussed and should reflect the priorities of the City Council. I know that this process will produce some additional apprehension within our organization, but I believe it is a necessary part of our business planning.

ATTACHMENT B

If we postpone a levy lid lift vote until a spring election, the levy rate for the first year of the levy lid lift is established, but in the following years the levy will be subject to the 1% levy increase limit. In 2003 the legislature approved a measure in which a voter approved levy lid lift can be increased annually by some amount (i.e., CPI, any percentage amount, etc.) as stated in the ballot title for up to six years. Although this is the case, the legislation requires that this type of levy lid lift be approved on a September primary or November general election.

The following table summarizes the advantages and disadvantages of holding a levy lid lift election in 2004 or the spring of 2005.

Election Dates	**September 2004**	**November 2004**	**Spring 2005**
Advantages	• Passage would exempt City from I-864 in 2005 • Levy lid lift ballot measure could include a way to annually increase the property tax levy beyond 1% for up to six years	• Passage would exempt City from I-864 • Levy lid lift ballot measure could include a way to annually increase the property tax levy beyond 1% for up to six years	• Known outcome of I-864 • More time for Council decision making process • More time for campaign process
Disadvantages	• Limited time for Council decision making (July 30th) • Limited time for campaign development • May be most expensive option depending on the type of primary election held • Do not know outcome of I-864	• Limited time for Council decision making (Sept. 14th) • Limited time for campaign development • Do not know outcome of I-864 • There will be numerous items on the ballot	• If I-864 passes we would lose $1.7 million in revenue for 2005 • Future annual levy increases would be subject to the 1% limit

The recommendations discussed above do not include any recommended change in the City's current policy of allocating a portion of the City's operating revenue for capital purposes. We currently allocate approximately 5% of our General Fund revenues for capital purposes. Given the City's capital needs and our community's desire for capital improvements, such as sidewalks and parks, this is a reasonable amount of our operating revenue to allocate for such purposes. Although this is the case, it is not nearly enough to meet all of our capital needs. As the Council reviews the City's Master Plans for parks, transportation, surface water, and capital facilities a number of projects will be identified for which we do not have a funding sources to complete. As we have discussed, it will be appropriate to consider a voted bond issue as a way to finance these projects. This is also an appropriate way to have those that are benefiting from the improvements help pay for them.

SUMMARY

The City of Shoreline has done an excellent job in conservative financial planning and limiting cost increases as services have increased. The City is currently in good financial position with operating reserves nearing 30% of our annual operating revenues. Although this is the case, our long-term financial projections indicate that we will not be able to maintain current service levels as a result of the City's revenue base growing at a slower rate than expenditures. Additionally, the latest Eyman Initiative (I-864) would further erode our ability to maintain services. This report provides a recommended plan to address the long-term budget gaps and the loss of revenue the City would experience if I-864 passes in November.

RECOMMENDATION

No Council action is required for this item, but staff would like feedback from the Council on the City Manager recommendations.